Cashing In or Cashing Out?

THE FAIR TAX ACT OF 1999

*Bruce W. Bennett**

I. INTRODUCTION

"Taxes are what we pay for civilized society...." [1]

With those famous words the venerable Justice Oliver Wendell Holmes recognized we could not exist in a safe, orderly and competitive nation without taxing the populace. The debate over raising revenue has sparked more than a century of controversy; now, with Presidential election campaigns in full swing, it's time again to renew the debate over tax reform. But what exactly is tax reform? Many confuse it with tax reduction or discuss it in the context of fiscal budgeting; however, it is more aptly described as overhauling or replacing the current tax system.[2]

Today there are at least five major tax proposals emerging from various political and special interest organizations.[3] However, each is merely a different rendition of two possible economic theories.[4] The first theory suggests taxes should be based on one's income and accumulated assets, while the second theory purports that savings, investment and international competitiveness will be boosted if taxes are collected from the consumption of goods and services.[5]

---

*Bruce W. Bennett CPA, JD, graduated from The John Marshall School of Law in 2000.

1. Compañía General de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

2. *See* Michael A. Leopold, *The Tax Reform Debate*, NAT'L B. ASS'N. MAG., Jan.-Feb. 10, 1996 at 26.

3. The five primary tax proposals are as follows: (1) The National Retail Sales Tax (e.g., the Fair Tax Act of 1999); (2) The Value-Added Tax (VAT); (3) The Flat Tax; (4) The Cash Flow Tax (e.g., the USA Tax); and (5) The Pure Income Tax. Other plans may vary slightly; however, the basic tenets of the other proposals fit into one of the above categories. For example, certain consumption-based plans tax goods and services while others tax only goods. Also, VAT plans may calculate the base differently by using either the credit-invoice or subtraction-method approach. The National Retail Sales Tax and VAT proposals are consumption-based, the Pure Income Tax is income-based and the Cash Flow Tax is a hybrid consumption/income tax-based system.

4. *See* William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

5. *See* Leopold, *supra* note 2, at 26.

Herein exists a long-running debate over whether our tax system should be regressive or progressive. However, the issues are not clearly defined. For example, a consumption tax, which is naturally regressive since all income earners are taxed the same, can be made progressive by exempting daily necessities or offering scaled cash rebates according to one's income level. Thus, a person with lower income is given a higher rebate than is one with higher earnings. Conversely, our current system, which taxes higher incomes at higher rates, can be made regressive by lowering accumulation taxes such as the capital gains. In addition, the present system incorporates regressive components like flat rate payroll taxes. Both theories include progressive and regressive features, complicating the debate and often suffusing it in political rhetoric.

Tax reform is complex, and tax planning and compliance trouble many taxpayers. The current system is burdensome, frustrating and confusing. The Internal Revenue Code consists of over 5.5 million words and continues to grow each legislative session.[6] Countless regulations, rulings, forms and judicial decisions augment the problem and politicians demonize tax laws to their political advantage.[7] Each year, businesses spend 3.4 billion and individuals 1.7 billion hours simply complying with the tax code, which is the equivalent to a staff of three million people working full-time, year-round, just on taxes.[8] Ignoring such frustrations is ill-advised, considering it was King George III's 1773 Tea Act Tax that ignited the Revolutionary War.[9]

Despite the difficulties associated with tax reform, it is encouraging that these issues are back in the national headlines. Whether the present system is reformed or a new one installed, any individual who has family, works or owns property should listen critically to tax reform debates.

II. PURPOSE AND SCOPE OF THE ARTICLE

The purpose of this article is to study the economic and political impact of the Fair Tax Act of 1999 ("FTA") and examine issues pertaining to its implementation and execution.[10] The FTA is a national retail sales tax and variant of prior sales tax proposals. Its bipartisan support in Congress and supporters, grass-roots efforts have recently grabbed the national spotlight and thrust it onto the political canvass.[11]

The article's scope encompasses a discussion of the major provisions of the FTA. It is examined under macro- and micro-economic models and attempts to integrate the political realities of enacting tax reform. Although constitutional issues are often gleamed over by scholars in the context of tax policy administration, this article considers the

6. Nat'l. Fed'n. of Indep. Bus., *Campaign for Responsible Tax Reform: Why Sunset the Tax Code?* (visited Nov. 1, 1999) <http://www.nfibonline.com/policy/take_action/abolish_code/background.htm>.

7. Republican Presidential Candidate Steve Forbes makes his Flat Tax proposal the centerpiece of his year 2000 election campaign.

8. Nat'l. Fed'n. of Indep. Bus., *supra* note 6.

9. *See* Tax Analysts, *1756-1776: The Seven Years War to the American Revolution* (visited Oct. 27, 1999) <http://www.tax.org/museum/1756-1776.htm>.

10. Fair Tax Act of 1999, H.R. 2525, 106th Cong. (1999).

11. *See id.* John Linder (R-GA) and Colin Peterson (D-MN) co-sponsor the Fair Tax Act of 1999. The bill was introduced to the House of Representatives and referred to the Committee on Ways and Means on July 14, 1999.

constitutional ramifications of direct and indirect taxation by a consumption-based system.[12] However, it does not provide an in-depth comparison to contemporary proposals.

For many Americans, tax reform is a complex and often unintelligible issue. The news media often oversimplifies the issues and focuses rather on budgets or tax reduction initiatives. But, advocates of the FTA are well organized and continue to garner national attention.[13] For these reasons, a deeper understanding of the FTA is helpful to effectively compare its advantages and disadvantages to competing tax systems.

A. Historical Context of the U.S. Tax System

The roots of the U.S. tax system are traceable to the French and Indian War that ended with a British victory in 1763. At the Treaty of Paris, the British were granted control over the Atlantic shipping lanes and North American continent east of the Mississippi River. However, the war lasted seven years and burdened the British Empire with enormous debt that it attempted to collect from the colonies. The resulting disputes between the English Crown and colonies over apportionment of debt eventually gave rise to duties and excise taxes, which later ignited the Revolutionary War. [14]

After the war, the Americans' disdain for taxes and levies remained great.[15] The government operated on revenues from tariffs, import duties and excise taxes from the sale of goods and services. The first income tax was suggested during the War of 1812 and was based on the progressive British Tax Act of 1798; however, it was never enacted. In 1861, nearly fifty years later, a second income tax was proposed and again failed. But, on July 1, 1862, President Lincoln signed the Tax Act of 1862, giving the nation its first progressive income tax, which became the precursor to our present system. The rates were 3% on income above $600 and 5% on incomes above $10,000, with exemptions for property owners who received rental income. Although compliance was low and the tax was allowed to expire in 1872, it marked a historical moment in our nation's fiscal policy.[16]

In addition to existing revenue sources, the federal inheritance tax was imposed in 1862 to fund the Civil War. In 1898, the federal estate tax was enacted to support the Spanish-American War. [17]

From 1872 to 1913, the federal government relied primarily on revenues raised from tariffs and excise taxes to fund activities. Meanwhile, state and local government revenue was derived from property and excise taxes.[18] In 1894, the Supreme Court issued a

---

12. Erik M. Jensen, *The Apportionment of "Direct Taxes": Are Consumption Taxes Constitutional?*, 97 COLUM. L. REV. 2334, 2339-2345, 2405-2407 (1997).

13. The Americans for Fair Taxation is the primary political organization promoting the bill. Their website may be accessed at <http://www.fairtax.org>.

14. A History of Taxation, (visited November 2, 1999) <http://www.taxworld.org/History/ TaxHistory.htm>.

15. *See id.* The Whiskey Rebellion was in response to settlers' frustration over whiskey taxes that eventually led to rioting against tax collectors. President Washington was forced to send in troops to quell the rebellion.

16. *See* <www.tax.org/museum/1861-1865.htm>.

17. *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, 105TH CONG., 2D SESS., PRESENT LAW AND BACKGROUND RELATING TO ESTATE AND GIFT TAXES 8 (Comm. Print 1998).

18. *See* Alan Schenk, *Radical Tax Reform For The 21st Century: The Role For A Consumption Tax*, 2 CHAP. L. REV. 133, 134 (1999).

landmark decision in *Pollock v. Farmer's Loan & Trust Company*[19], declaring the income tax unconstitutional.[20] The Court examined the sources for the tax and reasoning behind the Direct Tax Clause,[21] which was inserted into the Constitution by the Founding Fathers at the Second Constitutional Convention. First, the Court reasoned that because direct taxes had to be apportioned among the states and land taxes were direct, the revenue derived from land was direct.[22] In essence, the Court made no distinction between real and personal property and held that income from any property must be apportioned. Second, the Court held Congress could not tax revenue from state and municipal bonds, because doing so violated the principle of federalism, which denies the federal government power to tax instrumentalities of the state.[23]

In 1913, the Sixteenth Amendment was passed authorizing Congress to tax the citizenry on income from whatever source derived.[24] Fifty-one years later, the Twenty-fourth Amendment outlawed poll taxes as prerequisites to voting in federal elections.[25] The Supreme Court extended this provision to state elections in 1965.[26] From 1916 to 1999, federal tax laws changed in response to wars, shifts in social policies[27] and tremendous economic growth caused by the emerging industrial revolution.[28] Clever tax strategists, using sophisticated planning techniques, further compounded the need for additional legislation.

