[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS: S. 353 (EDUCATIONAL SAVINGS BONDS); S. 442 (VALUE ADDED TAX); S. 659, S. 838, S. 849 (ESTATE FREEZES); AND S. 800 (MORATORIUM ON CERTAIN STATE TAX LAWS)

Scheduled for a Hearing

before the

SENATE COMMITTEE ON FINANCE

ON MAY 17, 1989

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

MAY 11, 1989

U.S. GOVERNMENT PRINTING OFFICE

97-673 WASHINGTON : 1989 JCS-11-89

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, DC 20402

CONTENTS

	Page
NTRODUCTION	1
I. SUMMARY OF THE BILLS	2
II. DESCRIPTION OF S. 353: EDUCATIONAL SAVINGS BONDS	4
II. DESCRIPTION OF S. 442: VALUE ADDED TAX	6
A. Description of Tax Provisions	6
B. Allocation of Revenues from Value Added Tax	9
C. Analysis of Specific Issues	9
1. Definitions of taxable transactions and taxable persons	9
2. Invoice requirement/credit mechanism	12
3. Zero-rated items and exemption from the VAT	14
4. Treatment of real property	22
5. Determination of the location of goods and services	23
6. Treatment of insurance and other financial services	25
7. Administrative provisions	28
V. DESCRIPTION OF S. 659, S. 838, AND S. 849: ESTATE TAX INCLUSION RELATED TO VALUATION FREEZES	32
V. DESCRIPTION OF S. 800: MORATORIUM ON CERTAIN STATE TAX LAWS	34

INTRODUCTION

The Senate Committee on Finance has scheduled a public hear-
ng on May 17, 1989, on tax bills relating to (1) educational savings
onds (S. 353, Senators Exon, Shelby, DeConcini, Harkin, and Lie-
erman); (2) value added tax (S. 442, Senator Hollings); (3) estate
reezes (S. 659, Senator Symms, S. 838, Senator Heflin, and S. 849,
enators Daschle, Heflin, Boren, and Symms); and (4) moratorium
n certain State tax laws (S. 800, Senators Bradley, Lautenberg,
odd, and Lieberman).

Part I of the pamphlet [1] is a summary of the bills. Parts II–V pro-
ides a description of the bills, including present law and effective
ates. Part II describes S. 353; Part III describes S. 442; Part IV de-
cribes S. 659, S. 838, and S. 849; and Part V describes S. 800.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Tax Bills: S. 353 (Educational Savings Bonds); S. 442 (Value Added Tax); S. 659, S. 838, S. 849 (Estate Freezes); and S. 800 (Moratorium on Certain State Tax Laws* (JCS-11-89), May 11, 1989.

I. SUMMARY OF THE BILLS

S. 353: Educational Savings Bonds (Senator Exon and Others)

Interest income earned on a qualified U.S. Series EE savings bond issued after December 31, 1989, is excludible from gross income, if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year. The exclusion is available only to taxpayers age 24 years or more at the time of bond purchase. "Qualified higher education expenses" are limited to tuition and required fees paid for the attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at an eligible institution.

S. 353 (introduced by Senators Exon, Shelby, DeConcini, Harkin, and Lieberman) would allow the exclusion of U.S. savings bond interest when the taxpayer pays tuition and required fees of any individual at an eligible educational institution. The bill no longer would limit the provision to payments of qualified expenses for the taxpayer or the spouse or dependents of the taxpayer.

S. 442: Value Added Tax (Senator Hollings)

S. 442 (introduced by Senator Hollings) would amend the Internal Revenue Code to impose a 5-percent value tax (VAT), effective for transactions occurring after December 31, 1989. The bill would provide a trust fund in the Department of the Treasury restricting the use of the revenue from the VAT to deficit and debt reduction.

S. 659 (Senator Symms), S. 838 (Senator Heflin), and S. 849 (Senators Daschle, Heflin, Boren, and Symms)

Estate Tax Inclusion Related to Valuation Freezes

Under the Omnibus Budget Reconciliation Act of 1987, the value of certain property transferred pursuant to a valuation freeze is includible in the decedent's gross estate. The bills (S. 659, S. 838, and S. 849) would repeal this treatment retroactively from OBRA's enactment (i.e., property transferred after December 17, 1987).

S. 800: Moratorium on Certain State Tax Laws (Senator Bradley and Others)

New York State recently adopted legislation that requires nonresidents to pay income tax on their New York-source income based on the tax bracket they would be in if all of their income were New York-source. Prior to the legislation, nonresidents' tax brackets were determined solely by reference to their New York-source income.

S. 800 (introduced by Senators Bradley, Lautenberg, Dodd and Lieberman) would temporarily suspend the effect of this law and any State legislation enacted in response to the New York law. In addition, the bill would establish a commission to study all such legislation.

II. DESCRIPTION OF S. 353: EDUCATIONAL SAVINGS BONDS

Present Law and Background

Section 135 was added to the Internal Revenue Code by the Technical and Miscellaneous Revenue Act of 1988. This section provides that interest income earned on a qualified U.S. Series EE savings bond issued after December 31, 1989, is excludible from gross income, if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[2]

The exclusion from gross income of interest on U.S. Series EE savings bonds is available only to taxpayers who are issued such bonds after having attained age 24.[3] During the year the bond is redeemed, the taxpayer to whom such bond was issued must pay "qualified higher education expenses," meaning tuition and required fees for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at an eligible educational institution.[4] A taxpayer cannot qualify for the interest exclusion by paying for the education expenses of another person (such as a grandchild or other relative) who is not a dependent of the taxpayer.[5]

The exclusion provided by section 135 is phased out for certain upper-income taxpayers. A taxpayer's AGI for the year the bond is redeemed (not the year the bond was issued) determines whether or not the phaseout applies. For taxpayers filing a joint return, the phaseout range is for AGI between \$60,000 and \$90,000.[6] For single taxpayers and heads of households, the phaseout range is for AGI between \$40,000 and \$55,000.[7] The phaseout rate for the exclusion

---

[2] If the aggregate redemption amount (i.e., principal plus interest) of all Series EE bonds redeemed by the taxpayer during the taxable year exceeds the qualified education expenses, then the amount of excludible interest is determined by multiplying the total interest received by a fraction, the numerator of which is the amount of qualified education expenses and the denominator of which is the sum of principal and interest on all Series EE bonds redeemed by the taxpayer during the taxable year (sec. 135(b)(1)).

[3] Section 135(c)(1)(B). The exclusion will not be allowed if bonds are purchased by a parent (or other relative) and put in the name of a child or other dependent who is under the age of 24 at the time of purchase.

[4] Eligible educational institutions are defined in section 1201(a) and 481(a)(1) (C) and (D) (i.e., nursing schools) of the Higher Education Act of 1965, as in effect on October 21, 1988, and in the Carl D. Perkins Vocational Education Act (subparagraph (C) or (D) of sec. 521(3)), as in effect on October 21, 1988. An eligible educational institution does not include proprietary institutions.

"Qualified higher education expenses" do not include expenses with respect to any course or other education involving sports, games, or hobbies other than as part of a degree program (sec. 135(c)(2)(B)).

[5] For purposes of section 135, a "dependent" is any person as to whom the taxpayer is allowed a personal exemption deduction under section 151.

[6] Married taxpayers (within the meaning of sec. 7703) who file separate returns are not eligible for the exclusion under section 135 (sec. 135(d)(2)).

[7] Section 135(b)(2). The phaseout ranges will be adjusted for inflation beginning in 1990. Such adjustments will be rounded to the nearest \$50.

is applied gradually over the income phaseout range, as is the case with other income phaseouts provided for by the Code.[8]

Generally, all Series EE savings bonds can be purchased through payroll savings plans, at most commercial banks, at many savings and loan associations, and at other qualified financial institutions. Such bonds can be purchased in various denominations, ranging from $50 to $10,000. The purchase price is one-half the denomination (or face value) of the bond. In any one year, a person may purchase Series EE savings bonds with denominations (or face value) totalling up to $30,000. The interest rate on Series EE savings bonds varies, depending on how long the bonds are held. The interest rate on such bonds held for more than five years is based on the market rate for Treasury outstanding obligations with five years to maturity. Bonds held for less than five years earn interest on a fixed, graduated scale. Interest earned on Series EE savings bonds is paid when the bonds are redeemed.[9]

Explanation of the Bill

S. 353, introduced by Senators Exon, Shelby, DeConcini, Harkin, and Lieberman on February 7, 1989, would amend the term "qualified higher education expenses" under section 135 to include tuition and required fees paid by a taxpayer for the enrollment or attendance of *any* individual at an eligible educational institution.

Thus, under S. 353, if a person (who is at least 24 years old) purchases a Series EE savings bond after December 31, 1989, interest earned on that bond would not be subject to Federal income tax if, during the year the bond is redeemed, the purchaser pays for qualified education expenses of any individual (e.g., a relative who is not a dependent of the purchaser). provided that such education expenses paid by the purchaser exceed the proceeds (principal and interest) received upon redemption of the bond and the purchaser's AGI for the year of the redemption is below the phaseout range provided for by section 135(b)(2).[10]

Effective Date

The bill would apply to U.S. Series EE savings bonds issued after December 31, 1989.

