The AICPA's 10 Guiding Principles

Annette M. Nellen, San Jose State University
The AICPA’s 10 Guiding Principles

Any proposed changes to our tax system will require analysis to determine whether they conform to good tax policy. The AICPA has defined “good” tax policy in a Tax Policy Concept Statement that contains 10 guiding principles. This article applies the principles to actual examples of proposed tax-system modifications.

Should the Federal income tax be replaced with a consumption tax or additional savings incentives added to the income tax system? How should e-commerce be taxed? Should equipment depreciable lives be shortened to help stimulate investment? These and similar questions are often asked by legislators, economists, tax practitioners and taxpayers.

How should proposed changes be analyzed? The AICPA Tax Division’s Tax Legislation and Policy Committee (Committee) sought to answer this question. The Committee focused on analyzing fundamental tax-reform proposals (such as a flat tax and a national sales tax); it determined that the proposal debate was missing an analytical framework to determine whether the proposals incorporated principles of “good” tax policy.

The Committee created a framework to present the principles of a good tax system; it can be used both to analyze proposals and to modify them (if necessary), so that any changes will strengthen the tax system, rather than weaken it. It can also serve to identify and design improvements to the tax system (to better incorporate good tax policy principles). The framework can be used to analyze tax proposals of any size, degree and at any government level.

The framework outlined in AICPA Tax Policy Concept Statement No. 1 helps analyze proposed changes to existing tax rules. This article explains the framework’s 10 guiding principles of good tax policy, followed by examples applying the principles to analyze (1) the Armey flat tax, (2) a proposal to allow nonitemizing individuals a charitable deduction and (3) the application of sales and use taxes to e-commerce.

Ten Guiding Principles

Discussed below are the 10 principles of good tax policy (see Exhibit 1 on pg. 101). They are of equal importance and presented in no particular order (although the first four stem from Adam Smith’s tax policy maxims).

One: Equity and Fairness

This precept commands that similarly situated taxpayers be taxed similarly. “Equity” refers to both horizontal and vertical equity. Horizontal equity means that taxpayers with equal ability to pay should pay the same amount of tax; vertical equity means that taxpayers with a greater ability to pay should pay more tax. The framework does not resolve how much more tax people with higher incomes should pay; it merely serves to note the importance of the principle, not state how to achieve it. The definition and achievement of equity for a tax system is a matter of political, social and economic debate.

The presence of both horizontal and

---

Editor's note: Prof. Nellen chaired the AICPA Tax Division’s Fundamental Tax Reform Task Force, which produced the Tax Policy Concept Statement discussed in this article.

vertical equity in a tax system is thought to create fairness. However, “fair” means different things to different people. For example, some would view an income tax system as “fair” if there were few exclusions and deductions; others might view an income tax as fair if there were only one tax rate.

Equity is likely best measured by considering the range of taxes paid, not just by looking at a single tax.

Two: Certainty

Under this principle, tax rules should clearly specify when and how a tax is to be paid and how the amount to be paid will be determined. There is no certainty if taxpayers have difficulty measuring the tax base or determining a transaction's applicable tax rate or tax consequences. Certainty may be viewed as the level of confidence a person has that a tax is being calculated correctly. For example, if a taxpayer cannot determine whether (1) an expenditure should be capitalized or expensed or (2) a particular transaction will be subject to sales tax, certainty does not exist.

Three: Convenience of Payment

According to this principle, a tax should be due at a time or in a manner most likely to be convenient for the taxpayer. Convenience helps ensure compliance. The appropriate payment mechanism depends on the amount of the liability and ease or difficulty of collection. Discussion of this principle in designing a particular rule or tax system should focus on whether it is best to collect the tax from a manufacturer, wholesaler, retailer or customer, as well as collection frequency.

Four: Economy of Collection

This notion dictates that the costs to collect a tax should be kept to a minimum for both the government and taxpayers. It considers the number of revenue officers needed to administer a tax and taxpayer compliance costs. This principle is closely related to the next.