From 1947 to 1997, federal spending as a percent of Gross Domestic Product increased from 14.4% to 21.1%, while receipts only increased from 17.3% to 20.8%.[29] As pressure to generate revenue rose, issues relative to tax reform surfaced and critical attention focused on the mechanics for raising funds.

B. Consumption Versus Income Tax-Based Approach

As with any complex issue, there are favorable and unfavorable characteristics to be considered. Proponents of income tax-based systems hail the progressiveness of a tiered-rate, pay-what-you-can-afford system, whereas advocates of cash flow and consumption-based systems espouse their program's theoretically possible macro-economic benefits.

Tax systems typically have multiple goals. For example, in addition to raising reve-

19. Pollock v. Farmer's Loan & Trust Co., 158 U.S. 601 (1895).
20. *See id.*
21. U.S. CONST. art. I, § 2, cl. 3.
22. *See* 158 U.S. at 618.
23. *See id.* at 666.
24. U.S. CONST. amend. XVI.
25. U.S. CONST. amend. XXIV.
26. Harman v. Forssenius, 380 U.S. 528 (1965).
27. *See, e.g.*, Social Security Act of 1935, Pub. L. No. 271, 49 Stat. 327 (codified as amended at 42 U.S.C. 1395 (1994)). The Social Security Act was passed in 1935 providing the public with old age and disability benefits, and substantially amended in 1965 to provide for Medicare coverage. Taxes for these programs are levied separately on businesses and individuals and deposited into the Social Security trust funds.
28. U.S. DEPARTMENT OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS, ANNUAL GROSS DOMESTIC PRODUCT, REP. 1959.1 (1999). GDP has grown in seasonably adjusted dollars from $237.4 Billion in 1947 to $8254.5 billion in 1997.
29. *See id.*

nue, they seek to redistribute income, stabilize the economy and encourage other economic and social agendas. However, as the number of goals increase, the system itself becomes more complex and less equitable.

The Internal Revenue Code was reconstituted and republished in 1986.[30] A significant part of this effort resulted in an alternative minimum income tax that plugged loopholes and trimmed passive loss deductions.[31] Although Congressional actions were well intended, the result was a more complex and arguably less fair system.

Today, revenue is a predictable short-term variable in the economic "accretion" model. This model holds that taxable income is equal to the sum of personal consumption (spending) plus accumulation (saving) without regard to distinctions between sources and uses of funds.[32] It is used by economists in determining relationships between fiscal and monetary policies and the impact these relationships have on the economy. Business cycle effects on revenue streams are more predictable in income-based models because consumption patterns are more elastic during economic swings.[33] Moreover, the effects of administrative decisions, judicial interpretations and legislative enactments aimed at engineering social behavior have been explored and tested within the current economic framework.

Our system is predicated on one's ability to pay and is hence progressive by design. In theory, individuals and firms receiving greater incomes consume a greater portion of public services and should therefore pay higher rates. It also redistributes income, attempts to encourage certain behavior and implements social agendas. These multiple objectives sometimes conflict and create unintended results or entitlements that are difficult to change or retract. For example, the earned income tax credit was enacted by Congress to reduce employment. However, the system was poorly designed since unscrupulous wage earners gained additional deductions by adding fraudulent Social Security numbers to their tax return.[34] Underground markets selling bogus Social Security numbers emerged, and in 1995, the I.R.S. identified over 4.6 million returns that listed improper dependents.[35]

The current system also requires wage and investment earners to reconcile current tax liabilities with the government each year. By "settling up" this way, taxpayers are more likely to be cognizant of the government's burden and involved in the political process.

An income tax system involves the government in matters taxpayers consider personal and confidential since income and investments are taxed. Information regarding taxpayers' address, income level, retirement savings, medical savings and other deductions is captured and stored by various agencies. Business and personal expenditures may be audited and third-party information subpoenaed. Moreover, tax evasion and

30. The Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 19 U.S.C., 26 U.S.C., 29 U.S.C., 42 U.S.C.) which replaced the 1954 code, was the most sweeping federal tax legislation since World War II.

31. 26 U.S.C. § 55 (1994 & Supp. IV 1998).

32. *See* Andrews, *supra* note 4, at 1114.

33. Staff of the Joint Economic Committee, 104th Cong., Consequences of Replacing Federal Taxes With a Sales Tax (1996).

34. Letter from James R. White, Associate Director, Tax Policy and Administration Issues, Internal Revenue Service,to The Honorable William V. Roth, Jr., Chairman, Committee on Finance, U.S. Senate (Sept. 18, 1996) (on file with the General Accounting Office).

35. *See id.*

collection costs shot up to over $100 billion , or 6% of net tax revenues.[36]

In addition, the federal income tax system is not synergistic with state income or sales tax systems. Each state has its own unique set of exemptions, deductions, credits and phase-outs that differ from the federal system. A consumption tax might eliminate some of these differences initially, but over time, state and federal legislatures may adopt changes that eventually lead to more complexity.

Consumption advocates claim a national retail sales tax can simply piggyback onto existing state computer administration systems. However, seven states do not have a sales tax and many others require significantly greater resources to interface with federal authorities.[37] If the FTA abolishes the IRS, another collection system is needed to perform essentially the same functions. However, once a transition to a consumption tax collection process is complete, the FTA may be less difficult to administer than if it existed as a separate, stand-alone system.

Sales taxes encourage savings by taxing consumption, whereas income taxes discourage savings by taxing income when earned or recognized. As national savings rates increase under a consumption tax system, the potential for economic growth increases and tax rates may be theoretically lowered if contravening political pressures are ignored.[38] Also, sales taxes eliminate the need to differentiate between ordinary and capital gains income.

Finally, a tiered-rate income tax is progressive since taxpayers are taxed based on the amount of taxable income. But consumption tax advocates disagree, claiming rebates and exemptions offset their system's natural regressiveness.[39] For example, food and medicine may be exempted, rebates could be issued to families according to family size, or different products or services could be taxed at different rates. Thus, a consumption system may be constructed progressively through the use of additional exemptions or credits.

The present tax system is actually a hybrid consumption/income tax system and has become more consumption-based over the past twenty years. Individual retirement accounts and employer-sponsored retirement plans have grown exponentially.[40] These investment vehicles allow taxpayers to escape current taxes and defer income recogni-

36. James L. Payne, COSTLY RETURNS: THE BURDENS OF THE U.S.TAX SYSTEM (1993).

37. STAFF OF THE JOINT COMMITTEE ON TAXATION, 104TH CONG., IMPACT ON STATE AND LOCAL GOVERNMENTS AND TAX-EXEMPT ORGANIZATIONS OF REPLACING THE FEDERAL INCOME TAX (1996). The seven states without a sales tax are: Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming.

38. David R. Burton & Dan R. Mastromarco, *Emancipating America From The Income Tax: How A National Sales Tax Would Work*, CATO Policy Analysis No. 272 (April 15, 1997) <http:/www.cato.org//pubs/pas/pa-272.html>. The authors cite Harvard economist Dale Jorgenson's prediction that GDP would increase by 13% initially before leveling off to 9%. They also note a study by Boston University Economist Lawrence Kotlikoff who predicts a 7% to 14% increase in the national output within 20 years, with about half occurring in the first two years. The authors estimate that because of these factors, the consumption tax rate could decline to 10% to 12% while remaining revenue neutral.

39. Gilbert E. Metcalf, THE NATIONAL SALES TAX: WHO BEARS THE BURDEN? (1997).

40. Kevin L. Kliesen, *Federal Reserve Bank of St. Louis, Enhancing Future Retirement Income through 401(k)s*, REGIONAL ECONOMIST Oct. 1998 at 8. In 1994, 401(k) plans accounted for nearly two-thirds of all assets in deferred compensation plans. In addition, total 401(k) assets alone increased from $92 billion dollars in 1984 to approximately $1.5 trillion dollars in 1998.

tion until funds are withdrawn. Taxes on fuels, tobacco, liquor and many other products are consumption based. Annuities, certain life insurance policies and municipal bonds provide permanent or temporary income deferral. While the convergence of these systems has muddled their differences, they are far from similar. Until more quantitative studies are conducted, assumptions about their respective advantages or disadvantages should be analyzed with a healthy dose of skepticism.

