THE FAIR TAX ACT: A PLAN FOR A SIMPLE, FAIR, AND ECONOMICALLY RATIONAL TAX

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INTRODUCTION

It is no secret that the Federal income tax laws need reform. They are unfair and overly complicated, they lack certainty and consistency, and they create economically inefficient business decisions.

The economic and social costs of the current tax system are considerable. The American taxpayer's frustration with the system contributes to a growing loss of faith in government.[1] Because of the complex nature of the Tax Code, many taxpayers are required to invest substantial amounts of time and money to calculate their tax liability in order to comply with its provisions.[2] Even worse, many other taxpayers devote much effort to evading their tax obligations by seeking out a myriad of tax loopholes.[3] The aggregate revenue losses from these lawful tax loopholes when combined with those from illegal tax evasion are staggering.[4]

Although these problems have existed for years, few comprehensive solutions have been forthcoming. My recent efforts to achieve a workable solution to the problems raised by the current tax system have largely coincided with similar efforts by Senator Bill Bradley (D-N.J.). We have labelled our combined proposal to revise the current tax code, The Fair Tax Act.[5] This article discusses some major problems with the present tax system, why these problems are so difficult to solve, and how the Fair Tax Act will deal with these problems.

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1. The majority of middle and lower income taxpayers (86%) feel that the Government is helping the rich get richer through the Tax Code. They feel that only lower and middle income taxpayers are paying their fair share of taxes by taking standard deductions while higher income taxpayers are avoiding tax payments through loopholes and tax shelters. *Flat Rate Tax Hearings Before the Senate Comm. on Finance*, 97th Cong., 2d Sess. 245 (1982) (statement of Louis Harris, Chairman and C.E.O. of Louis Harris Associates) [hereinafter cited as *Flat Rate Tax Hearings*].
2. Few taxpayers are able to complete the Federal tax form without assistance. Nearly 57% of all taxpayers who filed form 1040 in 1982 hired a professional tax preparer at a total cost of $62 billion. *See Flat Rate Tax Hearings, supra* note 1, at 100 (statement of Sen. Dan Quayle (R-Ind.)). The taxpaying public spent a total of 613 million hours in 1977 preparing tax forms; an average of 7 hours for each of the 90 million corporate and individual returns filed. *See Federal Paperwork Requirements: Hearing Before the Subcomm. on Government Regulation and Paperwork of the Senate Select Committee on Small Business*, 96th Cong., 1st Sess. 100 (1979) (testimony of Professor James T. Bennett).
3. Today, there are 104 special preferences in the Tax Code which can be taken through tax shelters, loopholes, deductions, exemptions and credits. *See* CONGRESSIONAL BUDGET OFFICE, TAX EXPENDITURES: BUDGET CONTROL OPTIONS AND FIVE YEAR BUDGET PROJECTIONS FOR FISCAL YEARS 1983-87 89 (1982).
4. These tax expenditures will deprive the Government of an estimated $273.1 billion dollars in fiscal year 1983. *Id.*
5. H.R. 800, 99th Cong., 1st Sess., S. 409, 99th Cong., 1st Sess., 131 CONG. REC. H215 (daily ed. Jan. 30, 1985); 131 CONG. REC. S404 (daily ed. Feb. 6, 1985).

PROBLEMS WITH THE CODE

The tax system's fundamental goal is "to raise enough revenue to finance government spending consistent with sensible fiscal policy."[6] The current tax system succeeds partially in achieving this goal. Justice and logic, however, dictate that our method of raising revenue be fair, efficient, certain, and administered in a manner that promotes the health of the economy. Measured against these standards, the current system fails miserably.

Equity

The current Federal income tax system operates unfairly. Fairness requires that a tax system adhere to the basic concepts of horizontal and vertical equity. Horizontal equity provides similar treatment for similarly situated taxpayers.[7] Vertical equity provides for distribution of the tax burden on the basis of ability to pay.[8]

The present tax system possesses neither of these characteristics. Under the current system, one taxpayer may pay a substantial tax on his income, while another, similarly situated as to amount of income, may receive a tax refund. It is common, under the present system, that a millionaire pays less in taxes than does a taxpayer earning $60,000.[9]

This unfairness results from a disparity in the Tax Code's treatment of different types of income. There are two major ways in which this occurs. First, the Code taxes certain kinds of income while leaving untouched other kinds of income. Secondly, the Code taxes certain kinds of income more heavily than others.