---

[8] For example, if taxpayer filing a joint return has a AGI of $75,000, then the interest exclusion otherwise provided for by section 135 would be reduced by one-half (($75,000–$60,000)/$30,000).

[9] *See* Congressional Research Service, *Saving for College with Education Savings Bonds*, March 22, 1989, pp. 3–6.

[10] In contrast, present-law section 135 provides that interest on Series EE savings bonds is excludible from income only if, during the year the bond is redeemed, the person to whom the bond is issued pays tuition or required fees for his or her own education, or for the education of a spouse or dependent. Under current law, a taxpayer who pays for education expenses of another individual who is not a spouse or dependent would not be eligible for the interest exclusion provided for by section 135.

III. DESCRIPTION OF S. 442: VALUE ADDED TAX

S. 442, introduced by Senator Hollings on February 23, 1989, would amend the Internal Revenue Code of 1986 (the Code) to impose a 5-percent value added tax (VAT) (title I). The bill also would establish a trust fund in the Department of the Treasury that would restrict the use of the revenues from the VAT to deficit and debt reduction (title II).

A. Description of Tax Provisions (Title I of the Bill)

Imposition of the value added tax

In general, the bill would impose a VAT on the sale of property and the performance of services in the United States pursuant to a commercial transaction. In addition, a VAT generally would be imposed upon any sale or leasing of real property and any importing of property, whether or not pursuant to a commercial transaction.

The amount of tax generally would be 5 percent of the value of the property sold or the services performed and would be imposed on the seller at each stage of production and distribution, including the retail stage. Each taxable person in the production and distribution chain would receive a credit for the VAT previously paid by its suppliers on its purchases of goods and services in taxable transactions. Thus, each taxable person generally would pay a net tax equal to 5 percent of the value added by that person to property or services sold. The total VAT paid with respect to any property or service provided to a consumer (taking into account the net taxes levied at all stages of production) would equal 5 percent of the retail value of the property and services.

Taxable persons

The VAT would be imposed on persons who engage in taxable transactions. Taxable persons generally would include corporations, persons engaged in business transactions, sellers and lessors of real property, and importers.

In general, in the case of a sale of property in the United States, the VAT would be imposed on the seller. For property imported into the United States, the VAT would be imposed on the importer. In the case of the performance of services in the United States, the VAT would be imposed on the service provider. However, an employee would not be subject to the VAT with respect to activities engaged in as an employee.

Taxable amount

In the case of cash transactions, the amount subject to the VAT would be the price charged to the purchaser of the property or services, including all invoiced charges for transportation and other items payable to the seller, but excluding the VAT and any State and local sales and use taxes. In the case of any exchange of property or services, the taxable amount would be the fair market value of the property or services transferred by the taxable person.

In the case of imports, the taxable amount would be the U.S. customs value plus the U.S. customs duties. If there is no specified customs value, the taxable amount would be the fair market value of the property.

The bill would provide a special rule for the determination of the taxable amount for sales of certain used consumer goods. If a taxable person sells tangible personal property that was acquired in a nontaxable transaction from an ultimate consumer, the taxable amount would be reduced by the amount paid for the property by the taxable person.

Exceptions to imposition of the VAT

The bill would provide various exceptions to the imposition of the VAT. For instance, the bill would impose a zero tax rate [11] with respect to certain sales of food, housing, and medical care. A zero rating would also be provided for farmers, fishermen, mass transit services, exports, interest, and certain transactions with governmental entities and section 501(c)(3) organizations.

The bill also would provide a *de minimis* exemption from the VAT that may be elected by certain small businesses.

Special rules and treatment of certain transactions

The bill would provide special treatment with respect to the personal use of business property by any owner of the taxpayer, gifts of business property or services, the disposition of nonbusiness real property, and insurance.

Coordination with the Federal income tax system

Under the bill, the basis of any property for Federal income tax purposes would not include the portion of the purchase price that represents a creditable VAT. In addition, the amount allowed as an income tax deduction for any VAT would be determined without regard to any VAT credit. For purposes of computing percentage depletion, gross income would be reduced by the amount of VAT imposed and taxable income would be determined without regard to any deduction allowed for the VAT.

The VAT credit

A taxable person would be permitted to claim a credit for the VAT paid on its purchases of property and services to the extent such property and services are used in a business. The VAT credit would be applied first to reduce the VAT liability, with any excess treated as a refundable overpayment of tax. Generally, in order to claim a credit, the taxable person would be required to have an invoice that indicates the amount of VAT paid.

---

[11] In a zero-rated transaction, a rate of 0 percent is substituted for the normal VAT rate of 5 percent.

VAT administrative procedures

The "credit-invoice" method

The VAT system imposed by the bill would utilize the "credit-invoice" method. Thus, any taxable person engaged in a taxable transaction would be required to give the purchaser a tax invoice with respect to the transaction if the taxable person has reason to believe that the purchaser is a taxable person. The invoice would be valid only if it indicated the name and identification number of the seller, the name of the purchaser, the amount of VAT imposed on the sale, and certain other information.

The invoice generally would be required to be furnished no later than 15 business days after the tax point of the taxable transaction. The tax point would be the earlier of (1) the time that the taxable person must recognize income from the transaction for Federal income tax purposes, or (2) the time that payment is received. In the case of imported property, the tax point would be when the property is entered, or withdrawn from warehouse, for consumption in the United States.

Time for filing return and claiming the credit

The bill would require the taxable person to file a VAT return during the first month following the close of the taxable period. The taxable period generally would be a calendar quarter. The return would reflect the VAT due on taxable transactions having a tax point within the taxable period.

To the extent provided in regulations, monthly deposits may be required for the estimated VAT liability for any taxable period.

A VAT credit with respect to a taxable transaction would be allowed no earlier than the first taxable period by the close of which the taxable person has paid or accrued the VAT liability and has received a VAT invoice.

Treatment of related businesses

To the extent provided in regulations, a taxable person would be allowed to elect to treat all businesses under common control (as defined by section 52(b) of the Code) as one taxable person for purposes of the VAT. However, for purposes of the small business exemption, all businesses under common control would be considered one taxable person.

To the extent provided in regulations, a taxable person would also be allowed to elect to treat any of its divisions as separate taxable persons.

Treasury notification and regulations

The bill would require a taxable person to notify the Internal Revenue Service if certain events occur. The reportable events would be described in Treasury regulations and generally would include a change in the form of a business or any other change that would affect VAT liability, a VAT credit, or VAT administration with respect to the business.

The bill also would grant the Secretary of the Treasury broad authority to issue regulations with respect to the VAT.

Effective date

The bill would apply to transactions occurring after December 31, 1989.

B. Allocation of Revenues from Value Added Tax (Title II of the Bill)

The bill would establish a Deficit Reduction Trust Fund (DRTF) in the U.S. Treasury. Amounts equivalent to current estimates of receipts from the VAT would be transferred monthly from the General Fund in the Treasury to the DRTF. Correcting adjustments to these amounts would be made subsequently as more accurate information became available.

Amounts in the DRTF would be used solely to retire outstanding public debt obligations of the United States and to pay any administrative costs incurred in collecting the VAT and in operating the DRTF. Debt would be retired by paying off obligations at maturity, or by redeeming or buying obligations before maturity and retiring them (i.e., obligations redeemed from the public before maturity could not be resold to the public).

For purposes of calculating the maximum deficit amount under the Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman-Hollings), amounts received in, and disbursed from, the DRTF would not be included in total revenues and budget outlays. Consequently, VAT receipts could be used only to retire outstanding debt obligations and could not be used to finance current expenditures.

C. Analysis of Specific Issues

1. Definitions of taxable transactions and taxable persons

a. In general

Under the bill, the VAT would be imposed on each taxable transaction. 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. A "commercial-type transaction" would mean a transaction engaged in by a corporation (other than an S corporation) or by any other person engaged in a business. Commercial-type transactions also would include any sale or leasing of real property or any importing of property, whether or not engaged in by a corporation or in connection with a business. Importing of articles by a consumer free of duty under the personal exemptions of the United States Tariff Schedules would not be subject to the VAT.