Five: Simplicity

According to this principle, the tax law should be simple, so that taxpayers can understand the rules and comply with them correctly and cost efficiently. Simplicity in a tax system reduces errors and increases respect for the system, thereby improving compliance. A simple tax system better enables taxpayers to understand the tax consequences of their actual and planned transactions.

Six: Neutrality

This precept mandates that the tax law's effect on a taxpayer’s decision as to whether or how to carry out a particular transaction be kept to a minimum. Neutrality stands for the proposition that taxpayers should not be unduly encouraged or discouraged from engaging in certain activities due to the tax law. The tax system's primary purpose is to raise revenue, not change behavior. Of course, a completely neutral tax system is not really possible. For example, an income tax could be said to discourage earning income. However, within the system, the neutrality principle would come into play in determining how to measure income or ability to pay.

Seven: Economic Growth and Efficiency

A tax system should not impede or reduce the economy’s productive capacity, but be aligned with the taxing jurisdiction’s economic goals (e.g., eco-
nomic growth, capital formation and international competitiveness). The system should not favor one industry or type of investment at the expense of others. For example, a jurisdiction would probably not design an income tax that imposes a 90% rate on the top 25% of income earners, as this would harm its economic growth.

The principle of economic growth and efficiency might seem to conflict with the neutrality principle, but this is not necessarily the case. The former principle just recognizes that rules to calculate the tax base and rate have economic effects. For example, if an income tax system calls for a 30-year depreciable life for semiconductor manufacturing equipment, the jurisdiction must recognize that such a rule would have an adverse effect on the cost of semiconductors and the location of semiconductor manufacturing companies.

Eight: Transparency and Visibility

Under this principle, taxpayers should know that a tax exists and how and when it is imposed on them and others.

Transparency and visibility in a tax system enable taxpayers to know (1) the true cost of transactions and (2) when a tax is being assessed or paid and on whom.

Nine: Minimum Tax Gap

This precept states that a tax should be structured to minimize noncompliance. The tax gap is the amount of tax owed less the amount collected. To minimize the tax gap, procedural rules are needed to attain compliance. Generally, a balance must exist between (1) the desired level of compliance and (2) the tax system’s costs of enforcement and level of intrusiveness.

Ten: Appropriate Government Revenues

Under this tenet, a tax system should enable the government to determine how much tax revenue will likely be collected and when. A tax system should have some level of predictability and reliability. Generally, a government realizes better stability with a mix of taxes. For example, in an economic downturn, unemployment would lead to reduced income tax collections. If the jurisdiction also imposed other taxes (e.g., property and/or sales tax less affected (or unaffected) by decreased employment), total government revenues would be less adversely affected than if the government relied solely on an income tax.

Using the Guiding Principles

There are various challenges to incorporating the principles of good tax policy into current tax systems. The simplicity and neutrality principles are frequently challenged at both the Federal and state levels, as new rules are added to create special deductions, exemptions and tax credits. The frequency of changes also challenges the certainty and simplicity principles.

Realistically, no tax principles can be achieved to the same degree for all proposed changes; instead, a balance needs to be struck to achieve an optimal system. Consideration and discussion of how the guiding principles shape the tax system (and whether a particular proposal incorporates the principles and can be modified to better reflect them) should help in ensuring that the tax system reflects good tax policy.

Following are three examples of how the principles can be used to analyze proposals. The examples represent varying degrees of change at the Federal, state or local levels. The following analysis illustrates operation of each principle and how improvement might be warranted or issues further investigated.