One example of the current law's horizontal inequity is the treatment of compensation in the form of fringe benefits versus straight wage compensation.[10] For example, assume Taxpayer One and Taxpayer Two receive equal compensation. Taxpayer One receives $20,000 in wages. In addition, he receives employer-provided health insurance whose premiums cost the employer $1,000. Taxpayer Two, on the other hand, receives wage compensation of $21,000. Because income in the form of fringe benefits is not taxed,[11] Taxpayer Two bears a larger tax burden even though the total "value" of the compensation is equal. If Taxpayer Two purchases an equivalent amount of health insurance, he will have less net income than Taxpayer One, because the purchase must be made with after-tax dollars.

The Code also lacks vertical equity. This infirmity stems primarily from the disparity in the Code's treatment of different types of income. Vertical inequity results principally because as income rises, the ability to take advantage of tax shelters increases.[12] That is, only taxpayers who possess sufficient wealth that

6. Wetzler, *Tax Reform a la the Bradley-Gephardt Bill*, 37 NAT'L TAX J. 265 (1984).
7. Horizontal equity exists when a tax structure achieves equal treatment of equals so that people in equal economic positions pay equal taxes. *See* J. ARONSON, PUBLIC FINANCE 305 (1985).
8. Vertical equity is a tax structure which treats taxpayers unequally, so that each taxpayer is taxed in proportion to his ability to pay. *Id.*
9. *Raising Taxes: When, Whose, and How Much?*, BUS. WEEK March 26, 1984 at 96.
10. Section 132 broadly excludes fringe benefits from gross income as long as they are given to all employees without discrimination. I.R.C. § 132 (1982). For instance, § 105(b) in particular, excludes from gross income amounts received from an employee through an accident or health insurance plan to the extent of amounts paid to the taxpayer either directly or indirectly to reimburse him, his spouse or dependents for medical care. *Id.* § 105(b).
11. I.R.C. § 132 (1982).
12. Investments which take advantage of the Tax Code's disparate treatment of differing types of income are generally referred to as tax shelters and they contribute to horizontal as well as vertical inequity. The Code contains many tax shelters which help the rich get richer. Tax shelters exist in the Code as a result of lobbying by major industries, businesses and special interest groups. Congress has responded

they can afford to tie up a significant portion of their annual income in sheltered investments can take full advantage of tax shelters. Lower and middle income taxpayers, who must use all their income for food, housing, clothing, and other necessities, do not have this option.

In 1982, the last year for which complete information is available, the loss of revenue from tax shelters totaled $21 billion.[13] In addition, tax shelters introduce a hidden cost. As the tax base shrinks due to the "exemption" of income placed in tax-sheltered investments, the income remaining within the tax base, principally wages, must be taxed more heavily to maintain adequate revenue. The loss of tax revenue to shelters essentially shifts the tax burden to lower and middle income taxpayers, who usually cannot take advantage of tax shelters. Thus, these wage earners are required to absorb the shortage that tax shelters create through a higher tax on wages. According to one estimate, without the $24 billion loss of revenue from tax shelters in 1984, the average personal income tax bill would have been $300 less.[14] Thus, tax shelters result in vertical inequity.

In general, the impetus for enacting provisions which preferentially fail to tax certain income has been the desire to encourage behavior which results in production of that income. For example, fringe benefits are not taxed in order to encourage employers to provide these benefits.[15] Similarly, interest earned from local and state revenue bonds remains untaxed in order to encourage this type of investment. These preferential taxing provisions have, for the most part, achieved their goals. At the same time, however, it has become apparent that the inequities which accompany achievement of those goals have reached unacceptable proportions.