1. Economic Considerations

Can a change in tax policy really affect prosperity? Before answering, it may be helpful to understand how savings, investment and consumption work together in a macroeconomic environment.

Prosperity is often defined in terms of growth of real wages. Real wages increase when labor productivity increases, and labor productivity increases when national output increases.[41] Finally, national output increases when either savings or labor increase, therefore, savings increases drive real wages and prosperity up.

Many economists are alarmed over the steady drop in personal savings rates from stable historical levels of 7%-10% to less than 2% in September 1999.[42] These savings are converted into capital and used to purchase equipment, technology and real estate, which together create higher wages and better jobs. Since the FTA taxes consumption, its supporters claim savings rates will rise because of a direct incentive to save and spend less to avoid taxes. While the present system encourages spending and thereby depletes capital (savings) reserves, income tax supporters claim the consumption assertions are overstated since current savings incentives exist in the form of capital gain deferrals, pensions and individual retirement accounts.

Consumption model supporters further suggest their system reduces compliance costs by 90% since individuals no longer file.[43] They claim current tax collection efforts cost over $159 billion annually and compliance expenditures range from 20% to 50% of revenues or 4.1% of GDP.[44] Recently, in testimony before the House Ways and Means Committee, the chief tax accountant for Mobile Oil stated that the company spent fifty-seven man-years and $10 million just to prepare one year's tax return.[45] But the difficulty lies in accurately estimating the savings by switching to a new system.[46] For example, while additional costs are necessary to set-up and staff fifty state administrative bodies, these costs may (or may not) be offset by efficiency savings created from the elimination of personal income tax returns.[47]

There were ten million non-filers in 1990 and a voluntary compliance rate of 83-

41. National output is measured by dividing the sum of savings plus labor by each unit of labor.

42. *See* News Release, Bureau of Economic Analysis, Monthly Personal Annual Savings Rate (1999), at <http://www.bea.doc.gov/bea/newsreel/pio999.htm>.

43. *See* Burton, *supra* note 38 (citing Arthur Hall, *Compliance Costs of Alternative Tax Systems,* Tax Foundation Special report, (June 1995)).

44. *See id.*

45. S. Rep. No. 104-200, at 7 (1995).

46. Dan Sheviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 920 n.87 (1992); Joel Slemrod & Nikki Sorum, *The Compliance Costs of the U.S. Individual Tax Systems*, 37 NAT'L TAX J. 461 (1984) (estimating taxpayers spent $3 to $3.4 billion).

47. *See* Fair Tax Act of 1999, H.R.2525, 106th Cong. § 103(a).

85%.[48] Each percentage point of noncompliance costs taxpayers more than $7 billion.[49] In addition, of the $214 billion in unpaid assessments as of September 30, 1997, only 13% have any realistic chance for collection.[50] Since the FTA removes the issue of voluntary compliance from most individual taxpayers, lost revenue from non-filers should decrease.

Other economic transitioning problems may also prove difficult to administer. For example, the elderly might bear a greater burden in a switch to a consumption tax. Since tax is currently paid when income is recognized, previously taxed savings are subjected to double taxation when funds are withdrawn and consumption taxes paid. A system of tax credits is appropriate to mitigate this burden; however, these credits are likely to have a negative impact on the nation's savings rate. If the government borrows money to fund the credits, interest rates could increase and stock prices tumble as available money supplies tighten. The FTA provides no mechanism for managing these issues and instead relies on a theoretical assumption that prices will fall both proportionately and timely since current prices include built-in income and payroll taxes.

There are enormous transitional and economic factors to be examined. While the issues are significant, they should not stifle change if the FTA's benefits clearly outweigh the risks of keeping the current system.

2. *Political Realities*

In 1997, a Gallup poll found 58% of Americans believed their taxes were too high, compared to 63% fifty years earlier.[51] When Americans were asked whether they believed the income tax they pay is about right, the response was similarly close. Of those participants polled, 38% answered 'yes' in 1997 and 32% answered 'yes' in 1947.[52]

However, these statistics are not surprising for several reasons. First, many citizens are non-filers. In 1993, the IRS identified as many as sixty million potential non-filers, up from ten million in 1990, mostly by matching data on return information such as wage statements from employers and social security numbers. The IRS took no action on the majority of non-filers since most were not required to file.[53] Moreover, of the 116 million individuals who did file, 42% filed less complex 1040A and 1040EZ forms.[54] Demographics might also spawn the lack of interest in major tax reform. As the following table illustrates, a small minority of taxpayers bears the brunt of the individual tax burden.[55]

---

48. I.R.S. News Release IR-92-94 (Sept. 30, 1992).

49. *See id.*

50. General Accounting Office, GAO's Performance And Accountability Series And High Risk Update: Major Management Challenges and Program Risks: Department of Treasury, OCG-99-14 (January 1999), *available at* <www.access.gpo.gov/su-docs>.

51. Lydia K. Saad, *Americans Generally Disgruntled About Their Taxes*, 1999 GALLUP POLL MONTHLY 34-35.

52. *See id.*

53. General Accounting Office, Tax Administration: Potential Impact of Alternative Taxes On Taxpayers And Administrators (January 14, 1998) app. II at 2:.1 <http://www.taxboard.com/gaoreports/gao98-37.html>.

54. See id. at 40.

55. Dan Froomkin, *Tax Policy: Ripe For Reform? available in* <www.washingtonpost.com/wp-srv/ politics/special/tax/tax.htm.>, (April 28, 1998).

Table 1

Income Range	Percent of Taxpayers	Percent of Total Revenue
Under $25,000	54.6	6.1
$25,000-$100,000	40.9	46.4
$100,000-$200,000	3.4	16.5
$200,000 and up	1.1	31.0

To attract broad-based support, any tax proposal must treat various groups of taxpayers at least the same or better than they are treated under current law. [56]

Some economists believe eliminating the mortgage interest and property tax deductions will adversely impact property values, thereby chilling voters' penchant for tax reform.[57] Once accustomed to tax breaks, taxpayers resist giving these up.[58] For example, in 1993 alone, 29% of 1040 filers took itemized deductions on their return.[59]

In the current system, most taxpayers pay no estate or gift taxes because of statutory exemptions and proper estate planning.[60] The likelihood of being audited also is extremely low and remains relatively constant.[61] Therefore, the FTA offers most filers relatively minor advantages regarding these concerns.

Many taxpayers believe a consumption tax will become an add-on to the current system or evolve into a hidden value-added tax (VAT).[62] Such concern may be justified since implementing the FTA will require savvy political leadership to garner enough support to repeal the Sixteenth Amendment.

Finally, many taxpayers, especially employees receiving employer-prepared W-2 forms, do not know the extent of their tax burden since taxes are deducted from gross pay. The complexity of the Internal Revenue Code and its regulations, forms and filing requirements make it increasingly difficult for taxpayers to compare the current system to alternative proposals.

While Americans may not be satisfied with the present tax system, they show no new animosity indicating a desire to change. Many voters perceive the FTA as a way to in-

56. *See* Leopold, *supra* note 2, at 27.

57. *See id.*

58. *See, e.g.,*. General Accounting Office, *supra* note 53, app. II, at 2.1; table 4 Taxes, interest and charitable contributions are the most common itemized deductions.

59. *See id.* at app. II, 2.3.

60. *See* Staff of the Joint Committee on Taxation, *supra* note 17, at Table II.5.

61. The IRS historically examines 1-5% of individual tax returns; however, this rate fell to less than 1% in 1998. Tax Administration, *Audit Trends and Results for Individual Taxpayers* (Apr. 26, 1996) <http://www.taxboard.com/GAOReports/gao96-91html>.

62. The value-added tax (VAT) is a consumption-based tax charged on all products and services, regardless of who is the end-user. It is sometimes called a hidden tax because it becomes part of the product cost and is not easily discernible. VAT advocates argue taxes should be charged when value is added to the economy instead of when products are consumed.

crease taxes, and it may be increasingly difficult to make changes to Social Security and Medicare as more baby-boomers begin to receive benefits from those plans. Since political cynicism runs high, it will take a substantial majority of the voters to become sufficiently disgruntled with the present system before tax reform legislation is passed.

3. Constitutional Issues

The Constitution gives Congress broad powers to raise revenues: "The Congress shall have Power To lay and collect Taxes, Duties, Imposts, and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States . . . ."[63] However, this power is not plenary given specific constitutional limitations.

First, the Constitution requires that "all Duties, Imposts and Excises shall be uniform throughout the United States."[64] This clause, often referred to as the Uniformity Clause, has been held to apply geographically, meaning that standards applying in one state must apply in all other states.[65] Thus, the federal government cannot tax one transaction in Georgia at a different rate from the same transaction in Alabama.