Example 1: The Armey Flat Tax

\textbf{Facts:} In each of the past several Congresses, Congressman Dick Armey (R-TX) introduced a "flat tax" to replace the Federal income, estate and gift taxes. The current version of his proposal is HR 1040.\(^4\) The flat tax is designed as a consumption tax (with an interesting twist on the subtraction-method valued-added tax (VAT) to address the perceived regressivity of a consumption tax). Under a subtraction-method VAT, businesses calculate VAT using a formula much like the current formula for taxable income. However, no deduction is allowed for the value added by the business in the form of wages. Interest expense is nontaxable and interest income is nontaxable. The Armey flat tax allows businesses to deduct wages (but not fringe benefits or payroll taxes), then taxes the wages to individuals in a system calling for large personal and dependency exemptions.

HR 1040 provides that the tax base for individuals includes cash wages for services performed in the U.S., retirement distributions, unemployment compensation and taxable income of each dependent child under age 14 (such child would have no filing obligation). Investment income and Social Security benefits are not taxable. This tax base would be reduced by a standard deduction based on filing status and number of dependents. All tax credits (including the earned income and child credits) would be eliminated; the alternative minimum tax (AMT) would be repealed.

For the first two years, the tax rate would be 19%, later dropping to 17%.

HR 1040 calls for all businesses (corporations, partnerships, etc.) to be taxed in the same manner. The tax base would equal gross active income less deductions for cash wages for services performed in the U.S., retirement plan contributions, amounts paid for property sold or used in a business, amounts paid for nonemployee services and excise, sales and customs taxes imposed on deductible purchases. "Gross active income" refers to gross receipts from the sale or exchange of property or services in the U.S., plus gross receipts from the export of property or services from the U.S. Thus, the Armey flat tax is an origin-based tax (goods and services are taxed where the


value is produced). No deductions are allowed for fringe benefits, interest expense, state and local taxes or payments to owners. Sales proceeds of previously expensed assets would be included in gross active income. As with individuals, the tax rate is 19% for the first two years, dropping to 17% thereafter. All tax credits (such as the research tax credit) would be eliminated and the AMT repealed. A business with a loss would convert it into the equivalent of a credit to be used in future tax years. The excess loss would be increased by an interest factor before conversion.

Applying the Guiding Principles

**Equity and fairness:** With a large personal and dependency exemption, vertical equity is achieved, but not to the same extent as with a progressive rate structure. Also, with almost all deductions and credits eliminated, horizontal equity would be better achieved. While economically, all income is taxed, it will be difficult to convince most individuals that investment income is taxed the same as earned income when only earned income is reported on a tax return. Thus, it will generally not be apparent that horizontal equity is achieved.

**Certainty:** The tax on individuals is quite clear, as only three types of income are subject to tax (and a Form W-2 or 1099 would likely be issued for each). For businesses (including sole proprietors and landlords), the calculation probably will not be any more uncertain than under the current income tax rules.

**Convenience of payment:** Assuming wage and pension withholding remains, the flat tax should satisfy this principle (at least for most individuals).

**Economy of collection:** The simpler personal tax calculations involved with the flat tax should reduce costs for both the government and individuals. Businesses (including landlords and sole proprietors) will still have record-keeping requirements, but overall, the tax calculations will be simpler than under the current income tax system.

**Simplicity:** For nonbusiness individuals, the flat tax will be easier than the current income tax, because all credits are eliminated, as are most deductions. Also, only three types of income are reportable and taxpayers receive Forms W-2 and 1099 with the necessary information. Businesses will no longer have inventory or depreciation calculations. Some complexity would exist, in that wage earners who also have business income would need to file multiple returns. In addition, it may be difficult to distinguish nontaxable investment activity from taxable business activity (for example, when does an art collector become an art dealer?).

**Neutrality:** With most deductions and credits eliminated, neutrality is likely better achieved than under our current Federal income tax system. However, the system’s structure may affect some business decisions. For example, independent contractors will appear to be a more optimal tax deduction than employees, because payroll taxes and employee benefits are not deductible by a business. Also, financing decisions will likely be affected by the nondeductibility of interest expense.