Equity alone constitutes a justifiable and worthwhile goal of tax policy. The economic consequences of an inequitable Code are, however, much more far-reaching than simply the violation of one's sense of justice. With an alarming frequency, taxpayers have begun to express their dissatisfaction with the tax system by rebelling. This rebellion takes the form of cheating, evasion, and participation in the "underground economy."[16] Recent figures indicate that this "rebellion" translates into a loss of $80 billion a year.[17] Furthermore, it is estimated that the "compliance gap," which is an estimate of the difference between what taxpayers legally owe and what they actually pay, is growing by at least one percent each year.[18] It is clear that taxpayer perceptions of an unjust and inequitable tax system contribute to the increasing level of noncompliance.

The inequities in our tax system cannot be justified as unavoidable conse-

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by amending the Code to provide tax incentives or relief to these groups. The interest groups which receive most of the benefits are the automotive, banking, chemical, pharmaceutical and tobacco industries. *See Flat-Rate Tax Hearings, supra* note 1 at 121-24 (statement of Sen. Dan Quayle, R-Ind.). One popular tax shelter is the § 611 deduction for depletion of wasting assets such as mines, oil, gas wells and other natural deposits. I.R.C. § 611 (1982). By using the percentage depletion method, the taxpayer is allowed to deduct a certain percentage of income depending on the asset which may continue for the entire life of the asset despite the fact that such deductions may exceed cost. *Id.* § 613(a). Another popular shelter is the depreciation deduction under § 167(a) for exhaustion, wear and tear of capital assets. *Id.* § 167(a). Section 167(b) allows the taxpayer to use the double-declining balance method and the sum of the year's digits which give the taxpayer a higher deduction, in essence, the tax avoider receives an interest free loan from the Government in the early years. *Id.* § 167(b).

13. Meyer, *Running for Shelter*, PUB. CITIZEN, February, 1985, at 1.
14. *Id.* at 17.
15. For instance, § 105 was enacted to encourage employers to provide health insurance. *See* S. REP. 83rd Cong., 2d Sess. 9, *reprinted in* 1954 U.S. CODE CONG. AND AD. NEWS 4818-4820 (codified at I.R.C. § 105 (1982)).
16. Kullberg, *Noncompliance-Death Knell for a Tax System*, 2 FISCAL POL. F. 3 (1984).
17. Egger, *Compliance-Managing the System*, 2 FISCAL POL. F. 4 (1984).
18. Calkins, *A Federal Income Tax Designed For Revenue Only*, TAX NOTES April 9, 1984, at 209.

quences of policies tailored to provide compensating benefits to society. Therefore, as a matter of public policy, allowing these inequities to continue is wrong. Moreover, as a matter of fiscal policy, particularly during the recent period of record budget deficits,[19] maintaining a system which produces these inequities is unwise.

Complexity

Our tax system is overly complicated. In 1939, one commentator asserted, "the taxpayer cannot hope to cope with its vast bulk, its involved language, or its infinitude of technicalities."[20] At that time, the Code consisted of 140 pages. The current Code runs over 2000 pages in length and is supplemented by over 10,000 pages of explanatory regulations. In addition, an enormous body of case law interprets the various provisions of the Code.

Understandably, many taxpayers feel incompetent to complete their own tax returns. The sentiment of many Americans is expressed in a letter sent to the Internal Revenue Service, in which a frustrated taxpayer wrote, "I can't figure out the tax form. Just send me a letter telling me how much you would like and I'll think it over."[21] Despite its complexity, the current tax system purportedly is one of self-assessment. Yet, the figures show that self-assessment is becoming the exception, rather than the rule. A conservative estimate is that over 40% of those who file returns have a professional tax preparer prepare the returns for them, and of that number approximately 4% use Form 1040EZ.[22] A system in which this many taxpayers depend on outside assistance to complete their returns, including the least complicated form, demands simplification.