"Taxable persons" would mean persons who engage in a business or in a commercial-type transaction. The term "business" would include a trade and an activity regularly carried on for profit. An employee would not be considered a taxable person with respect to activities engaged in as an employee.

b. Sales of property

Under the bill, the term "sale of property" would not be restricted to the sale of property for cash in the usual sense. For purposes of the VAT, a sale of property would include:

(1) the exchange of property for property [12] or services;

(2) the transfer of property to an employee as compensation (unless the transfer is a type for which no amount is includible in the income of the employee);

(3) a sale of property to a governmental entity; [13] and

(4) a sale of property by a governmental entity or by certain tax-exempt entities.[14]

The bill would define "property" to mean any tangible property. Thus, the sale of such intangible property as stocks, bonds, securities, franchise rights, patents, copyrights, and other intellectual property would not be subject to the VAT. This dichotomy in the treatment of tangible versus intangible property raises certain issues. For instance, certain assets possessing characteristics of both tangibility and intangibility (such as computer software) would be difficult to classify for purposes of taxation. Such classification issues often have arisen in the area of State sales and use and property taxation and in the area of the investment tax credit as it existed before the Tax Reform Act of 1986.[15]

In addition, since the sale of tangible property by a corporation would be subject to the VAT, while the sale of intangible property by an individual would not, a shareholder who wishes to dispose of his or her wholly-owned corporate business may sell his or her stock rather than have the corporation sell its assets and liquidate in order to avoid the VAT.[16] Alternatively, an individual may wish to dispose of an asset that would otherwise be subject to the VAT (such as real property). In order to avoid the VAT, the taxpayer could contribute the property to a newly formed corporation and sell the stock.

c. Performance of services

The performance of services in a commercial-type transaction would be subject to the VAT. The bill would provide several examples of includable items rather than an overall definition of services. Activities treated as the taxable performance of services would include (but would not be limited to) permitting the use of property, the granting of a right to the performance of services or

---

[12] Such an exchange presumably would include a like-kind exchange of property which would be tax-free under section 1031 of the Code. Administrative and procedural issues arise as to how the VAT would be collected and reported on such a transaction without affecting its tax-free status under the income tax.

[13] Note, however, that the sale of property to a governmental entity will be zero rated for purposes of the VAT, as further discussed at pp. 20–21 of this pamphlet.

[14] Certain sales of property by a governmental entity or a tax-exempt organization would have a zero rating while other sales would be subject to the VAT at the full five percent rate. See pp. 20–22 of this pamphlet.

[15] *See*, for example, Robert W. McGee, *Software Taxation*, National Association of Accountants, 1984, chapters 1 and 3.

[16] Under the British VAT this is not a problem, as the U.K. Treasury has exercised its authority to rule that the transfer of a business as a going concern is not a transaction subject to tax. *See*, Alan Schenk, *Value Added Tax—A Model Statute and Commentary, A Report of the Committee on Value Added Tax of the American Bar Association Section of Taxation* (hereinafter "ABA Report"), 1989, p. 29.

to reimbursement (including the grant of warranties, insurance,[17] and similar items) and making of a covenant not to compete (or a similar agreement to refrain from doing something).

Because property would be defined to include only tangible property, it is unclear whether the bill would treat the licensing of intangible property to be the taxable performance of a service. Other VAT systems would subject the licensing of intangibles to tax, either by providing a broad definition of taxable services or by specifically including the licensing of intangibles as a taxable service.[18]

d. Definition of business

A noncorporate person would be subject to the VAT only if that person sells or leases real property, imports property, or sells property or performs services in connection with a business. Business would be broadly defined to include a trade or activity regularly carried on for profit. Thus, it appears that activities that constitute a trade or business (under Code sec. 162) or that encompass expenses for the production of income (under Code sec. 212) would qualify as a business under the bill. However, an activity that is regularly carried on without a profit motive (for example, a hobby) would not be subject to the VAT. Other VAT systems often define business in greater detail or include all activities regularly carried on as taxable, irrespective of the profit motive.[19]

e. Treatment of employees

For purposes of the bill, an employee would not be treated as a taxable person with respect to activities engaged in as an employee. These services would be incorporated into the value of the goods or services sold by the employer to customers and would be subject to the VAT upon sale. Since services provided by nonemployees would be subject to the VAT, the distinction between an employee and an independent contractor would be significant. The bill would utilize the payroll tax definition of employee utilized in present law for the payroll tax.

An employer's services for an employee would not be treated as the performance of a taxable service under the bill unless the services are a type that are included in the gross income of the employee. Thus, fringe benefits provided to employees that are excluded from Federal taxable income also would be excluded from the VAT. Some have argued that all fringe benefits provided to employees should be subject to the VAT on the theory that if the employee had been paid in cash (rather than with the fringe benefit) and had used the cash to purchase the fringe benefit, a VAT would be collected on the subsequent purchase. The desire to adhere to such a theory must be weighed against the administrative difficulties in creating two separate tax regimes (VAT and income) for the same fringe benefit.

---

[17] *See* pp. 25–28 for a discussion of the special rules relating to insurance.

[18] *See*, Duignan, James "Technical Features of the Value-Added Tax in Europe," prepared for the International Monetary Fund, Fiscal Affairs Department, 1970, at pp. 19–22.

[19] *See*, New Zealand Stat. 1985 No. 141, sec. 8(1) (New Zealand Goods and Services Tax Act) and sec. 4003 of the American Bar Association's Model VAT Statute, both of which would subject hobby transactions that are regularly carried on to the VAT.

f. Treatment of business gifts

The gift of business property or services would be a taxable transaction in the amount of the fair market value of the gift. The term "gift" would include property or services transferred in connection with business promotion activities. Thus, if a corporation donated inventory to a charitable organization and the inventory had a fair market value in excess of the corporation's cost, the donor corporation would be subject to a net VAT liability (after taking into account the VAT credit) on the amount of value the corporation had had added to the inventory. Other VAT systems either impose no tax when property or services are transferred at no cost or impose a tax based on the cost of the property or service.[20]

Imposing a VAT liability on the fair market value of promotional transfers raises issues concerning sales of goods or services at less than fair market value (i.e., "loss leaders"). If a taxable person sold a new product at a deeply discounted price in order to create a market for such a good, it is unclear whether the VAT liability, as imposed under the bill, would be based on the undiscounted, fair market value of the good or the discounted purchase price. If the undiscounted, fair market price controls, the determination of such an amount may be difficult and potentially subject to dispute between the taxable person and tax authorities. In addition, even if the fair market price could be determined at the time of the sale, the seller would be required to charge a customer a VAT based on the higher fair market value or make up the shortfall itself.

If, on the other hand, VAT liability were based on the discounted purchase price of the goods or services when sold, but were based on the fair market value of the goods or services when a gift, there would be a strong incentive to structure business gifts in the form of purchases for nominal amounts.

g. Personal use by owners

The bill would treat the personal use of business property or services by an owner of the business as a taxable transaction subject to the VAT at the fair market value of the property or services. Such treatment is consistent with the treatment prescribed by the bill for taxable fringe benefits provided to employees and business gifts and with the present law income tax rules regarding the constructive distribution of property or services to shareholders. However, it has been suggested that this rule, as drafted, could technically tax farmers and fishermen on the personal use of their own produce.[21]

2. Invoice requirement/credit mechanism

Under the bill, business purchasers would receive tax credits for VAT paid by domestic sellers of inputs or for VAT paid on imported inputs. Although tax would have to be paid by sellers on each

---

[20] *See*, sec. 10(9) of the New Zealand VAT Act, supra, and art. 11A(1)(b) European Economic Community's Sixth Council Directive of May 17, 1977, "On the Harmonization of the Laws of the Member States Relating to Turnover Taxes-Common System of Value Added Tax: Uniform Assessment," Official Journal No. L145.

[21] *See*, ABA Report, at p. 162.

transaction at every stage of production and distribution, credits would also be provided to all purchasers (except the final (nonbusiness) purchaser (the ultimate consumer)), so the net taxable amount at a particular stage of production or distribution represents the value added by that taxpayer at that stage of production or distribution. VAT credits prevent the imposition of multiple layers of tax with respect to the total final purchase price.[22]

The VAT credit would be used to reduce VAT liability. If VAT credits exceeded VAT liability, an amount equal to that excess is refunded to the taxpayer.

In order to receive a credit, a business purchaser would be required to possess an invoice from a seller that contains the name of the purchaser and indicates the amount of tax collected by the seller on the sale of the input to the purchaser. However, regulations could waive the invoice requirement where the amount of credit is *de minimis*, the taxpayer through no fault of his own does not posses a tax invoice, or the amount of credit can be reliably documented by sampling or some other method.

It is often argued that one advantage of the credit invoice method of collecting a VAT is that enforcement is enhanced because invoices are available for audit purposes.[23] In addition, the VAT possesses a degree of self-enforcement since the tendency by sellers to underreport sales and reduce taxes will be offset by the incentive of purchasers to report sales at their full price in order to receive full tax credits. However, these enforcement mechanisms are useful only if there is a credible threat of audits. Also, at the retail level, there is no incentive for the final consumer to counter the sellers' incentive not to report sales since the final consumer does not receive a VAT credit.[24]

Credits should only be available to businesses when purchases are used for business purposes. If final consumers receive credits, no net tax is paid. For example, an automobile used for nonbusiness purposes would entirely escape tax if credits were allowed on the purchase for nonbusiness purposes. The bill would disallow credits for property not used for business purposes. This may, however, lead to administrative complexity, in that whether something is subject to the VAT depends on the use to which the item is put, not just the identity of the purchaser. Thus, there may be significant avoidance of the VAT with respect to purchases of business property that is used for nonbusiness purposes. Similarly, credits should not be allowed for inputs allocable to nontaxable transactions. If property or services are used partly for nonbusiness purposes or partly for nontaxable transactions, the amount of VAT credit allowable would only be that amount allocable to taxable business transactions.