A second limitation is imposed by the fourth clause of Article I, Section 9, which states "[n]o Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."[66] This "Apportionment Clause" means a state will receive an apportionment of revenue equal to its pro-rata share of the national population.

In 1913, the Sixteenth Amendment was added to fund World War I and rectify the *Pollock v. Farm Loan & Trust Co.* decision, which declared the 1894 Income Tax Act an unconstitutional direct tax since it was not apportioned between the states.[67] The Twenty-fourth Amendment later barred poll taxes in federal elections,[68] and the Court subsequently extended its provisions to the states in 1965.[69]

In modern day tax reform, three classes of taxes evolved subject to constitutional limitations. The first is indirect taxes, such as those on "duties, imports, exports and consumption."[70] Under this definition, the FTA appears to be on solid constitutional ground. The other two classes of tax are "direct," that is, the national government directly taxes individual taxpayers. The first is the current income tax system, which is constitutional by way of the Sixteenth amendment. The second class of direct taxes include the USA tax, cash-flow tax and consumption-base flat tax, all of which apply a single tax rate to a consumption base determined generally by deducting savings from

63. U.S. CONST., art. I, § 8, cl. 1; *see also* Loren P. Beth, THE DEVELOPMENT OF THE AMERICAN CONSTITUTION 1877-1917, at 154 (1971) (describing the Clause as "so sweeping that it has seldom been construed as an interference with any tax measure").

64. *Id.*

65. Jensen, *supra* note 12 at 2340.

66. U.S. CONST. art. I, § 9, cl. 4.

67. U.S. CONST. amend. XVI; *see also Pollock*, 158 U.S. at 601.

68. U.S. CONST. amend. XXIV.

69. *See* A.M. Harman, 380 U.S. at 528.

70. *See, e.g.*, Alexander Hamilton, THE FEDERALIST NO. 21, at 142-43 (Clinton Rossiter ed., 1961) (noting that "Impositions of this kind ["imposts, excises, and ... all duties upon articles of consumption"] usually fall under the denomination of indirect taxes ....").

income.[71] However, the constitutionality of this second class is suspect, since these taxes fail to meet the requirements of the Apportionment Clause.[72]

Congress may run afoul of the Tenth Amendment if it commandeers state executive powers to administer and enforce the FTA.[73] Justice Scalia, writing for the majority in *New York v. United States,* [74] underscored the jurisprudence of federalism by declaring that state executive officers could not be dragooned into administering federal law. Although he seemed to rely on the non-textual authority of state sovereignty, the two concurring opinions specifically referred to the limitations imposed by the Tenth Amendment.[75] These limitations also apply to ministerial and temporary functions.[76] While Congress has the power to carry out its functions under the Necessary and Proper Clause, its authority might be challenged should the IRS be abolished and administrative functions shifted to the states.[77]

Constitutional questions in taxation are important and often slip through the cracks.[78] But when sweeping reform is considered and constitutional amendments are repealed, it behooves legislators to re-examine their role and authority in the context of dual sovereignty.

C. Framework For The 21st Century

Until 1913 brought the enactment of the Sixteenth Amendment, the U.S. tax structure was consumption-based. Customs levies accounted for approximately 40% of the revenues, alcohol and tobacco taxes accounted for another 40%, and the rest came mostly from postal services.[79] Since then, income, payroll and investment taxes have become the primary drivers of revenue, accounting for 96% of total government receipts in 1997.[80] Although the modern trend toward taxing income evolved piecemeal since the early 20th century, it has developed into a single consumption/income tax hybrid because of IRAs, pensions and an increasing number of exemptions and deductions. This change to a hybrid tax may result in part from global economic pressures. When the U.S. left the gold standard in favor of a fluctuating currency, the impact of domestic tax policies became less relevant. For example, the impact of domestic tax policy on product prices lessened while international competitiveness and the balance of trade improved.[81] However, it may be imprudent to use tax legislation to enhance the balance of trade since our trading partners would likely copycat such posturing.[82]

---

71. Staff of the Joint Committee on Taxation, 104th Cong., Impact On Small Business Of Replacing The Federal Income Tax, pp. 37-44 (1996).

72. *See* Jensen, *supra* note 12, at 2338.

73. U.S. CONST. amend. X. (establishing and protecting state sovereignty).

74. 505 U.S. 144 (1992).

75. *See id.* at 188-196.

76. Printz v. United States, 521 U.S. 898 (1997) (holding that the federal government may not compel the states to enact or administer a federal regulatory program).

77. U.S. CONST. art. I, § 8, cl. 18.

78. *See* Jensen, *supra* note 12, at 2419.

79. U.S. DEPARTMENT OF COMMERCE & LABORATORY, STATISTICAL ABSTRACT OF THE UNITED STATES: 1903, at 29-40 tbl.7 (1904).

80. I.R.S., INTERNAL REVENUE COLLECTIONS BY PRINCIPAL SOURCE, tbl.5 (1997).

81. *See* Schenk, note 17, at 153.

82. *See id.*

Federal tax revenues as a percentage of GDP have been remarkably stable since World War II, ranging from 20.4% in 1945 to 19.8% in 1997.[83] But state and local tax revenues tell a different tale. At the end of World War II, sales and local taxes comprised 20% of all government receipts, compared to 33% in 1995.[84] During this period, consumption taxes dropped from 25% to 20% of the total state and local revenue stream, indicating a greater reliance on income taxes.[85] Thus, state and local governments tend to steer away from consumption and toward income taxes, which is opposite to the direction proposed by the FTA.

Since 1939, the number of individual tax returns filed as a percentage of the population has steadily risen. Table 2 below illustrates how this burden impacts succeeding generations:[86]

Table 2

Year	Individual Tax Returns Filed (Millions)	% of Population
1939	7.6	6.0
1945	50.0	35.0
1995	140.0	45.0

FTA proponents suggest the savings alone from taking 140 million people off the tax roll is sufficient to extract marked improvements in the productivity of the economy. However, no empirical studies supporting this presumption are cited taking into account the compliance shift to business and state governments or transition costs involved. Further, it is presumptuous to assume states will automatically eliminate income taxes because individuals are removed from federal tax roles. Thus, taxpayers may continue to pay income taxes while businesses are forced to conform to the new FTA requirements.

With the emergence of the Internet, many jurisdictions are seeing local revenues decrease at the expense of businesses that now 'reach in' to their localities to sell goods and services. Sales and use taxes attempt to address this issue; however, enforcement is difficult since websites are transient and difficult to monitor. Thus, underground economies could surface and supplant current evasive practices. In addition, a three-year moratorium on "Internet taxes" is in effect until the issues are more crystallized.

Many factors should be considered before embarking on tax reform. Americans pay lower taxes as a percentage of GDP than Germany, the Netherlands and the United Kingdom.[87] We compete effectively with international partners and our standards of

83. EXECUTIVE OFFICE OF THE PRESIDENT OF THE UNITED STATES, BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 1999, Historical Tables 27-28 tbl.2.1, 31-32 tbl.2.3 (1998).

84. ECONOMIC REPORT OF THE PRESIDENT 305 tbl.B-67 (1969)(1945 data); Economic Report of the President 378 tbl.B-83 (1998)(the data excludes local grants).

85. *See id.* at 381 tbl. B-86.

86. BUREAU OF THE CENSUS, U.S. DEPARTMENT OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES: 1949 337 tbl.368 (1950) (1939 and 1945 data); Internal Revenue Service, U.S. Department of the Treasury, Statistics of Income Bulletin, Spring 1998, at 12 fig.A. (1995 data).

87. National Federation of Independent Business, (visited November 16, 1999) <http://www.publicagenda.org/issues/factfiles_detail.cfm?issue_type=federal_budget&list=17>.

living improve each generation. However, history is not always the best guide to future decisions. Tax reform should be based on long-term objectives, and ultimately any tax reform proposal must represent the shared values of the taxpaying public according to its perception of fairness.

III. GENERAL PROVISIONS OF THE FAIR TAX ACT OF 1999

The FTA replaces federal income, payroll, capital gains and estate and gift taxes with a sales tax on gross payments on taxable property for use or consumption in the United States. It also adopts a constitutional amendment repealing the current Sixteenth Amendment authorizing Congress to collect taxes on income.

The FTA imposes a single 23% consumption tax on goods and services purchased beginning in 2001, which may be adjusted to assure revenue neutrality. A host of credits are available to businesses and individuals to make the system more progressive. Taxes are generally imposed on the seller, except as provided specifically under the Act or where property is purchased outside the United States for domestic use or consumption. Purchases made in the ordinary course of business, for investment purposes, or for use or consumption outside the United States are not taxable. Financial intermediaries (e.g., banks, brokerages and insurance companies, etc.) may compute their tax differently if their tax liability is substantially similar to the liability due under the sales tax.