In fact, the current system is so complicated that even with the aid of tax professionals, the taxpayer cannot always be assured of receiving a definite answer to a tax question. According to one report, "expert tax practitioners must concede (they do every day to clients who seek their advice) that in many areas they cannot predict with a reasonable degree of certainty the tax consequences of a transaction."[23] One expert noted that "complex tax laws often give taxpayers wide latitude to take alternative positions on a tax return."[24] The extreme complexity of the Code has created what another commentator refers to as the "tax lottery."[25] For all but the most routine transactions, the tax system has become a

19. In 1982, the deficit was $111 billion dollars while in 1983, it was $195 billion dollars. The deficit is estimated to escalate to $208 billion in 1985. EXECUTIVE OFFICE OF THE PRESIDENT, ECONOMIC REPORT OF THE PRESIDENT 36 (1984).

20. Eichholz, *Should the Federal Income Tax Be Simplified?*, 48 YALE L. J. 1200, at 1201 (1939).

21. 129 CONG. REC. S7856 (daily ed. June 8, 1983) (remarks of Senator Max Baucus, D-Mont.).

22. *Tax Reform and Deficit Reduction Hearings Before the House Comm. on Ways and Means*, 98th Cong., 2d. Sess., 200, at 214 (statement of Emil M. Sunley, Director of Tax Analysis For Deloite, Haskins, & Sells) (1984).

23. Committee on Tax Policy, New York State Bar Association, *A Report on Complexity and the Income Tax*, 27 TAX L. REV. 325, at 334 (1972).

24. Tax Reform and Deficit Reduction *Hearings Before the House Committee on Ways and Means*, 98th Cong., 2d. Sess., 203 (statement of Emil M. Sunley, Dir. of Tax Analysis for Deloitte, Haskins, & Sells) (1984).

25. McDaniel, *Simplification Symposium Overview: The Viewpoint of the Tax Lawyer*, 34 TAX L. REV. 5, at 9 (1978). Mr. McDaniel postulates a complex sequence of questions confronting a taxpayer which make prediction of tax liability a "Lottery."

> When a taxpayer encounters a doubtful issue in a proposed transaction or in a consummated transaction prior to preparation of his return, he is confronted with the tax lottery:
> (1) Will his return be selected for audit?
> (2) If so, will the agent be sufficiently skilled to discover the issue?
> (3) If so, can the issue be resolved at less than the full tax on the basis of trial hazards?
> (4) If not, will the government counsel make the telling contentions to the court?
> (5) If so, will the court understand the issue?

game of chance in which the competing contestants are the taxpayer and the IRS, and the stakes are tax dollars.

Whether or not particular taxpayers participate in the game, taxpayers, as a group, have little reason to respect the tax system or the Government that instituted and maintains the system. Taxes are perhaps the single greatest determinant of the public's view of their government for "[n]o other branch of law touches human activities at so many points."[26] Given the inequality and the complexity of the current tax system, it is little wonder that the Government's image as a whole has been tarnished. Under these circumstances, lawmakers cannot realistically expect an atmosphere of cooperation to continue to exist between the Government and taxpayers.[27]

Uncertainty

The current system is fraught with uncertainty. In part, this problem is a byproduct of the system's complexity. Uncertainty also results from frequent changes in the Code. Over the years, there have been several attempts to "reform" the Tax Code. In some instances, as with the Tax Equity and Fiscal Responsibility Act,[28] reforms were enacted to curb specific abuses. In other cases, as with the Economic Recovery Tax Act,[29] they were enacted simply to amend the tax rates. Frequently, the result has been mass confusion over the correct interpretation of the various changes.

Regardless of the motive for the reforms, individual taxpayers, as well as tax practitioners, must expend considerable resources to keep abreast of the changes. Repeated changes in the Code also significantly burden the Internal Revenue Service.[30] Possibly most serious are repeated changes in the Code which undermine the ability of individuals and businesses to plan, since they cannot depend on the tax laws remaining constant over time. If the goals of tax reform are to minimize uncertainty and complexity, the recently enacted "reforms" have not only failed to achieve their goal, but they have actually exacerbated the problems.

Economic Inefficiency

The current Federal income tax system encourages economically inefficient behavior in several ways. First, it encourages investment in unprofitable endeavors. Due to various tax preferences, investment decisions are frequently based not on the profitability of the underlying capital-producing item, but on the tax savings which will result from the investment. Indeed, investors may actively seek investment losses to maximize their net after-tax income.[31] The tax system thus subsidizes economic inefficiency. At the same time, the system detracts from the

Id.