---

[22] For an example of how this operates, see Example 2 in C.3., pp. 15–16.

[23] *See*, for example, Charles E. McLure, "Tax Restructuring Act of 1979: Time for an American Value-Added Tax?" *Public Policy*, Vol. 28, No. 3, p. 306.

[24] *See* U.S. General Accounting Office, *The Value-added Tax—What Else Should We Know About It?*, PAD–81–60, March 3, 1981, pp. 32–34.

3. Zero-rated items and exemptions from the VAT

a. In general

Exclusions from the VAT

Most VAT experts believe that the simplest and most efficient VAT would impose a uniform, flat rate of tax on a broad base of goods and services. However, economic, social, political, and administrative factors often dictate that certain goods and services are either excluded from the VAT or are subject to the VAT at a reduced rate. For example, a VAT that would impose a flat rate of tax on all consumption is considered by some to be regressive because consumption (as a percentage of income) falls as income rises. Therefore, in order to mitigate regressivity, almost all VAT systems adopted to date provide exclusionary relief for certain basic necessities such as food, clothing, shelter, or medicine. Certain enterprises (such as small businesses or farms) often are exempted from the VAT because both the compliance costs of the taxpayer and the administrative costs of the government are considered to outweigh the benefits of additional tax collections. Other goods or services often are eliminated from the VAT system because of the difficulty in accurately measuring the amount of value added (for example, financial services). Finally, exported goods generally are not subject to the VAT (this is generally accomplished by permitting the exporter to claim a credit for the VAT previously paid on the item being exported).

Goods, services, or enterprises may be taken out of a VAT system either by providing a zero rating or an exemption. There are significant differences in the two alternatives. If a sale is zero rated, the sale is still a taxable transaction, but the rate of tax is zero percent. Thus, sellers of zero-rated goods or services will not collect or remit any VAT on their sales. However, sellers of zero-rated goods or services may claim refunds for the VAT they paid with respect to purchased goods and services. Likewise, sellers that are exempt from VAT on their sales of goods or services will not collect any VAT on their sales. However, such sellers may not claim any refunds of the VAT they may have paid on their purchases.

Examples of zero rating and exemption

Whether a sale is zero rated or exempted from the VAT will have different effects upon the seller and the government, as shown in Examples 1–3 below.

Example 1. Assume a manufacturer purchases cotton from a supplier for \$1000. The supplier has no purchases that are subject to the VAT. The manufacturer converts the cotton into clothing which is sold for \$1200. The jurisdiction in question levies a VAT at a rate of 10 percent.

If the jurisdiction provides VAT relief for clothing but not cotton, either through exemption or through zero rating, the results would be as follows:

Production stage	Exemption	Zero rating
Supplier:		
Gross VAT	100	100
Credit	0	0
Net VAT	100	100
Manufacturer:		
Gross VAT	0	0
Credit	0	(100)
Net VAT	0	(100)
Total VAT collected	100	0

In the example above, if cotton rather than clothing were the item to which relief was granted, either an exemption or a zero rating would produce the same result, as follows.

Production stage	Exemption	Zero rating
Supplier:		
Gross VAT	0	0
Credit	0	0
Net VAT	0	0
Manufacturer:		
Gross VAT	120	120
Credit	0	0
Net VAT	120	120
Total VAT collected	120	120

The stage in production at which the VAT relief is granted may affect the amount of total taxes collected. A VAT system that zero rates sales at the final stage of production has the effect of refunding all VAT collected throughout the production of the item. A system that zero rates an intermediate step of production will result in the same amount of tax being collected as if no relief had been granted.

Example 2. Assume the same facts as in Example 1 above, except that the manufacturer sells the clothing to a retailer, who in turn sells the goods to consumers for $1500. The results of providing a zero rating at various stages of production are as follows.

Production stage	Zero Rating for—		
	No one	Manufacturer	Retailer
Supplier:			
Gross VAT	100	100	100
Credit	0	0	0
Net VAT	100	100	100
Manufacturer:			
Gross VAT	120	0	120
Credit	(100)	(100)	(100)
Net VAT	20	(100)	20
Retailer:			
Gross VAT	150	150	0
Credit	(120)	0	(120)
Net VAT	30	150	(120)
Total VAT collected	150	150	0

Example 3. If the relief granted in Example 2 were in the form of an exemption rather than a zero rating, the results would be as follows:

Production stage	Exemption for—		
	No one	Manufacturer	Retailer
Supplier:			
Gross VAT	100	100	100
Credit	0	0	0
Net VAT	100	100	100
Manufacturer:			
Gross VAT	120	0	120
Credit	(100)	0	(100)
Net VAT	20	0	20
Retailer:			
Gross VAT	150	150	0
Credit	(120)	0	0
Net VAT	30	150	0
Total VAT collected	150	250	120

In Example 3, the exempt manufacturer may be in a worse position than if no exemption were granted. Although the manufacturer pays no VAT on the sale, neither the manufacturer nor the retailer receive credit for the $100 of VAT paid by the supplier. Thus, the total amount of VAT paid through the production process is greater when the intermediate seller is exempt from the VAT than when the intermediate seller is taxable (even if it is zero rated). In addition, if an intermediate seller is exempt from the VAT, the total amount of VAT paid will be greater than (and bear no necessary relationship to) the theoretically correct amount of the VAT on an item.

Administrative issues

The form of the relief from the VAT (zero rating versus exemption) raises certain administrative issues. For instance, if the intent of the relief is to ease the administrative burden of a certain class of sellers, the exemption method may be preferable since it totally eliminates VAT bookkeeping requirements. Under a zero-rating system, the seller is still considered a VAT taxpayer and must maintain records in order to determine the amount of VAT credit for which it is eligible.

On the other hand, an exemption may increase the total VAT paid and cause administrative complications in some instances. The VAT credit generally is allowable only with respect to the VAT paid on the purchase of goods or services that are used for the production of taxable goods and services. If a taxpayer engages in both taxable and tax-exempt transactions, the amount of VAT paid on inputs must be allocated or apportioned between the taxable and tax-exempt activities in order to determine the amount of VAT credit allowable. Such an issue does not arise under a zero rating system. If a taxpayer engages in both fully taxable and zero-rated transactions, all his activities are considered to be taxable for purposes of the VAT credit and no allocations need be made.

Finally, with respect to either exempted or zero-rated activities, a clear definition of the transactions that qualify for the relief becomes critical for purposes of reducing the number of potential disputes between the taxpayer and the taxing authorities and between the taxpayer and its customers.

For these and other reasons, it generally is agreed among VAT experts that a VAT system that is applicable to a broad base of consumption is theoretically preferable to a system that provides a wide range of exclusions. It is also generally agreed that zero-rating is theoretically preferable to exemptions.

b. Exclusions provided by the bill

The bill would provide various exclusions from the VAT. Most of the explicit exclusions are in the form of zero ratings (discussed in detail below) as opposed to exemptions. Explicit exemptions would be provided for employee services to his employer,[25] and for *de minimis* activities.[26] However, the bill also would provide for implicit exemptions by narrowly defining taxable transactions. For instance, it appears that the sale of intangible property would not be subject to the VAT.

Food

The bill would provide that the retail sale of food and nonalcoholic beverages for human consumption (other than consumption on the premises) would be zero rated.

Most VAT systems in other countries provide some sort of relief for purchases of food, generally on the grounds of the regressivity of the VAT. Those who favor a tax on all consumption argue that an exclusion for food (as well as other items normally considered to

---

[25] As discussed in section III. C. 1. of this pamphlet, p. 11.
[26] As discussed in section III. C. 7. of this pamphlet, pp. 28–29.

be necessities of life) favors those with higher incomes who are better able to afford more expensive foodstuffs. They would propose other ways to combat any regressivity imposed by a broad-based VAT, including income tax relief or increased means-tested government assistance. In addition, those who favor a broad-based VAT argue that providing exclusions from the VAT may create artificial consumer demands for the excluded products or services.

Other VAT systems have addressed the regressivity issue with respect to food by providing different VAT rates for different types of food, with "luxury" items bearing a greater tax rate.[27] Such systems, however, impose the administrative burdens of identifying goods that are similar but are differently rated. This type of administrative burden may also exist in the VAT imposed by the bill. For instance, the bill would tax food prepared and consumed on the premises, while it would zero rate food prepared on the premises but consumed at home. This would require different tax treatment of identical items purchased at a facility that offers the purchaser the option of either eating on the premises or carrying food out (e.g., a fast food restaurant).

Housing

The bill would provide a zero rating for the sale and renting of residential real property used by the purchaser or tenant as a principal residence. A mobile or floating home would be treated as real property.

Zero ratings for housing would favor those who choose to spend a relatively large proportion of their income on housing and may provide an incentive to increase housing consumption relative to other goods. However, the taxation of housing is a troublesome area even for those who favor a tax on all consumption.[28] First, if housing were to be subject to the VAT, purchasers and tenants should be treated equally. The taxation of tenants is relatively easy—a VAT would be imposed on periodic rents.