Finally, the IRS is abolished and replaced with state tax collection bureaus. Each state chooses to establish its own bureau or outsource its collections to another state and periodically submit federal collections to the U.S. Department of Treasury. Accommodations for other administrative functions, including examinations, phase-ins, and phase-outs are embodied in the Act.

A. Repeal Of Income, Payroll And Estate And Gift Taxes

The FTA repeals all income, capital gains, Medicare, Social Security and estate and gift taxes on December 31, 2001.[88] While income, capital gains, Medicare and Social Security revenues are replaced by a sales tax, estate and gift taxes are permanently eliminated. The FTA does not propose to change recipient eligibility for Social Security and Medicare benefits, nor does it propose altering benefit levels.

1. Sixteenth Amendment Repealed

The Sixteenth Amendment is repealed and replaced with an amendment prohibiting the federal taxation of incomes, investments, wages, estates and gifts.[89] However, there is no provision requiring the repeal of the Sixteenth Amendment before the sales tax is implemented. Thus, taxpayers could be saddled with a sales and income tax, an outcome feared by many FTA opponents.

The passage of any constitutional amendment requires sweeping bipartisan support from the nation's voters. To illustrate, there have been just sixteen amendments to the

---

88. *See* Fair Tax Act of 1999, H.R.2525, 106th Cong., §§ 101-104. The FTA repeals Subtitles A (Income Taxes), B (Estate and Gift Taxes) and C (Employment Taxes) under Title 26 of the I.R.C.

89. The Fair Tax Act of 1999 repeals specific federal statutes and merely calls for a repeal of the Sixteenth Amendment. *See* H.R. 2525, §§ 101-104 (1999).

Constitution over the past 208 years since the Bill Of Rights. Thus, until FTA supporters obtain support at home and in Washington, their efforts to repeal the Sixteenth Amendment by the year 2001 may be tenuous at best.[90]

2. Federal Statutes Repealed

The FTA specifically repeals subtitles A (Income Taxes), B (Estate and Gift Taxes) and C (Payroll Taxes) from Title 26 of the United States Code. These subtitles are replaced by subtitle A (Sales Tax), and current subtitles D through H and I through K are re-designated, beginning with subtitle B and continuing in successive order.[91] These subtitles generally address administrative issues, excise taxes and miscellaneous health benefits. Subtitle H, which relates to the funding of Presidential campaigns, is repealed and not replaced.[92] Finally, the code is renamed the Internal Revenue Code of 1999.[93]

B. Enactment of the Sales Tax

The sales tax, now designated as subtitle A of the Internal Revenue Code of 1999, incorporates all matters regarding tax computation, special rules for financial intermediaries, refunds, the family consumption allowance and collection practices. The sales tax generally becomes effective on January 1, 2001.

1. Determining Who Pays the Tax

The tax is paid by consumers on all new goods and services at the final point of consumption. Business-to-business purchases are excluded if the business maintains a tax exemption certificate.[94] Other exceptions include: (1) purchases for export from the United States for the use or consumption outside the United States; (2) property or services purchased exclusively for investment purposes; (3) certain government enterprises; (4) vending machine purchases; (5) certain mixed-use property; and (6) sales to untaxed affiliated firms.[95] In addition, allocations between income and principal are required for financing leases.[96] For example, if the principal component and financing fees of a lease are taxed with respect to the interest portion, then the gross lease or rental payments are not taxable. Financial intermediaries are not required to charge tax on fees, insurance premiums, commissions or other similar services and implicit interest rate differentials specifically charged to consumers.[97] However, these institutions must remit taxes equivalent to the sales tax that would have been collected from the taxation of those items.[98]

---

90. *See* U.S. CONST. art. V (specifying requirements to amend the U.S. Constitution).
91. *See* Fair Tax Act, H.R. 2525, 106th Cong., 106th Cong., §§ 101-104 (1999).
92. *See id.* § 104(a)(1).
93. *See id.* § 104(b)(1).
94. *See id.* § 102(a)(1)(A).
95. *See id.* §§ 101-103.
96. *See* Fair Tax Act, H.R. 2525, 106th Cong., §§ 804, 904 (1999).
97. *See id.* § 801.
98. *See id.*

It is sometimes difficult to distinguish who is an end-consumer. Mixed-use property is sometimes not determinable at the time of sale. Property may be purchased with an intended business purpose only to be re-designated for a consumer purpose or vice versa. Also, businesses granted an exemption certificate could intentionally or accidentally use their tax-favored status improperly. Barter incentives could increase since prices for products and services are likely to rise, at least in the beginning until hypothetical efficiency savings are recognized and built-in costs from prior income taxes are flushed out of inventory reserves.

However, choosing a business entity may be simplified by switching to a consumption tax. Under the current system, business entity considerations are complicated and an important concern since some entities pass taxes directly through to the taxpayer while others withhold profits in capital or reserve accounts.[99] Under the FTA, the consumer pays the tax, thus the business entity choice becomes less relevant.

The FTA includes interesting provisions with consequences that might not be palatable to a number of taxpayers. For example, payments for food, medical care and education are taxable whereas the purchases of lottery tickets and other chance wagers are exempt.[100] Tax on receipts from chance wagers are paid by individual gaming organizations after deducting payoffs to chance purchasers. Thus, although gaming receipts are ultimately taxed, they appear to be tax-exempt to consumers. Further, if higher taxes fail to increase prices for gaming tickets, they may appear comparatively inexpensive to other entertainment purchases. Therefore, higher payout rates caused by the deductibility of these expenses could encourage more participants.

While the FTA eliminates certain questions regarding who must pay the tax, new issues arise and some solutions may not be as simple as suggested by its sponsors.

2. *Figuring The Tax*

The FTA greatly eases the tax calculation in applying a single rate structure to goods and services purchased by the end-consumer. However, figuring the tax is complex. Tax and financial statement revenues must still be computed independently if sales are made to non-end consumers. End-consumers might disguise purchases as operating leases or bundle them with non-end use purchases. Sales could also be disguised as loans, and the value of products and services may be difficult to ascertain or separate in mixed-use properties. In addition, the FTA retains the cash and accrual methods of accounting. When used together, these methods have historically complicated determination of the tax base. It further complicates 'book to tax' reconciliations by allowing taxable entities to change yearly accounting methods under certain circumstances.[101] Purchases for non-end consumer purchases may be converted to end-consumer purchases, credits must be accounted for and applied, changes to the family allowance must be updated, and trust income and financial leases must be allocated in certain situations.[102] But, compared to the vast array of tax issues today, the FTA appears to offer relief from much of today's

99. Profits may be booked to traditional capital accounts such as retained earnings or withheld in contra-asset accounts (e.g., reserve for bad debts).

100. *See* Fair Tax Act, H.R. 2525, 106th Cong., § 702 (1999).

101. *See id.* § 503.

102. *See id.* §§ 305, 804, 904.

current tax law complexities.

a. The Gross

In general, the FTA taxes all property and services purchased for consumption by end-users. At first blush, these terms seem reasonably straightforward; however, they become less obvious upon further scrutiny. More specifically, taxable property includes end-use items and leaseholds, but excludes intangible and used property. Taxable services generally include all services performed by wage-earning employees for use by end-users. However, services performed by qualified not-for-profit organizations and government-owned or -operated enterprises (not the government itself) are exempt.[103] Also, all taxable property and services are measured at fair market value when purchased.[104]

Mixed-use property, which includes property or services used for both taxable and nontaxable purposes, is subject to tax if 95% or more of the purchase is used for taxable purposes.[105] However, any person or business liable to collect taxes is entitled to the business use credit, which is calculated by multiplying the mixed-use property amount by the business use ratio times the sales tax rate.[106] The mixed-use property amount and business use ratio is determined according to a statutory formula based on the class of property and operable type of ownership (e.g., business purpose miles to total miles for mixed-use vehicles).[107] In addition, exports for end-use outside the United States are exempt, as is property and services held for investment purposes.[108] Financial intermediaries, including banks, brokerages and insurance companies are allowed to compute their tax liability on a different basis if the taxes paid are equal to the amount of taxes that would be due on a per transaction basis.[109] Special rules allocating income and principal apply to financing leases, hobby sales and chance wager sales by gaming sponsors.[110]

Rule technicalities pertaining to the calculation of gross income are complex and distinctions between tangible and intangible properties sometimes blur. Also, according to the "bundle of sticks" theory, which describes the multiple interests in a single article or parcel of property, separate interests representing both taxable and nontaxable sales may be conveyed by a seller. In addition, sellers of taxable property and services must adhere to property class schedules similar to current depreciation rules and report installment sales for items such as automobiles, real property and other tangible items. Moreover, definitions of new and used properties may be ambiguous. For example, the FTA treats the sale of real property as 'new' property, but makes no references to the treatment of land improvements or remuneration from seizures by eminent domain. Nor does the Act

103. *See id.* §§ 2(a)(14), 704.
104. *See id.* § 2(a)(13).
105. *See* Fair Tax Act, H.R. 2525, 106th Cong., § 705 (1999).
106. *See id.* §705 (a)(3).
107. *See id.*
108. *See id.* § 102.
109. *See id.* § 801.
110. *See* Fair Tax Act, H.R. 2525, 106th Cong., §§ 701, 704, 804 (1999).

explain how insurance proceeds from catastrophic losses exceeding market value are treated. Finally, there are no provisions excluding previously taxed savings used to make taxable purchases.