26. Dobson v. Commissioner, 320 U.S. 489 (1944).

27. *See* Paul, *Simplification of Federal Tax Laws*, 29 CORNELL L.Q. 285, at 287 (1944). Paul notes that:

> You may persuade, but you cannot coerce. Taxpayers are, after all, to some degree in control of their destinies. Paying taxes gives citizens a very real sense of participation in Government. But they must participate with the feeling of partners, not arithmetical slaves. They cannot derive satisfaction from contact with their Government when they are befuddled by a maze of complexities.

28. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982).

29. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 175 (1981).

30. The IRS Commissioner, Roscoe L. Egger, Jr. addressed this point, saying that, "as an agency, we are tied up in knots drafting regulations to explain the frequent changes in law." Egger, *Compliance-Managing the System*, 2 FISCAL POL. F. 4. (1984).

31. For instance, the Code may in fact be encouraging corporate taxpayers to extend credit to risky parties who are in debt because § 166(a) allows deductions for any business debts that have become worthless in a taxable year. I.R.C. § 166(a) (1982). Individuals, on the other hand, may deduct losses if they are

ability of profitable businesses to attract investment capital by diverting potential investment dollars away from such profitable businesses to less profitable, or even to completely unproductive activities.

Second, the current Code promotes inefficiency in the area of compensation. Because fringe benefits are not taxed,[32] employers may offer and employees may accept these benefits at values substantially greater than the employee would otherwise want or need. There are simply no incentives for the employee to be a cost-conscious fringe benefit consumer. This distortion of consumer incentives interferes with the normal operation of the market by substituting tax-influenced decisions for more cost-effective individual decisions.

The current system also acts as a disincentive to work. As mentioned earlier, the aggregate loss of tax revenue resulting from the numerous credits, exclusions, and deductions incorporated within the current Tax Code, must be recouped if the Government is to provide the goods and services citizens want and need. To compensate for these losses, wages are taxed more heavily than would otherwise be necessary. As wages are taxed more heavily, work becomes less profitable.[33]

THE DIFFICULTIES OF TAX REFORM

Despite numerous previous attempts to redress these serious and persistent problems, we have failed thus far to find a cure. Vested interests serve as one obstacle standing in the way of tax reform. Congress faces a situation in which taxpayers regard special treatment for certain items as a matter of entitlement. Such special treatment, once granted, is not readily relinquished. Repealing tax preferences, like pulling teeth, is difficult and painful. Nevertheless, this drastic remedy appears to be necessary to halt the decay caused by the current tax system. Although taxpayers acknowledge the need for tax reform, they frequently balk at the notion once they discover that a provision granting them favorable treatment stands to be repealed.[34]

This obstacle though, is not as insurmountable as it appears initially. More often than not, it is the creation of representatives of special interest groups. As one commentator noted:

> Lobbyists representing beneficiaries of tax expenditures constitute a factor that virtually without exception, propels the income tax system in the direction of greater complexity. Any efforts at simplification through repeal or reduction of an existing tax expenditure is met with a well financed campaign portraying an apocalyptic vision of a world of unemployment, unfavorable balance of payments or trade, weakened national security, energy dependence, or whatever the current economic problem, if their clients' particular tax subsidy is curtailed.[35]

The lobbyists' continued success in effectively blocking comprehensive tax reform depends on their continued success in convincing members of Congress and the general public that tax reform will not be in the country's best interest. But what

not compensated for and are incurred in a trade or business, or in a transaction entered into for profit or arise from a natural disaster. *Id.* § 165(c).

32. Section 132 excludes certain fringe benefits such as qualified employee discounts, working condition fringe benefits and de minimus fringe benefits. *Id.* § 132(a).

33. According to the CBO, "higher tax rates make work less attractive because more and more leisure must be given up to earn each additional dollar in take-home pay." CONGRESSIONAL BUDGET OFFICE, REVISING THE INDIVIDUAL INCOME TAX 32 (1983).