The VAT treatment of purchasers may be more difficult. The tax point for purchases of goods generally would be the date of acquisition. In the case of home sales, imposing a large VAT liability at the point of purchase, however, may be viewed as burdensome and may discriminate between existing home owners and new purchasers. One solution to the differing treatment of owners and renters would be to base the VAT on the imputed fair rental value of owner-occupied housing. Such imputations historically have been difficult to implement and administer.

The bill does not define principal residence, but presumably the term would be given the same meaning as that used for Federal income tax purposes. Also not addressed in the bill is the situation of the purchase or rental of furnished housing. In such instances, an allocation must be made between amounts charged for the zero-rated item (housing) and the taxable item (furnishings).

---

[27] For example, Italy imposes a 18-percent VAT on the purchase of pate and fancy chocolates, but only a 2-percent VAT on bread and pasta.

[28] *See*, the discussion in *Treasury Report for Fairness, Simplicity, and Economic Growth*, Treasury Department Report to the President (hereinafter "Treasury Report"), Vol. 3, 1984, p. 72.

Medical care

The bill would provide a zero rating for medical care. Medical care would be defined as the performance of any service and the retail sale of any property, the payment of which would eligible for an income tax deduction (ignoring the limits imposed by section 213(a)). Such costs would include health insurance premiums.

The analysis of whether or not to exclude medical care from the VAT is no different than the analysis required for any other good or service. A zero rating of medical care would encompass amounts spent for private as well as publicly supported care. It can be argued that the regressivity of imposing a VAT on medical care can be alleviated by increasing other means-tested health programs rather than by providing a zero rating.

Farmers and fishermen

Sales by farmers and fishermen (other than at retail) of their produce would be zero rated under the bill. Presumably, the retail sale of such items would qualify for the zero rating allowed for sales of food (to the extent they constitute food).

The 1984 Treasury Report [29] states that it is not feasible to treat farmers and their products the same as other segments of the economy. The report suggests that it may be appropriate to exempt farmers from the VAT since including the large number of small farmers in the VAT system would tend to increase administrative costs and burdens for both the Government and taxpayers. In addition, some sort of exclusion may be appropriate since a relatively large percentage of U.S. agricultural produce is shipped overseas and a VAT system designed consistently with the destination principle would zero rate exports.

Exempting rather than zero rating farmers would not allow farmers to claim a credit for the VAT incurred on farm inputs. Several solutions have been offered with respect to this issue. Farmers could be zero rated (as would be done under the bill) despite the increased administrative and compliance costs. Alternatively, farmers could be allowed to elect to be either zero rated or exempt. Such an election may discriminate in favor of large farmers who could bear the related compliance costs. Farmers could be exempted from the VAT but allowed an income tax credit for the VAT on their purchases. Such a solution would only be feasible if all farmers filed income tax returns and may merely shift the underlying complexities to the income tax system. One solution that is widely used in Europe would be to exempt farmers and allow the purchasers of farm products to presume that a certain percentage, specified by the government, of the purchase price of farm products is related to the VAT. The purchasers would be allowed a VAT credit with respect to the presumed VAT, thus attempting to compensate for the lack of VAT credit at the farm level. A final solution would be to exempt farmers and zero rate sales to farmers. Under such a proposal, farmers would not bear any compliance or purchase costs but would, however, be required to prove their status at the time of purchase.

---

[29] Treasury Report, at p. 61.

Mass transit

The performance of mass transportation services in urbanized areas would be zero rated under the bill. The bill does not provide a definition of either mass transportation or urbanized area. Thus, for example, while bus or subway service within one city would likely qualify for the zero rating, it is unclear whether rail or air service between two cities in a densely populated area (e.g., within the Northeast corridor) would also qualify.

As in the case of medical care, the bill would not distinguish between mass transportation subsidized by the government and that provided by private enterprises. However, since most urban mass transportation is subsidized by a government in order to relieve problems caused by traffic congestion and pollution, it may be appropriate to exclude such services from the VAT. If such services were taxed, fares would rise by the amount of the tax and ridership may fall, thus requiring increased subsidizes. In addition, because of the relatively small dollar value of each purchase, there may be administrative benefits to excluding these services.

Exports

The bill would provide a zero rating for exports. This provision is consistent with the destination principle that holds that goods and services should be taxed in the jurisdiction of consumption rather than the jurisdiction of origin. Other VAT systems also zero rate exports so that they may enter international trade free of all domestic VAT burden.[30]

Interest

The bill would provide a zero rating for interest. The term "interest" is not defined by the bill but presumably would include the items and amounts considered to be interest for Federal income tax purposes. The taxation of financial products and transactions, including interest, generally presents difficult issues for a VAT system.[31]

Government activities

Under the bill, sales to government entities would be zero rated. The providing of property or services by a governmental entity in connection with the education of students would also be zero rated. In addition, sales of property or the performance of services by government entities would also be zero rated unless the sale involves a specific charge or fee.

The treatment of governmental entities involves issues of administration, competitiveness, and intergovernmental relations. Specifically, questions arise as to whether the tax base can be accurately measured and how the tax would be collected, whether the government entity is in competition with a private enterprise, and whether it is appropriate for the Federal Government to include a State or local government in its tax system.

---

[30] For a more detailed discussion of the treatment of exports, see section III. C. 5. of this pamphlet, pp. 23–25.

[31] *See* section III. C. 6. of this pamphlet, pp. 25–28, for a discussion of the treatment of financial services.

Federal, State and local governments generally provide services to the public for free or at a reduced charge. If governmental entities were required to collect VAT on such services, valuation and collection issues would arise. On the other hand, certain government services are provided at a cost commensurate with their fair market value (e.g., some city-owned parking garages). In such cases, the governmental entity may be viewed as if in competition with a private enterprise that offers the same service. It may be appropriate to subject such a sale to the VAT. Finally, intergovernmental relationship issues arise if a State or local government is subject to a Federal VAT on its purchases of goods and services. Even if the relationship issues could be resolved, there may be administrative problems in having all governmental entities register for the VAT and file the appropriate returns.

The bill would attempt to resolve these issues by providing that a governmental entity would not be required to pay VAT on the goods and services it purchases or collect VAT for the performance of its services (with the exception of services for which a separate fee is charged). In this way, governmental entities would not be burdened by the VAT on their purchases and most governmental entities would not be required to collect VAT pursuant to the performance of their services. In essence, such entities would have the benefits similar to exemption without the related cost of having to pay VAT on their purchases. Those governmental entities that charge a separate fee for their services would be required to collect VAT, as are private enterprises that perform similar services. However, the governmental entities would not be required to pay VAT on their purchases. Issues could arise under the bill as to whether it is appropriate to subject to VAT the performance of traditional government services where a nominal fee is charged (e.g., automobile licenses).

Exempt organizations

Under the bill, taxable transactions engaged in by an entity described in section 501(c)(3) of the Code (i.e., entities organized and operated for religious, charitable, educational, etc. purposes) would be zero rated unless such transactions are part of an unrelated business. Section 501(c)(3) organizations would be allowed a credit for all the VAT they were paid. In addition, sales of property or the performance of services by any tax-exempt entity other than a section 501(c)(3) would be also zero rated unless the sale involves a specific charge or fee.

The analysis of the issues relating to the taxation of tax-exempt entities is similar to that of governmental entities. Specifically, the issue arises as to whether it is appropriate to subject to the VAT either the purchases or activities of entities that have been granted income tax relief. In addition, it may not be possible to value the services provided by such entities. Although it may not be appropriate to subject most tax-exempt entities to the VAT, activities through which such entities compete with taxable entities may appropriately be subject to the VAT.

The bill would treat charitable organizations in much the same way that governmental entities are to be treated. Specifically, section 501(c)(3) organizations would not be required to collect VAT on activities other than activities for which they would be taxable as unrelated business income. Unlike governmental entities, such entities would be subject to the VAT on their taxable purchases, but would be able to obtain a refund for the entire amount paid. Tax-exempt entities other than section 501(c)(3) entities would be subject to the VAT on their activities for which a separate charge had been made.

4. Treatment of real property

In general, the bill would tax the sale or lease of business or nonbusiness real property by applying the VAT rate to the amount paid by the purchaser or lessee.[32] A seller of real property would receive a VAT credit for the VAT paid on the purchasing, constructing, or improving of the property. A lessor of real property would receive a credit for the VAT paid on the purchasing, constructing, improving, or maintaining of the leased property.

The bill would provide an important exception to these general rules by providing preferential treatment for certain housing. Under the bill, the sale or lease of housing used as a primary residence would be taxed at a zero rate. Thus, none of the value added with respect to housing used as a primary residence would be subject to tax.[33]

The bill would treat sales of new nonbusiness real property differently from sales of existing nonbusiness real property. While new nonbusiness real property would be taxed on the full sales price, existing nonbusiness real property would be taxed only on the difference between the sales price and the adjusted basis of the property. However, under the bill, amounts incurred before the effective date of the VAT would not be included in basis. Therefore, existing nonbusiness real property not previously subject to the VAT would be taxed on the full sales price.