**Economic growth and efficiency:** The flat tax is a consumption tax; proponents suggest that it will improve savings rates. A zero direct-capital-gain tax and an exclusion for interest income should improve capital investment. However, taxpayers with high levels of debt at the transition date and significant assets will suffer a decline in asset value and increased financing costs. Application of generally accepted accounting principles to the new tax may affect stock values. As for international taxation, the flat tax is origin-based, not border-adjustable. The economic effects (if any) of this approach need to be considered.

**Transparency and visibility:** Proponents argue that the flat tax is more transparent than the current income tax, because there are fewer deductions and no credits. However, it will likely be difficult for taxpayers to understand indirect taxes (such as corporate tax paid on earnings before distributions to shareholders).

**Minimum tax gap:** Proponents suggest that a lower rate will improve compliance.

**Appropriate government revenues:** Meeting this principle depends on several factors, which will likely be difficult to determine due to the significance of the proposed change. For example, what should the tax rate be for HR 1040 to be revenue-neutral? How will expected changes in savings and consumption affect the determination of a revenue-neutral rate? Today, many states base their income tax system on the Federal one. If the Federal income tax were replaced with a consumption tax, many states would also likely change to conform. Most states would then have two consumption taxes (the flat tax and state sales tax), which might not be a good mix for the state’s revenue stability and predictability.

**Example 2:** Charitable Deduction for Nonitemizers

**Facts:** HR 777 would allow individuals who do not itemize deductions to claim a charitable deduction that does not exceed the standard deduction.

**Applying the Guiding Principles**

**Equity and fairness:** The analysis should consider how to measure ability to pay in determining whether taxpayers are similarly situated. Is a person who makes a $500 contribution and claims the standard deduction similar to one who makes the same contribution and has other itemized deductions? Arguably, the answer is

---

“no” if the standard deduction is intended to be a substitute for claiming itemized deductions.

The fairness aspect also leads to a question: should an extra deduction for interest (or some other expense) be allowed for individuals claiming the standard deduction? Would equity and fairness be better met by just increasing the standard deduction?

Certainty: The proposal would increase taxpayers' recordkeeping burdens and require individuals who do not itemize to familiarize themselves with the charitable deduction rules.

Convenience of payment: The proposal raises no issue.

Economy of collection: The proposal could lead to increased audit work but, given the current low audit rates, that is unlikely. There will be some additional compliance costs for individuals who do not itemize, but it is unlikely to be significant.

Simplicity: This proposal is not as simple as the standard deduction alone. Individuals who do not itemize will have additional recordkeeping burdens and need to know the basic charitable-deduction rules.

Neutrality: The proposal may affect a person's decision as to how to spend, with an added incentive to donate to a charitable organization. Thus, the proposal is not neutral, because it may affect decisionmaking.

Economic growth and efficiency: The proposal may lead to an increase in donations to charitable organizations. The effect on the economy is difficult to measure, because some of the donated funds would otherwise have been spent for other purposes.

Transparency and visibility: The proposal raises no issue.

Minimum tax gap: The proposal could lead to some taxpayers claiming deductions for donations not actually made because there is no substantiation requirement for donations under $250 or rule that donations must be made by check or credit card.

Appropriate government revenues: The proposal raises no issue, because the revenue effect can be reasonably estimated.

Example 3: Applying Sales and Use Taxes to E-Commerce

Facts: Much of the discussion about e-commerce taxation has focused on sales and use taxes. The debate ranges from exempting all e-commerce transactions from sales and use taxes to having Congress, in effect, reverse Quill Corp.6 to allow states to collect sales and use taxes from remote vendors. The following analysis uses the guiding principles of good tax policy to help identify the significant issues involved in determining how to apply sales and use taxes to e-commerce.

Applying the Guiding Principles

Equity and fairness: Vendors selling goods and services online should be treated similarly to "Main Street" vendors selling the same goods and services and vice versa. While the sales and use tax is imposed on the buyer, rather than the seller, the compliance burden and price competition make this a significant tax for vendors. Certainly, the compliance costs are greater for vendors with customers and taxable presence (nexus) in many states, because of the varying sales tax rules among the states (and even some cities).