The above examples point out only a few of the obstacles regarding income interpretation under the FTA. While gross income continues to be a definitional problem under the current system, shrewd taxpayers and professionals will likely find loopholes and ambiguities under any tax proposal.

b. The Credits

The FTA provides five credits that may be taken against a taxpayer's individual monthly tax liability.[111] These credits are non-cumulative and are as follows:

(1) business use conversion credit;
(2) intermediate and export sales credit;
(3) administration credit;
(4) bad debt credit; and
(5) insurance proceeds credit.

The application and timing of these credits is sometimes complicated. For example, taxpayers can strategically utilize individual credits to minimize taxes since they may be applied to any source of taxable revenue. Moreover, new credits could be added by subsequent legislation, which opens the door to additional complexity and political misuse.

The business-use conversion credit applies to property and services previously taxed and used at least 95% of the time for a business purpose.[112] It is calculated by multiplying the sales tax rate by the fair market value of the property or service when its use is converted to a business purpose, and dividing that amount by one minus the tax rate.[113] Therefore, historical records and current appraisals may be necessary to calculate the credit when taxable property is converted.

The intermediate and export sales credit equals the sales tax paid on the purchase of any taxable property or service purchased for a business purpose for export and consumption outside the United States.[114] In effect, the credit is inserted to comply with the constitutional restriction prohibiting duties on exports.[115]

The FTA also permits an administrative credit for each person or firm liable to remit or pay tax. The credit is equal to the greater of $200 or .25% of the tax collected to encourage the prompt remittance of receipts.[116] A timely monthly report must be filed along with the gross taxes due.

The bad debt credit is derived from bad debts for accrual-based taxpayers.[117] These debts must be business bad debts, which are wholly or partially worthless, either be-

111. *See id.* §§ 202-06.
112. *See id.* § 202.
113. *See id.*
114. *See id.* § 203.
115. U.S. CONST. art. I, § 9.
116. *See* the Fair Tax Act of 1999, H.R.2525, 106th Cong. § 204 (1999).
117. *See id.* § 205.

cause they are discharged in bankruptcy or they are at least 180 days in arrears and deemed uncollectible by the payee.[118] Unpaid invoices must also be at least 180 days in arrears; however, the FTA makes no reference to invoices discharged in bankruptcy.[119] While unpaid invoices between related parties cannot generate the credit, the FTA's language makes unclear whether the credit applies to related-party bad debts.[120] Thus, taxpayers could obtain the credit by re-characterizing related-party transactions unless the text is redrafted with more consistent language.

Finally, taxpayers may be entitled to the insurance proceeds credit. This credit is derived from insurance contracts where proceeds exceed premiums that are taxed and used for insurance (not investment) purposes. It is calculated by multiplying the tax rate by the insurance premium and dividing that amount by one minus the tax rate.[121] Insurance contracts under this section include all common forms of property, casualty, marine, accident, liability, health and long-term care policies.[122]

The FTA credits are considerably less cumbersome than those employed by the current system. However, credits under today's system were also much simpler before Congress began using them to redistribute wealth, and there are no guarantees the FTA will not change similarly. The Act requires strict record-keeping, possible appraisals, and is complicated by timing differences and rate changes. It makes no provision to pay interest on credits for taxes paid in prior periods and fails to address which period to use when calculating the credit due. Although FTA credits are less complicated than many of those found in the current code, more clarification is needed before the bill becomes law.

c. The Family Allowance

Qualified families receive a sales tax rebate each month equal to the sales tax rate multiplied by the monthly poverty level.[123] These families are generally defined as one or more family member sharing a common residence and include the following:

(1) an individual;
(2) the individual's spouse; and
(3) all lineal ancestors, descendants, legally adopted children and children under legal guardianship of each individual and individual's spouse.

Each person must have a social security number and be a resident of the United States, which is a departure from current law that allows residents of Canada and Mexico to qualify as dependents.[124] The definition of a family member is also more restricted since it no longer includes brothers, sisters, aunts, uncles or foster children unless they share

118. *See id.* § 802.
119. *See id.*
120. *See id.* § 205.
121. *See* Fair Tax Act, H.R. 2525, 106th Cong. § 206 (1999).
122. *See id.*
123. *See id.* § 301.
124. *See* I.R.C. § 152 (b) (3) (1994).

the same residence.[125] However, students living away at school still qualify.[126]

The FTA requires annual registration to receive the allowance, including family member names, social security numbers, residence address and person or persons to whom the allowance should be paid.[127] If the registration is not made by the required date, no allowance is paid. Thus indigents, elderly citizens living below the annual poverty level and possibly other families will want to file returns to receive their rebate, whereas these individuals are often not required to file under current law.[128] It might also be difficult to ascertain who "shares" a residence and is eligible for the allowance under the qualified family definition. Even the residence itself may be hard to identify. Problems could surface when more than one family member pays sales tax but receives no rebate since the allowance is based on the size of the collective family. It implicitly encourages larger families by increasing the allowance as the number of family members rises, thereby forcing smaller families to subsidize larger households. Although rebates may be divided among family members, there is no easy way to determine how a family should distribute its allowance fairly unless each member keeps receipts for all sales taxes paid. Finally, intra-family disputes over rebates could splinter intact families or encourage deceitful behavior.

Nevertheless, the family allowance has advantages. The marriage penalty and certain dependency tests are eliminated.[129] Also, concerns over distinctions between the classification of employees and independent taxpayers are no longer relevant.[130]

The Social Security Administration (SSA) administers the rebate and may provide taxpayers with smartcards carrying cash balances that could be used at retail establishments or transferred to personal accounts.[131] If the taxpayer's family status changes, a revised form is sent to the SSA and signed by all members of the family.[132] This might prove difficult since multiple parties must act on short notice. Family members could be traveling, ill, or stubbornly resistant to changes. Families that move must also notify their social security office promptly to ensure that monthly rebate checks are properly routed. The FTA does not make revisions to the family status necessary. While this may be an oversight, it could be easily corrected to prevent families with downward revisions from receiving unentitled monies.

These examples represent a sampling of the issues affecting the socio-economic fabric of the family. Although many changes could be minimized through transitional programs and informational campaigns, they will likely create initial confusion and make the switch to the FTA difficult. Again, however, these complications should be viewed

---

125. *See* Fair Tax Act of 1999, H.R. 2525, 106th Cong., § 302 (1999).

126. *See id.* § 302 (b) (1).

127. *See id.*, § 302 (c) (1).

128. *See* General Office Accounting Report, *supra* note 50, at 28. While it is difficult to estimate the number of non-filers, the IRS estimated there were about 60 million in 1993. Also, many elderly citizens receive nontaxable social security benefits with no tax withheld and do not need to file returns.

129. Since the family allowance is based on the number of individuals in the family and not filing status, the marriage penalty is eliminated. Also eliminated are the joint return and support tests for non-students.

130. The troubling requirement to differentiate between employees and independent contractors is eliminated since the family allowance determines the rebate according to the number of members reported in the family.

131. *See* Fair Tax Act, H.R. 2525, 106th Cong. § 305 (1999).

132. *See id.*

in light of the complexities, costs and burdens of the current system.

3. Calculating The Tax Rate

The FTA estimates a 23% tax rate is sufficient to pay for revenues lost from the repeal of income, payroll and estate and gift taxes, and is comprised of the following three components:[133]

(1) the general revenue rate;
(2) the old-age, survivors and disability insurance rate; and
(3) the hospital insurance rate.

The general revenue rate is set at 14.91% for the year 2001 and covers lost revenue from income, capital gains and estate and gift taxes. The last two components cover Social Security and Medicare costs, which are currently taxed at a combined rate of 7.85%.[134] After 2001, Congress is authorized to raise or lower rates to ensure revenue neutrality.

Defining the proper tax rate has created a thicket of controversy ever since the bill was introduced in its original form in 1996.[135] Three notable economists estimate the rate could reach as high as 45.4%.[136] Other economists project a rate of 32%, while still others place the rate as low as 15%.[137] However, these estimates fail to identify supporting quantitative analysis or underlying assumptions making it difficult to draw meaningful conclusions. Moreover, proponents of the FTA predict lower rates while opponents' estimates are higher. The true rate most likely is somewhere in the middle, but additional independent analysis is needed before a widely accepted rate is adopted.