This special treatment accorded existing nonbusiness real property is not relevant if the rate of tax is zero. Because housing used as a primary residence is zero rated under the bill, no VAT is imposed with respect to both new and existing housing used as a primary residence. However, nonbusiness real property that is not used as a primary residence, such as second homes, would be taxed to the extent VAT was not paid on previous sales.

Under any VAT, the preferential treatment of certain items increases the costs of administration and compliance. The preferential treatment of principal residences in particular adds complexity to the administration of the VAT. Unlike the preferential treatment of food, it is necessary for sellers and lessors of housing to

---

[32] Instead of applying a VAT to the purchase price of an asset, the VAT could be applied each taxable period to the rental value of the housing provided during that period. This would theoretically provide the same tax treatment as up-front application of the VAT because the purchase price of a capital asset should equal the present value of the expected rental stream. However, the amount of rental value for each year is difficult to determine without actual rental payments.

[33] An alternative method of providing preferential treatment for housing would be to provide a VAT exemption for (rather than zero rating) the sale or lease of housing used as a primary residence. If housing used as a primary residence were exempt from the VAT, a seller or lessor would neither pay tax on their sales nor receive credits on their purchases. Consequently, the value added by those other than the seller or lessor would be subject to tax. As with other preferentially treated items, exemption of housing at the retail level provides substantially less tax benefit to the taxpayer than zero-rating.

determine how the housing will be used (i.e., whether the buyer or lessee will use the property as a principal residence.) In addition, difficult administrative issues may arise if a portion of the purchase price is attributable to nonhousing components (for example, appliances and other amenities, or business use of the home) or if a portion of the rent is attributable to nonhousing services (for example, parking or other facilities). In such cases, the preferential treatment of principal residences may be available for consumer goods other than housing.

The preferential treatment of principal residences may also reduce economic efficiency. The additional tax incentive for residential housing provided by the bill could encourage the purchase of residential housing beyond economically efficient levels. The tax treatment of housing in the bill does not, however, favor owner-occupied housing over rental housing, as does the current income tax.

5. Determination of the location of goods and services

The bill generally would define taxable transactions as sales of property in the United States, the performance of services in the United States, and the importation of property into the United States. Exports would be subject to tax at a zero rate.

A VAT can be designed on the origination principle, whereby goods and services are taxed where produced, regardless of where they are consumed, or on the destination principle, whereby goods and services are subject to tax where they are consumed, regardless of where they are produced. Virtually all VATs, including the VAT proposed in the bill, are based on the destination principle. In order to implement the destination principle, exports must be relieved of the domestic VAT and the domestic VAT must be imposed on imports. This treatment of exports and imports is referred to as the border tax adjustment.

The border tax adjustment of a destination principle VAT serves two purposes. By taxing imports and not exports, the border tax adjustment generally ensures that the tax base for the VAT is domestic consumption. In coordination with VAT systems in other countries, border tax adjustments also ensure that value added taxes do not distort international trade and leads to neither taxation in multiple jurisdictions nor exemption from VAT in any jurisdiction. For purposes of performing the border tax adjustment, it thus is necessary to determine the location of potentially taxable transactions. The rules for determining the location of a transaction for tax purposes are known as source rules.

The bill would provide for border tax adjustments by subjecting imports to tax at the standard 5-percent rate and subjecting exports to tax at a zero rate, thus permitting refunds for previously paid VAT on the exports. Under the bill, imported property would be sourced where delivery takes place, except that real property would be sourced where the real property is located.

Services are typically more difficult to source than tangible goods. The bill generally would source services according to where the services are performed. This rule, while administratively simpler than some other alternatives, violates the purest form of the destination principle. For example, a U.S. firm may contract for services performed abroad but for use in the United States. Such a transaction presumably would not be subject to tax under the bill. However, the destination principle argues that this transaction should be a taxable transaction. Since the seller of the services may have no other connection with the United States, it may be administratively infeasible either to collect the tax from the seller or to identify the purchase of the service as an import and levy the tax on the importer. Likewise, services performed in the United States for use abroad ought to be exempt from tax under a strict interpretation of the destination principle, but would be taxable under the bill.

The problem of some services provided abroad being exempted from domestic VAT may not be a serious problem. As long as the sales of the purchaser of the service is subject to VAT, no tax revenue will be foregone. Since the cost of services provided would be reflected in the final sales of the purchaser, and thereby subject to tax, the full amount of VAT would be collected regardless of whether the seller of the service paid the VAT. The full amount of VAT would be collected because there would be no offsetting credit for previous VAT paid on the services purchased. Only in the case of exempt purchasers would the tax on foreign-provided services be avoided.

Value added taxes in other countries differ somewhat in their sourcing of services. The Sixth Directive of the European Communities generally provides for sourcing the service in the country where the supplier is established.[34] Under the directive, however, certain services, such as patent licenses, advertising, financial operations and certain others are sourced in the country of the establishment of the purchaser. It is necessary, therefore, under the directive, to determine the location of the seller's or purchaser's establishment. To the extent that sourcing rules can be harmonized among taxing jurisdictions, the number of transactions subject to tax by multiple jurisdictions or no jurisdictions can be reduced or eliminated.

For services performed both inside and outside the United States, the bill would provide that the service would be sourced in the United States if 50 percent or more of such service is performed in the United States; otherwise, the service would be sourced outside the United States. Examples of services performed both inside and outside the United States include international transportation and communications services.

The Internal Revenue Code, for purposes of determining whether income is within or without the United States, generally allocates and apportions income and expense between U.S. and foreign source income, including gross income earned partly within and without the United States (sec. 863). Special rules apply for international transportation and communications income so that half of the income is sourced within the United States and half without.

Rules similar to these existing source rules in the Code could serve as an alternative to the source rules in the bill. The rule in

[34] Sixth Council Directive of May 17, 1977, "On the Harmonization of the Laws of the Member States Relating to Turnover Taxes-Common System of Value Added Tax: Uniform Basis of Assessment," Official Journal No. L145, reprinted in 2 CCH Common Mkt. Rep., par. 3165 (1977).

:he bill would eliminate the need to allocate and apportion sales of ;ervices based on the percentage of the service connected to different locations. Under the bill, transactions would either be subject :o full tax or no tax depending on whether more or less than 50 percent of the service is provided in the United States. Because of the all-or-nothing nature of the source rule in the bill, significant pressure may be placed on the accurate determination of the percentage of service provided in the United States in those cases where the percentage may be near 50 percent. Presumably, for cases where the percentage provided in the United States is not near 50 percent, the rule in the bill would be administratively easier than an apportionment rule.

;. Treatment of insurance and other financial services

a. Treatment of insurance and other financial services

Under the bill, the provision of insurance would be considered he performance of services, and, consequently, would be subject to he 5-percent VAT that generally applies to the sale of property or he performance of services in the United States. In the case of in-urance, the amount subject to tax would equal the excess of (1) the portion of the premium attributable to insurance coverage over (2) he actuarial cost to the insurer of providing the insurance cover-age.

The provision of financial services by banks, savings and loans associations, and other similar entities would also be considered he performance of services. The bill provides, however, that the ate of tax imposed with respect to interest would be zero (i.e., zero ated).

b. Issues relating to the application of a VAT to insurance and other financial services

n general

One of the most difficult issues that must be addressed in developing a VAT is the treatment of insurance and other financial ervices. It is generally believed that based on considerations of economic efficiency and equity, all services (including financial ervices) should be included in the base of any VAT and should be axed at the rate that generally applies to ordinary goods and servces. A VAT that exempts or zero rates insurance and other finanial services would create an artificial incentive to purchase these ervices rather than other taxable goods or services, and, consequently, would distort consumer preferences and the efficient alloation of resources. In addition, because higher-income individuals generally purchase greater amounts of insurance and other finanial services than lower-income individuals, the exemption or zero ating of these services would make a VAT more regressive.

Notwithstanding these considerations, nearly all countries that urrently impose a VAT provide an exemption for insurance and he lending activities of financial institutions.[35] The principal ar-

---

[35] All countries that are members of the European Economic Community (EEC) provide a 'AT exemption for the lending activities of banks and similar financial institutions and for in-urance, reinsurance, and related services performed by insurance brokers and agents. Some ountries that exclude insurance from the VAT impose a separate retail tax on insurance.

gument for exempting or zero rating insurance and the lending ac tivities of financial institutions is that it is difficult as a practica matter to determine what portion of the premiums received by ir surers and what portion of the deposits received by banks an other similar financial institutions should be subject to tax. Th principal service provided by insurers to policyholders is the poo ing of risks of loss. The primary service provided by banks an other similar entities to depositors is intermediation (i.e., the poo ing of money for the purpose of investing). The imposition of VAT on the gross amount of premiums or deposits received woul result in a tax that bears no relation to the value added by insu ers and other financial institutions.