34. *See* Gephardt, *A "But For" Test*, 29 ST. LOUIS U.L.J. — (1985). This "but for" problem describes a frequent response to the Fair Tax Act: "I like your bill, but for one provision."

35. McDaniel, *Federal Income Tax Simplification: The Political Process*, 34 TAX L. REV. 27, at 72 (1978).

I am hearing from my colleagues in the halls of Congress, from my constituents, and from other members of the general public, convinces me that the time is ripe for tax reform. Moreover, taxpayers are coming to understand what proponents of tax reform have stressed all along: successful tax reform can only be accomplished through a series of trade-offs. Under the Fair Tax Act, many taxpayers will be affected by the repeal of one or more "special treatment" provisions. In exchange for more income being taxed, however, most taxpayers will find themselves in a lower tax bracket with a net decrease in total tax liability.

The other major hurdle which has blocked tax reform has been the historical party split regarding what kind of tax reform is most appropriate. Thus, prior tax reforms frequently have reflected differing party ideologies, rather than differing tax concepts. Recently, however, members of Congress from both parties have come to recognize that the need for tax reform has reached a critical stage, requiring politicians to set aside their political differences. Given this unity of purpose, Congress is presented with a unique opportunity for tax reform.

THE FAIR TAX ACT

In recent years, proponents of tax reform have proposed several alternative methods of taxation totally unlike that embodied in the current Code. These include the value-added tax,[36] the consumption tax,[37] and the pure flat tax,[38] among others. Although each of these alternatives has something to offer in the way of simplification, in my view each must be rejected as failing to adequately balance the competing goals of tax reform. Intially, it must be acknowledged that simplicity and equity are substantially competing goals. As has been noted, "equity calls for looking at all the circumstances that might bear on the fairness of the amount of tax, while the essence of simplicity is to ignore some facts."[39] The best approach to tax reform balances these competing goals at maximal levels, without relegating either to obscurity. An income tax with progressive tax rates, although far from perfect, most persuasively achieves this balance.[40]

For this reason, I felt that the goals of equity, simplicity, and economic rationality can best be achieved by working within the context and structure of the

36. A value-added tax is a tax which is assessed on the increase in value of a good at each stage of the manufacturing process. R. LINDBLOOM, VALUE-ADDED TAX AND OTHER TAX REFORMS 27-57 (1976).

37. The Consumed Income Tax is imposed on the difference between an individual's net income and change in net receipts (wages, borrowed income, proceeds from sale of assets, withdrawals from savings accounts and all income in kind) less the individual's savings and investments (costs of earning income, purchases of plant and equipment, repayment of loans, reinvested dividends and interest). The difference is the tax base upon which the tax is imposed. SEE U.S. DEPT. OF THE TREASURY, OFFICE OF TAX ANALYSIS, BLUEPRINTS FOR BASIC TAX REFORM 113-212 (1977).

38. The flat tax is a single tax imposed across the board on all taxpayers. An example of a flat-tax plan is the bill proposed by Senator Dennis DeConcini (D-Ariz.). S. 321, 99th Cong., 1st Sess. 131 CONG. REC. S885-93 (daily ed, Jan. 31, 1985). The bill imposes a 14% tax on all income both corporate and individual. *See also* Note, *Flat Tax, Fair Tax: New Hope for Reforming the Internal Revenue Code*, 11 J. LEGIS. 521 (1984).

39. Surrey and Brannon, *Simplification and Equity as Goals of Tax Policy*, 9 WILLIAM AND MARY L. REV. 915, at 916 (1968).