Equity dictates that similarly situated taxpayers be taxed similarly. This principle could be interpreted to mean that all vendors have to collect sales tax (assuming the customer resides in a jurisdiction that imposes sales tax). However, is a multistate vendor similarly situated to a "Main Street" vendor with a single location? For example, assume vendors are required to collect sales tax from all customers, even in states in which a vendor has no physical presence. A Main Street retailer with a store in San Jose, California, would have much lower compliance costs than an online vendor also located only in San Jose, but who sells to customers in all states. The online vendor would need to determine where all of its customers live and charge applicable sales tax. (In contrast, under current sales tax laws, a Main Street vendor can charge the San Jose rate only to all customers who come into the store, on the presumption that consumption occurs at the sale site).

Thus, arguments of "leveling the playing field" for Main Street and Internet vendors must consider the added compliance burden for vendors required to collect tax based on their customers' location. While the prices charged by multistate and Main Street retailers would be the same if both are required to collect sales tax, the playing field is not level if the online vendor has greater compliance costs. Arguably, equity and fairness between Main Street and online vendors require balancing of these costs, as well as the sales tax charged. The equity and fairness principle might be achieved by, for example, (1) requiring a Main Street retailer to charge sales tax based on where customers live (increasing complexity); (2) allowing an online vendor to charge sales tax for the vendor's jurisdiction to all customers, regardless of where they live (origin approach); (3) providing compensation to an online vendor for the extra compliance costs; or (4) providing a mechanism (such as a government-funded third-party collector) to handle the online vendor's compliance activities. Each potential remedy presents additional issues.

Certainty: Today, with over 6,000 jurisdictions able to assess sales tax and a lack of uniformity in (and frequent changes to) the rules, multistate vendors face uncertainty. Improvement is needed, such as by streamlining the rules among jurisdictions or replacing the individual state and local sales taxes with a Federal tax to be distributed back to the states. Again, consideration of the guiding principle helps to identify areas of further analysis and discus-

---


Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.
The framework outlined in the AICPA’s Tax Policy Concept Statement helps analyze proposed changes to existing tax rules.

Convenience of payment: This principle is mostly met by current sales tax rules, which tend to require periodic filing and payment after a sale.

Economy of collection: The costs of complying with sales taxes are quite significant for multistate vendors, due to the large number of taxing jurisdictions and lack of uniformity in the rules.

Simplicity: For multistate vendors, sales taxes fail to satisfy the simplicity principle. The multiple definitions, rules, registration procedures, exemptions, rates and filing and audit procedures are complex. Some of the improvements suggested to simplify the sales tax system include uniformity of rules and procedures, better use of technology to compute and collect the tax, use of a third party to compute and remit the tax or use of a Federal tax to replace state sales taxes.

Neutrality: The sales tax law is not neutral as to e-commerce for either vendors or customers. Sales tax has played a part in location and form-of-operation decisions for some vendors. For example, one reason Amazon.com did not locate in California is because it expected to have many customers there and did not want to have to charge sales tax. Also, as noted in Peter Lowy’s testimony for the E-Fairness Coalition before a congressional committee on Internet taxation, some brick-and-mortar vendors established separate subsidiaries for their online sales to reduce the number of states in which the online entity would have a physical presence (and thus, a sales-tax-collection obligation). The sales tax has played a role in taxpayer location and form-of-operation decisions and is not neutral.

Because remote (i.e., nonpresent) vendors are not required currently to collect sales and use taxes, a customer’s decision as to how and where to purchase goods and services may be affected. For example, a customer may decide to purchase a computer online to avoid sales tax from a Main Street vendor. Also, in a few states (e.g., California), software transferred online is not subject to sales tax, while its tangible counterpart (i.e., software sold on a tangible medium) is. Thus, the sales tax law is not neutral, in that it can play a role in a customer’s decision of how and where to purchase certain products.