Determination of taxable amount in the case of insurance

In the simplest case, the value added by insurers may be mea ured by the excess of the premiums received over the claims paid The premiums paid for most life insurance contracts, however, ir cludes a savings element that does not represent value added b the insurer for insurance services. Under a consumption-type VAT the savings element of insurance contracts should not be include in the VAT base.

The bill attempts to address this concern by including in the ir surer's VAT base only the excess of (1) the portion of the premiu attributable to insurance coverage over (2) the actuarial cost to th insurer of providing the insurance coverage. The bill, however, doe not provide guidance on how to determine the portion of the prem um attributable to insurance coverage or the actuarial cost to th insurer of providing the insurance coverage. For example, in th case of single premium whole life insurance, it is unclear under th bill what portion of the premium is attributable to insurance cove age because the single premium funds the cost of insurance for th life of the insured. With respect to the actuarial cost of providin insurance coverage, it is uncertain under the bill whether the cos is to be based on industry-wide actuarial data or the insurer's ow experience, and, if the latter, how to determine the insurer's ow experience.

In order to avoid these difficult questions, it has been suggeste that an alternative system apply to insurance.[36] Under th system, insurers would be subject to VAT on the gross amount o premiums received. Upon the occurrence of a claim, the insure would gross-up the amount of the claim by the VAT rate in effe at that time. The insurer would be permitted to claim an inpu credit for the amount of the gross-up.[37]

Under this system, an insurer would be taxed solely on the valu of the risk-pooling service that it provides without resorting to est mates or industry averages to determine the portion of the prem

[36] *See* Barham, Poddar, and Whalley, "The Tax Treatment of Insurance Under a Consum tion Type, Destination Basis VAT," 40 *National Tax Journal* 171 (1987).

[37] The treatment of the policyholder under this system would vary depending on whether not the policyholder was a business. In the case of a business policyholder, an input credit wou be available for the VAT imposed on the premium payments. At the time of a claim, t amount of the gross-up would be considered VAT payable by the business. In the case of a no business policyholder, no input credit would be available as premiums are paid and no VA would be payable with respect to the amount of the gross-up.

um attributable to insurance coverage or the actuarial cost of insurance. Nevertheless, such an approach may be criticized for not taxing the value of the financial intermediation services provided by insurers that issue life insurance with a savings element.

In order to address this criticism, it has been suggested by some that insurers should be subject to a subtractive-method VAT or an additive-method VAT in lieu of the credit-method VAT.[38] If a subtractive or additive method of computing VAT liability was adopted with respect to insurance while the rest of the economy was subject to a credit method, an adjustment would be necessary to insure that business purchasers of insurance obtain a credit for the VAT paid by insurers.

Determination of taxable amount in the case of lending activities of financial institutions

In the case of lending activities,[39] the value added by banks and other similar financial institutions may be measured by the excess of interest received from borrowers over the interest payable to depositors, reduced by the cost of purchased inputs. In order to tax this value added, it has been suggested that financial institutions be taxed on interest received from borrowers and that depositors be taxed on the interest paid by the financial institutions. In the case of nonbusiness depositors who cannot claim an input credit for such tax, however, this approach would result in the imposition of tax on interest income, which may be contrary to the purpose of a VAT.

In order to avoid the imposition of VAT on interest paid to nonbusiness depositors, it has also been suggested that insurers and other similar financial institutions be taxed under an additive or subtractive method VAT. The principal criticism of an additive system is that it requires a determination of the profits of insurers and other financial institutions, and, historically, it has been difficult under an income tax system to accurately determine such profits. It may also be difficult under an additive-method VAT to make accurate border adjustments that would be in compliance with GATT. A subtractive-method VAT for insurers and other financial institutions would pose similar problems.

Additional issues

If it is determined that the provision of insurance and the lending activities of financial institutions should be included in a VAT, at least two additional issues must be addressed. First, because a

---

[38] Under a subtractive-method VAT, the base to which the rate of tax applies would be determined for any taxable period by subtracting the total cost of inputs from total sales. Under an additive-method VAT, the base to which the rate of tax applies for any taxable period would be determined by adding together all the elements of value added including wages, rents, interest, and net profit. Under either a subtractive or additive-method VAT, the entire value added by insurers, including the value of financial intermediation services, should theoretically be included in the VAT base.

[39] The discussion contained in this section addresses lending activities of banks and other similar financial institutions because such activities pose the most difficult VAT issues. In the case of other goods or services provided by financial institutions, such as the rental of safe deposit boxes or the issuance of checks, a separate charge is generally imposed with respect to these goods or services. A VAT should apply to these goods and services under the general rules applicable to goods or services. Difficulties would arise, however, if a separate charge is not imposed or the charge does not reflect the full value of the good or service.

destination-based VAT only taxes services provided in the United States, rules are necessary to determine where insurance and lending activities are provided. Most countries that impose a VAT on insurance treat insurance services as occurring where the risk is located. Consequently, if a U.S. person insures a foreign risk, no VAT would be imposed on the transaction. Conversely, if a foreign person insures a U.S. risk, the transaction would be subject to the U.S. VAT. This approach may create collection problems in the case of foreign insurers that have no other connection with the United States. Second, it must be determined how the VAT is to apply to insurance and lending transactions where premiums or deposits are made before the effective date of the VAT and claims are paid or withdrawals occur after the effective date. A similar issue arises if the tax rate changes after the effective date.

7. Administrative provisions

a. Liability for VAT and invoicing

Under the bill, liability for the VAT would be imposed on the seller of property or services. In addition to paying the VAT, the seller would be required to provide a tax invoice (setting forth the amount of VAT imposed on the sale, the name and identification number of the seller, the name of the purchaser, and certain other information) to the purchaser if the seller has reason to believe that the purchaser is a taxable person. The invoice would have to be furnished no later than 15 business days after the "tax point" for the transaction.

Generally, a purchaser would not be allowed to claim a VAT credit with respect to a transaction unless it has received a tax invoice in which it is named as purchaser.

b. Small business exemption

The bill would permit certain small businesses to elect not to be treated as a taxable person except with respect to imports and the sale or leasing of real property. If an election is made by a small business, no tax would be imposed on its sales and no credit would be permitted for VAT paid on its purchases.

A person could elect to be exempt under the bill if its taxable transactions do not exceed $20,000 for a calendar year and can reasonably be expected not to exceed $20,000 for the next calendar year. The election, however, would terminate on the first day of the second month following any calendar quarter in that next year if the following has occurred:

(1) aggregate taxable transactions for the calendar quarter exceed $7,000, in the case of the first calendar quarter; or

(2) aggregate taxable transactions for the first two calendar quarters exceed $12,000, in the case of the second calendar quarter; or

(3) aggregate taxable transactions for the first three calendar quarters exceed $17,000, in the case of the third calendar quarter.

An exception from the VAT for small businesses could substantially reduce compliance and administrative costs. An exception for small business could also, however, distort economic behavior. The existence and extent of the distortion would depend in part on the identities of the parties to a transaction. In certain transactions, exempt small businesses would be favored over businesses subject to the VAT. For example, if an individual needs to have $1,000 of plumbing work performed on a personal residence, the individual would prefer that the plumbing be performed by an exempt plumber (who would charge $1,000) rather than by a taxable plumber (who would charge $1,000 plus a $50 VAT).[40]

On the other hand, in other transactions businesses subject to the VAT would be favored over exempt small businesses. For example, assume that under the previous example a grocery store is in need of the plumbing and the work involves $800 of materials and $200 of labor. The exempt plumber would be required to pay $40 VAT on its purchase of materials, and, because it is exempt, would neither be permitted to claim a credit for the VAT it has paid nor issue a VAT invoice so that the grocery store could claim a credit for the VAT paid with respect to the materials. Thus, the exempt plumber would charge $1,040 for his work, and the grocery store would not be permitted to claim a credit for the $40 VAT. In addition, when the grocery store raises its prices to offset the $1,040 plumbing expense, it will charge VAT a second time on the $40 VAT the plumber previously paid.

The treatment of a plumber who is subject to the VAT would differ. A taxable plumber would also pay a $40 VAT with respect to the materials, but would charge $50 VAT on the entire transaction and claim a credit for the $40 VAT previously paid on the materials. The grocery store similarly would be allowed to claim a credit for the $50 VAT that it pays the plumber. The grocery store would pay the plumber $1,050 ($1,000 for the plumbing plus a $50 VAT), but, because the grocery store can claim the VAT it paid as a credit, the cost to the grocery store is in effect $1,000. The grocery store would charge its customers the theoretically correct VAT on the overhead attributable to these plumbing costs, and would not have to raise its prices by an additional increment to compensate for the "double VAT" that would be paid if the work were done by a VAT-exempt plumber. If the size of the small business exemption were increased, these distortive effects would be more pronounced.

In addition, because the bill would permit small businesses to elect to be treated as exempt from the VAT, small businesses would likely make the election based on the types of customers they generally deal with, which could increase the distortive effects as compared with a non-elective small business exemption.

c. Time for filing return and claiming credit

Under the bill, the taxable period for the VAT would generally be a calendar quarter. A taxpayer would, however, be allowed to elect a calendar month as the taxable period. A taxable person would be required to file a VAT return during the first month following the close of each taxable period. The return would reflect the VAT due on taxable transactions with a "tax point" in the period as well as the VAT credit allowed for the period. To the

---

[40] This example assumes that both plumbers provide work of the same quality at the same price and that all of the economic burden of the VAT is borne by consumers.

extent provided in regulations, monthly deposits of estimated VAT liability may be required.