Key elements affecting rate determination include the tax base, credits, allowances and federal spending. As the tax base broadens the tax rate falls; however, as credits and allowances increase and federal spending rises, tax rates rise. FTA supporters claim a streamlined consumption tax reduces administrative and compliance costs, which allow for lower tax rates.[138] Their reasoning overlooks high transitional costs. Hence, there are no promises these savings will translate into lower rates.

Opponents of the FTA call it the first step towards a value-added tax (VAT).[139] Critics point out that everywhere a national sales tax has been instituted, it eventually turned

133. *See id.* § 101.

134. *See id.* The 1999 Social Security rate (component 2) is 6.2% and Medicare (component 3) is 1.65%, for a total of 7.85%.

135. National Retail Sales Tax of 1996, H.R. 3039, 104th Cong. (1996). This bill, also co-sponsored by Rep. John Linder, proposed a general revenue rate of 15% (compared to the 14.93% rate proposed by the Fair Tax Act of 1999).

136. BRUCE BARTLETT, SALES TAX WOULD REQUIRE HIGH RATE, NATIONAL CENTER FOR POLICY ANALYSIS 2 (1997). (citing studies performed by Daniel Feenberg, Andrew Mitrusi and James Poterba of the National Bureau of Economic Research).

137. *See* Froomkin, *supra* note 55 (estimating a federal tax rate of 30%). The Joint Economic Committee also estimates National Retail Sales Tax rates would need to be 32% or higher, but it fails to identify the details behind its calculation. Joint Economic Committee, *Consequences of Replacing Federal taxes With a Sales Tax* (visited 10/26/99) <www.senate.gov/~jec/salestx.html>.

138. *See* BURTON & MASTROMARCO, *supra* note 38 (quoting the Tax Foundation's assertion that compliance costs could be reduced by as much as 90%.)

139. Bruce Bartlett, "VAT in Drag," WALL STREET JOURNAL, July 19, 1996, at A12.

into a VAT.[140] In 1967, nineteen members of the Organization for Economic Cooperation and Development had a retail or wholesale tax. By 1995, all original nineteen members plus four others had VATs, and none of those countries dropped their income tax as they had planned.[141]

The FTA has also been chided as a hidden tax since over time it becomes an embedded cost of our products and services.[142] Opponents suggest consumption taxes are easier to raise since slight increases in product prices are less obvious than direct reductions to taxpayers' gross income. However, it could be argued an income tax is hidden since many taxpayers do not know their average tax rate or annual tax liability, and corporate taxes are passed through to consumers in the form of higher prices.

The FTA exempts most individual taxpayers from reconciling periodic economic gains with the cost of government each year. Although it reduces a tremendous amount of anguish around filing dates, the government's bite under a consumption tax is less onerous. As tax burdens become less conspicuous, voters may become complacent and not hold the government accountable. In fact, Americans pay lower average tax rates relative to U.S. Gross Domestic Product than any of their European and Far-Eastern counterparts using a VAT.[143]

Although a flat 23% rate seems high, the family allowance makes the tax progressive. For example, a family of four receives a rebate of $15,600 from the family allowance. Thus, a family that spends less than or equal to that amount pays no tax at all. But assume the same family earns $31,200. Under the present system, they pay $6,281 or 21.9% of their wages in income and payroll taxes. However, under the FTA, that family would pay $3,588 or just 11.5% in sales taxes assuming they spent their entire earnings. If they save part of their earnings, they pay even less.[144]

While the family allowance makes the consumption rate progressive, the FTA is not as progressive as the current income tax system. However, it is still more progressive than a flat tax, which taxes a smaller base by exempting investment income. For example, a retired billionaire living off her investments pays no tax under a flat tax proposal, but does pay under either the present system or FTA.

The FTA's initial rate may need raising to support a revenue neutral budget; however, it must increase if Congress shrinks the tax base by offering additional credits or exemptions.

4. *Collecting the Tax*

Sales taxes are collected by the states and remitted to the U.S. Treasury Department under one of two scenarios.[145] First, states may collect taxes as an administering state, which means the state has entered into a cooperative agreement with the Secretary of the Treasury. Otherwise, a state may choose to select another state to administer its pro-

140. *See id.*
141. *See id.*
142. *See id.*
143. *See* the National Federation of Independent Business, *supra* note 87.
144. Pete du Pont, *The National Sales Tax: A Big, Interesting, and Uneasy Idea*, <http://www.intellectualcapital.com/issues/98/0212/iced.asp.> (1998).
145. *See* Fair Tax Act of 1999, H.R. 2525, 106th Cong. § 401 (1999).

gram.[146]

The FTA abolishes the IRS since states now collect and remit taxes. Current IRS functions are divided amongst the fifty states, and each state is required to maintain provisions for the collection and expeditious transfer of funds, contact officers, dispute resolution, information exchange, confidentiality, taxpayer rights and a catch-all "other matters of importance."[147] In effect, fifty smaller federal revenue collection jurisdictions are created utilizing potentially duplicate resources. Moreover, the U.S. Treasury Department must establish a collection point to interface with each state, an issue not addressed by the FTA.

John Miskell, an Indiana University economist, points out that no two states have the same tax base for their sales taxes, and none comes close to being comprehensive. Thus, it is impossible for the federal government to simply piggyback its tax collections on state taxes without massive complexity, and that "attempting to levy a national sales tax as a supplement to state sales taxes would be folly."[148] Considerable resources must be brought to bear to orchestrate a simultaneous conversion. In addition, the displacement costs for current IRS employees could be staggering, considering the more than 100,000 workers involved.[149]

State collection officials may also balk at having to audit, prosecute and otherwise pursue their own citizens on behalf of the federal government. Although states benefit from collecting the tax, they have been insulated from these activities in the past.

Compliance rates for state sales taxes are not comparable to projected compliance rates under the FTA since states tax a much narrower range of goods and services.[150] Collection problems could be more complex since individuals may disguise consumption as business inputs, which are free of tax.[151] While states currently prosecute taxpayers engaged in evasive practices, the magnitude of these problems will escalate as incentives to evade taxes are compounded by significantly higher rates. In effect, the federal government shifts its collections burden to the states that are not equipped to coordinate both federal and state collection functions effectively.

But overall, the FTA should make collections easier. There are substantially fewer taxpayers, compliance is less voluntary, taxes are generally collected at the point of sale and the base is greatly simplified. Of course, eliminating the IRS merely reassigns responsibilities to the states where IRS offices are already located.

C. Administrative Matters

The U.S. Treasury Department authorizes and issues all rules, regulations and guidelines used by administering states to implement and manage the FTA.[152] The U.S.

146. *See id.* § 404.

147. *See id.* § 401.

148. *See* Bartlett, *supra* note 139, at 2.

149. IRS modernization efforts under Commissioner Charles O. Rossotti have not made substantial inroads in the reduction of labor costs.

150. *See* Bartlett, *supra* note 139, at 2.

151. *See id.*

152. *See* Fair Tax Act of 1999, H.R.2525, 106th Cong. § 402 (1999).

Treasury can revoke a state's collections license, issue penalties for nonconformance and provide uniformity in the administration of the tax and guidance to the public.[153] The department is also required to host an annual conference for all fifty states to resolve problems and map out future improvements.[154]

States manage their resources according to the U.S. Treasury Department's guidelines. However, while they can retain an administrative credit up to .25% of gross collections, it is unclear how far this credit will go to offset additional administrative costs.[155]

1. Effective Dates

The FTA would become effective on January 1, 2001, and is not dependent on the repeal of the Sixteenth Amendment. Excusing this prerequisite permits the sales tax to supplement the income tax, and once effective, political pressure to roll back the Sixteenth Amendment would likely subside. Further, it is unclear how realistic it is to staff, train and supply the states with sufficient capabilities to manage new system requirements and resolve taxpayer problems before the switch is made. The FTA omits provisions to bring states online through a transition phase; however, such changes could be added with comparative minor difficulties.

Finally, Congress could lessen the transitional impact by staggering effective dates. Simply retiring the current system overnight in favor of the FTA might sound drastic, but doing so shortens a difficult and unavoidable process.

2. Phase-in and Phase-outs

Title III of the FTA governs the phase-in and phase-out provisions that would repeal federal statutes and implement the sales tax.[156] In general, the sales tax becomes effective on January 1, 2001, and all applicable income, payroll, capital gains and estate and gift tax statutes are repealed simultaneously. Appropriations for any expenses supporting the IRS would get phased out by the year 2005.[157] Also, federal records related to the administration of taxes repealed by the FTA must be destroyed by December 31, 2005, except for records necessary to calculate Social Security benefits or required for the final disposition of ongoing litigation.[158]

Complex transitioning rules apply to certain qualified inventories that were subjected to tax under the current income tax structure. Inventory subject to sales tax held by a trade or business and sold before December 31, 2005, is entitled to the intermediate and export sales credit.[159] The trade or business captures this credit in the month sold and reports it to the sales tax administering authority.[160] The credit applies to work-in-

153. *See id.* § 401.