Simplification and some uniformity in sales tax rules are complex. Some suggestions as to how to make the system more neutral include: require sales tax to be charged by remote vendors; enforce use tax rules (customers making taxable purchases from remote vendors are required to remit use tax, although state enforcement and educational efforts are weak); exempt all digitized items from sales tax (along with their tangible counterparts); or tax all products, regardless of how transferred.

Economic growth and efficiency: Proponents of not taxing online sales may use the principle of economic growth and efficiency by arguing that taxation will impede Internet growth and be detrimental to the taxing jurisdiction’s economy. However, many people believe that the Internet is growing regardless of current tax rules.

The Commerce Department reported that e-commerce sales increased 33.5% in first-quarter 2001 over first-quarter 2000. In early 1998, prior to the enactment of the Internet Tax Freedom Act, the number of Internet hosts was growing at a rate of 40% to 50% annually. While some studies have found that taxation of online shopping will reduce such activity, the issue is not as simple as arguing that taxes should be avoided. Today, online purchases are subject to sales and use tax in all states that impose a sales tax. However, the states’ ability to collect use tax on remote online sales is quite low.

Transparency and visibility: Sales and use taxes are visible because they are shown on a customer’s invoice. Even invoices prepared at Internet sites will show any sales tax charged. However, many consumers may not know that sales tax exists in particular transactions. For example, many consumers not charged sales tax on online sales may believe the sale is exempt; in reality, the consumer likely needs to self-access use tax. Also, customers likely do not know all items to which sales tax applies. For example, does it apply to “free” items obtained from online vendors or to shipping charges?

Simplification and some uniformity in the state sales tax systems should help meet this principle.

Minimum tax gap: Use tax generates a tax gap, because few consumers (and even some businesses) are aware of its existence or relationship to sales tax. While some states have made efforts to inform residents about such tax (such as by adding a line on the

8 See Testimony of Peter Lowy (3/14/01), at www.senate.gov/~commerce/hearings/0314low.pdf.
9 See Dept. of Commerce, “Retail E-Commerce Sales in Second Quarter 2001 were $7.5 Billion, Up 24.7 Percent” (5/16/01), at www.census.gov/mrts/www/current.html.
personal income tax form), compliance rates are very low; many such tax dollars go uncollected. This issue becomes more widespread under the e-commerce model, because it enables vendors to make multistate sales despite having few physical locations (and thus, having fewer sales-tax-collection obligations).

Possible improvements include having state tax agencies educate consumers about the use tax and simplifying compliance, simplifying sales tax systems so that states could collect use tax from remote vendors or replacing sales tax with another type of consumption tax. The Internet not only makes it easier to purchase items from a vendor in another state, but also in another country. While Congress could require a remote vendor to collect a state's sales tax, it will be far more difficult (if not impossible) to get a vendor in a foreign country to collect a state's sales tax. Thus, if the tax is to be collected, states will need to get consumers to voluntarily comply or exempt foreign sales, violating neutrality. Discussion of the minimum-tax-gap principle might also lead to consideration of alternative consumption taxes to the sales tax. For example, a consumption tax could be based on the formula income minus savings. Of course, this would also involve extra recordkeeping and broaden the current tax base (as it would tax all consumption, rather than just tangible personal property).

**Appropriate government revenues:** Less than one percent of retail sales today are online sales; thus, the amount of lost use tax is still small. The potential growth of e-commerce poses the greatest use tax loss for state and local governments. This growth will adversely affect governments’ predictability and reliability in determining expected tax revenues. Also, the states that do not tax products transferred electronically will experience a decline in tax base as more and more items are transferred digitally.

**Conclusion**

The AICPA Tax Division has distributed its report on the 10 Guiding Principles to Federal and state legislators, to encourage policymakers to consider them for any tax law change, whether major or minor. Incorporating the principles into analysis and debate about any tax law change should better ensure an effective tax system based on good tax policy.