The "tax point" describes when a taxable transaction occurs for purposes of the requirement that a taxable person furnish a tax invoice, as well as for purposes of determining in what taxable period the transaction must be reported. For a sale of property or services the determination of the tax point would depend on whether the taxable person employs the cash method or an accrual method of accounting for Federal income tax purposes. In the case of a cash method taxpayer, the tax point would be the date that the taxable person receives payment for the goods or services. In the case of an accrual method taxpayer, the tax point would be the earlier of the date that the taxable person (1) should accrue income or loss with respect to the sale, or (2) receives payment for the goods or services. In the case of imports, the tax point would be the date that the imported property is entered (or withdrawn from warehouse) for consumption in the United States.

A VAT credit with respect to a purchase transaction would be allowed for a taxable period only if certain conditions were met. The taxable person would be required to have (1) paid or accrued (depending on its method of accounting for Federal income tax purposes) the VAT as part of the purchase price, and (2) received a tax invoice from the seller with respect to the transaction. The VAT credit would generally be allowed for the first taxable period in which both of these conditions were satisfied.

Many countries that impose a VAT use the calendar quarter as the taxable period.[41] Many countries also permit variations from the generally required schedule. Some permit (as does the bill) taxpayers to elect a calendar month as the taxable period. This election of a shorter taxable period may be of assistance to taxpayers that seek a more rapid refund of VAT that has been previously paid. Some countries also permit certain taxpayers to utilize a longer taxable period, such as a calendar year. Small businesses are often eligible for this longer taxable period in order to reduce the administrative burden that is imposed by a VAT.

A related issue is the time when deposits of VAT must be made. The bill would provide that regulations may require monthly deposits of VAT liability. Other deposit periods could also be considered. For example, under present law, corporations must deposit income taxes withheld from their employees and social security taxes as frequently as eight times a month (depending upon the size of the amounts to be deposited). A requirement that estimated VAT deposits be made with increasing frequency as the amount required to be deposited increases may help minimize collection problems for the Government. It would also be possible to require relatively infrequent deposits for some entities, such as small businesses. This can ease the administrative burden on these taxpayers. The Japanese VAT reportedly utilizes infrequent deposits by small businesses to encourage them to comply with the VAT (by giving them the use of the VAT they have collected for a period of time before it must be deposited). Decoupling the VAT deposit require-

[41] *See* ABA report, page 127.

ment from the return requirement may permit the utilization of longer periods for the return requirement without adversely affecting the flow of revenue from the VAT.

d. Treatment of related businesses

Under the bill, a taxable person would be permitted to elect to treat itself and all related businesses as one taxable person for VAT purposes, to the extent provided in regulations. A related business would encompass any business under common control with the taxable person under the more than 50-percent control test described in section 52(b) of the Code. However, for purposes of determining qualification for the small business exemption, all businesses under common control would be treated as one business.

In addition, to the extent provided in regulations, a taxable person would be allowed to elect to treat any of its divisions as a separate taxable person.

e. Treasury notification and regulations

The bill would require a taxable person to notify the Internal Revenue Service if certain events occur. These reportable events would include a change in the form of a business or any other change that may affect VAT liability, VAT credit, or VAT administration with respect to the business.

The bill would also authorize the Secretary of the Treasury to issue regulations to implement the VAT.

f. Other administrative issues

There are several other administrative issues raised by the bill that might also be considered. The bill would require the Internal Revenue Service to administer the VAT (because the VAT is added to the Internal Revenue Code). One important issue is the number of additional personnel necessary to administer the VAT. The Treasury Department estimated in 1984 that once fully implemented it would cost $700 million per year to administer a VAT.[42] For comparative purposes, the total budget of the IRS for fiscal 1984 was approximately $3.3 billion. Another issue is whether the administrative and judicial procedures currently contained in the Internal Revenue Code should be extended to the VAT.

The bill would be effective for transactions occurring after December 31, 1989. It is unclear how much time between enactment and the effective date the IRS would need to prepare itself and educate taxpayers concerning the VAT. It is possible that the IRS could require substantial lead time before it could properly begin administration of a VAT.

[42] *See* Treasury Report, p. 124.

IV. DESCRIPTION OF S. 659, S. 838, AND S. 849: ESTATE TAX INCLUSION RELATED TO VALUATION FREEZES

Present Law and Background

An estate freeze is a technique whereby an older generation seeks to cap the value of property at its present value and to pass any appreciation in the property to a younger generation. In doing so, the older generation retains income from, or control over the property.

To effect a freeze, the older generation transfers an interest in the property that is likely to appreciate while retaining an interest in the property that is not likely to appreciate. Because the value of the transferred interest increases while the value of the retained interest remains relatively constant, the older generation has "frozen" the value of the property in the estate.

In one common form, the preferred stock freeze, a person owning preferred stock and common stock in a corporation transfers the common stock to another person. Since common stock generally appreciates in value more than preferred stock, the transferor has "frozen" the value of his holdings in the corporation. Other freezes utilize partnerships, trusts, options and joint ownership in property.

Estate freezes present three possibilities for avoiding transfer tax. First, because split interests with differing appreciation rights are inherently difficult to value, their creation can be used as an opportunity for undervaluing gifts. Second, such interests involve the creation of rights that, if not exercised in an arms-length manner, may be used as a means of subsequently transferring wealth free of transfer tax. For example, wealth may pass from a preferred shareholder to a common shareholder if the corporation fails to pay dividends on the preferred stock. Or, by exercising conversion, liquidation, put or voting rights in other than an arm's length fashion (or by not exercising such rights before they lapse) the transferor may transfer part or all of the value of such rights. Third, the retention of a frozen interest may be used in order to retain enjoyment of the entire property. The transfer is, in reality, incomplete at the time of the initial transfer and, if the frozen interest is retained until death, the transfer is testamentary in nature.

In the Omnibus Budget Reconciliation Act of 1987, the Congress addressed the estate freeze transaction by including the value of the appreciating interest in the decedent's gross estate and crediting any gift tax previously paid (Code sec. 2036(c)). Such inclusion effectively treats the transfer as incomplete for transfer tax purposes until the freeze ceases. In the Technical and Miscellaneous Revenue Act of 1988, the Congress enacted safe harbors for the reention of debt and agreements to provide goods and services for air market value.

Explanation of the Bills

The bills (S. 659, S. 838, and S. 849)[43] would repeal the estate ax inclusion with respect to valuation freezes retroactively from he date of its enactment (i.e., property transferred after December 7, 1987).

[43] S. 659 (Senator Symms), S. 838 (Senator Heflin), and S. 849 (Senators Daschle, Heflin, B-en, and Symms).

V. DESCRIPTION OF S. 800: MORATORIUM ON CERTAIN STATE TAX LAWS

Present Law and Background

New York State adopted legislation in 1987, generally effecti for tax years beginning in 1988 (N.Y. Tax Law Art. 22, sec. 601(e that changed the formula used by noncorporate nonresidents wi New York-source income to compute their New York income taxe The legislation requires such nonresidents to pay income tax c their New York-source income based on the tax bracket they wou be in if all of their income (both New York and non-New Yor source) were New York-source. Prior to the legislation, such no residents' tax brackets were determined solely by reference to the New York-source income. New Jersey State legislators recently i troduced retaliatory legislation that would tax New Yorkers wh earn income in New Jersey at New York State tax rates, whic generally are higher than New Jersey tax rates.

Other States, including California, have similar methods of con puting income taxes of nonresidents with in-State income.

Federal tax law generally does not govern the State income ta ation of nonresidents.

Explanation of the Bill

Moratorium

S. 800, introduced by Senators Bradley, Lautenberg, Dodd ar Lieberman on April 13, 1989, would temporarily suspend the effe of the New York law described above, as well as any subseque similar New York legislation and any State legislation that is e acted in response to such New York legislation.

Study

The bill would establish an Interstate Taxation Commission study all such legislation, including consideration of appropria methods of determining the tax base, tax rates and allocation income, deductions and credits in the taxation of interstate incom and whether equitable and effective taxation of such income wou be best served by a Federal, regional or State formula. The Cor mission would be required to prepare and transmit a report on i study to the President and the Congress not later than 9 montl after the date the members of the Commission are appointed.

The Commission would be comprised of the Attorney General the United States (or his designee) and 3 members to be nominate by the President and confirmed by the Senate (1 each representin New York, New Jersey and Connecticut). The 3 nominees would b selected from a list of 6 individuals submitted to the President b each of the Governors of these States.

Effective Date

The moratorium period with respect to the State legislation described above would begin on January 1, 1988, and would end with any taxable year ending after the date which is one year after the date of the report to be prepared and transmitted by the Interstate Taxation Commission.