154. *See id.* § 403.

155. *See id.* § 401.

156. *See id.* §§ 104, 301.

157. *See* Fair Tax Act, H.R. 2525, 106th Cong., § 301(a) (1999).

158. *See id.* § 301(b).

159. *See id.* § 902(a).

160. *See id.* § 902(b). Section 263A of the Internal Revenue Code requires certain costs to be capitalized in inventory.

process inventory and capitalized inventory costs.[161] While the credit is generally not available to businesses exempt from sales tax under the FTA, certain exceptions apply. For example, it may be available if the Treasury Secretary certifies that the inventory was sold in a subsequent taxable transaction, or the credit is purchased from a trade or business authorized to receive the credit.[162]

A transition to a new form of taxation involves a myriad of issues that could significantly impact the nation's economy and flow of capital. For example, state and local government bonds with tax-deductible features are now on the same playing field as other debt instruments.[163] This could cause bond prices to plummet and force governments to pay higher interest rates, which in turn requires higher taxes. Medical insurance costs might increase, real estate prices could fall, and charitable contributions could wither with the elimination of the medical expense, mortgage interest and charitable contribution deductions. The market should theoretically equalize these pressures over time, but investor decisions over the range of investment options could spur a flurry of irrational speculation.

Other issues involving credits earned and taxes paid under the old system also need addressing. For example, prior decisions based on depreciation write-offs and previously taxed retirement savings now subject to double taxation should be resolved equitably.

The FTA pays little attention to these matters and implicitly relies on market liquidity, theoretical windfalls and efficiency savings to offset market changes. While it is debatable whether these benefits will be realized, it is certain that converting to the FTA will be chaotic at best.

3. *Other Administrative Provisions*

All taxes collected are due and payable to the U.S. Treasury Department by the 15th of the following month.[164] A seller collecting more than $20,000 in any of the previous twelve months is required to maintain separate bank accounts to receive tax receipts, in addition to meeting the bank or financial institution's minimum balance requirements and paying all account fees and costs.[165] Therefore, any seller who sells taxable goods or services totaling at least $87,000 in one month at the 23% proposed tax rate is subject to these requirements. Any seller collecting more than $100,000 in any of the preceding twelve months must make weekly deposits and furnish a bond or provide security equal to $100,000 or 1.5 times the seller's average monthly tax liability during the previous six months.[166]

All persons or firms liable to collect taxes must register as a seller with their sales tax administering authority.[167] Failure to obtain a proper certificate subjects the seller to

161. *See id.*

162. *See* Fair Tax Act, H.R. 2525, 106th Cong.,. § 902(c) (1999).

163. STAFF OF THE JOINT COMMITTEE ON TAXATION, 104TH CONG., IMPACT ON SMALL BUSINESS OF REPLACING THE FEDERAL INCOME TAX 97-98 (1996).

164. *See* the Fair Tax Act of 1999, H.R.2525, 106th Cong. § 501(b)(1).

165. *See id.* § 501(e)(1-2).

166. *See id.* § 501(e)(3),(g).

167. *See id.* § 502.

possible fines, temporary restraining orders or injunctions.[168] Reckless or willful failure to remit taxes subjects the party at fault to civil and criminal penalties.[169] Consumers who willfully file fraudulent family allowance forms face fines and/or imprisonment.[170] Criminal and civil penalties are also available to punish persons who violate confidentiality provisions of the FTA.[171]

In all sales tax disputes, the person engaged in the dispute with the sales tax administering authority bears the burden of production of documents and records. However, the sales tax administering authority bears the burden of persuasion.[172]

Attorneys' and accountancy fees are recoverable by the party engaged in a dispute with the sales tax administering authority, unless the sales tax administrating authority's position was substantially justified.[173] Audits and examinations are conducted under the auspices of the sales tax administering authority and the remitting person or firm must keep records for six years.[174]

If a person or firm sells taxable and nontaxable goods or services, a sales tax exemption certificate and record of each transaction is required, which is similar to the requirements under present law.[175]

Also, wage information is reported to the Social Security Administration for the calculation of social security and disability benefits.[176] Thus, a great deal of private information remains accessible by the federal government under the FTA.

Finally, interest is accrued on any over- or underpayment of tax according to the federal short-term, mid-term or long-term rate on U.S. obligations, depending on the type of financing instrument, debt or amount outstanding.[177]

Administering any major national tax system is a daunting task that strains the resources of all involved. The FTA spreads these responsibilities between the U.S. Treasury Department, Social Security Administration, state sales tax administering authorities and firms and persons collecting the tax, making it difficult to determine how efficiently or effectively the system operates. However, similar problems exist under the present structure, leaving meaningful comparisons complicated and difficult.

4. *Collection, Appeals and Taxpayer Rights*

The sales tax administering authorities collect taxes from the sellers of taxable goods and services.[178] Although the FTA imposes new collection duties on these persons and firms, all employers are relieved from withholding taxes from employees' paychecks. If the proper amounts due are not remitted, sales tax administering authorities may levy and seize property, garnish wages and file liens.[179]

---

168. *See id.* § 505.
169. *See* Fair Tax Act, H.R. 2525, 106th Cong., §§ 502(e), 505(a) (1999).
170. *See id.* § 505(i)(b)(2).
171. *See id.* § 505(p).
172. *See id.* § 506.
173. *See id.* § 507.
174. *See* Fair Tax Act, H.R. 2525, 106th Cong.,. §§ 508(b), 509 (1999).
175. *See id.* § 510.
176. *See id.* § 903 (a).
177. *See id.* § 512.
178. *See id.* § 601.
179. *See* Fair Tax Act, H.R. 2525, 106th Cong., § 602 (1999).

However, the FTA takes a novel approach to disputes by establishing independent problem resolution offices with officers reporting directly to either the Governor of that state or the President of the United States. These officers may enjoin collection activities and issue Taxpayer Assistance Orders releasing or returning improperly levied or seized property, or ordering liens released or garnished wages returned.[180] Problem resolution offices could become logical resources for educating the public on specific issues since its officers are trained in collection, compliance and appeals procedures.

The appeals process provides a timely hearing between the taxpayer and sales tax administering authority.[181] All communications to taxpayers must be written in plain English and include a description of the taxpayer's rights and appeals process.[182] Sales tax administrating authorities may also offer installment agreements and compromises to facilitate the collection effort.[183]

The FTA makes inroads in creating a more user-friendly collection process. Since there are likely fewer taxpayers, as well as fewer tax and information returns, the collection process should be less burdensome.[184] As taxpayer rolls decrease, the number of audits and examinations necessary to maintain compliance standards should correspondingly decline. While estimates of taxpayer compliance burdens vary widely under the current system, most are much larger than the IRS' fiscal year budget of $7.8 billion dollars.[185] In contrast, the FTA simplifies the collection structure and should save many taxpayers time, expense and heartache.

IV. CONCLUSION

Tax systems are commonly judged and compared according to four criteria: (1) equity, (2) economic efficiency, (3) simplicity, and (4) ease of administration.[186] Tax reform is historically reactive and often develops in response to external pressures. For example, wars drove the need for greater revenues and the Great Depression spawned new social initiatives such as the Social Security Act.

Because of many embedded credits and deductions contained in the current code, it remains uncertain whether FTA advocates possess the political fortitude to convince voters to abandon the current system in favor of a consumption tax. Voters may be more pensive than legislators expect since government cynicism runs high.[187] Moreover, members of Congress may be reluctant to relinquish control over the very tax incentives they use to control personal political agendas. Finally, important constitutional matters need addressing before the FTA reaches final form.

---

180. *See id.* § 603.

181. *See id.* § 604(a).

182. *See id.* § 605(a).

183. *See id.* § 606.

184. *See* General Accounting Office Report, *supra* note 50, at 26. In 1995, businesses and individuals filed 1.1 billion information and withholding documents.

185. *See id.* at 13.

186. *See id.* at 4.

187. FOX News Opinion Poll, The Federal Budget: Major Proposals (Opinion Dynamics, March 1999). 20% of respondents preferred a National Sales Tax, 27% preferred the current tax system, 43% preferred a Flat Rate Tax and 10% had no opinion.

The FTA has bona-fide advantages and disadvantages that deserve public debate without political hyperbole. As the new millennium marks a symbolic moment in history, Americans should decide whether the current tax system can meet the challenges of a technologically driven and globally interactive economy. While the FTA would effect the wallets of future generations, its destiny must ultimately and appropriately hinge on the approval of the current voting public.