40. Another, though necessarily less compelling rationale for continuing to utilize the structure of the current tax system is that each of the listed alternatives represents a significant departure from the current system. As such, our past experiences with the present system, and the knowledge we have accumulated, will provide little guidance in dealing with these alternative methods. According to one perspective, "we have had over 70 years of experience with the income tax and no experience with these other alternatives." *Tax Reform and Deficit Reduction Hearings Before the Committee on Ways and Means*, 98th Cong., 2d Sess., 306 (statement of Robert Goode Executive Vice-President, Hartford Life Insurance Co.) (1984). Our current system has many problems, but during these seventy years, we have managed to eliminate many others.

present code. Thus the Fair Tax Act retains the current progressive tax structure while broadening the tax base. In essence, the Fair Tax Act serves not as a substitute, but rather as an amendment to the present code. If the Act does not expressly repeal or change a provision, the provision remains unchanged.[41]

A comprehensive explanation of each provision of the Fair Tax Act is impossible given the restraints of this article. The remaining discussion, therefore, focuses on those aspects of the plan with the most far-reaching consequences. This discussion can be divided between its effects on individuals[42] and its effects on

41. H.R. 800, *supra* note 5, § 1(b):

(b) Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

42. Comparison of Present Law and the Fair Tax Act

	Current Law	Bradley-Gephardt
	INDIVIDUAL INCOME TAX	
Tax Rates		
Ordinary Income	11% - 50%	14%, 26%,30%[a]
Capital Gains	20% maximum rate	30% maximum rate
Alternative Minimum Tax	20%	Repealed
Exemptions		
Taxpayer	$1,000	$1,600
Spouse	$1,000	$1,600
Dependent	$1,000	$1,000
Blind, Aged	$1,000	$1,000
Zero Bracket Amount (single/ joint)	$2,300/$3,400	$3,000/$6,000
Indexing	Yes	No
Income Averaging	Yes	No
Taxable Income		
Dividends	$100 excluded	Included
Municipal Bond Interest	Excluded	Interest on public-purpose bonds excluded
IRA, Keogh Earnings and Earnings on Pension Reserves	Excluded	Excluded
Employer Contributions for Health Insurance Plans	Excluded	Included
Employer Contributions for Life Insurance Plans	Excluded	Included
Social Security Benefits (single/ joint)	Half benefits taxed if modified AGI over $25,000/$32,000[b]	Current law
Unemployment Compensation	Included depending on other income[c]	Included
Employment Income	Included	Included
IRA, Keogh Contributions	Deducted	Current law
State and Local Taxes	Deducted	Deducted at 14% rate
Income Property		
Real	Deducted	Deducted at 14% rate
Personal	Deducted	Not Deducted
Sales	Deducted	Not Deducted
Charitable Contributions	Deducted	Deducted at 14% rate
Medical Expenses	Only if more than 5% of AGI	Only if more than 10% of AGI
Home Mortgage Interest	Deducted	Deducted at 14% rate[d]

corporations.[43]

Other Nonbusiness Interest	Deducted	Nonbusiness interest limit to amount offset by net investment income, deductable at 14% rate[d]
Two-Earner Deduction	10% of earning of lesser earning spouse, up to $3,000	Not deducted
Capital Gains	60% excluded	Included
Capital Losses	50% taken against income, up to $3,000	Limited[e]
Loss Carryover	Unlimited	One year
Corporate Pensions	Deferred tax	Limited[f]
Tax Credits		
Earned Income Credit	Yes	Yes

a. 14% — on individual income up to $25,000; joint income up to $40,000.
26% — on individual income between $25,000 and $37,000; joint income between $40,000 and $65,000.
30% — on individual income exceeding $37,500; joint income in excess of $65,000.

b. Modified adjusted gross income (AGI) includes AGI plus one-half of the Social Security benefits plus interest on tax-exempt bonds.

c. If AGI plus unemployment compensation exceeds $12,000 for a single return ($18,000 joint return), half the excess is included in income up to the amount of the benefits.

d. Also deductible up to the limit of net investment income from adjusted gross income for taxpayers who pay the surtax.

e. Limited to capital gains plus the smallest of: taxable income; or $1,500 single ($3,000 joint); or net capital loss. For this purpose, taxable income excludes capital gains, capital losses, and personal exemptions.

f. Defined benefit plan limit reduced from present $90,000 to $60,000. Defined contribution plan limit reduced from present $30,000 to $20,000.

43. Comparison of Present Law and the Fair Tax Act

	Current Law	Bradley-Gephardt
	PROVISIONS AFFECTING BUSINESS (Corporate and Noncorporate)	
Investment Tax Credit	6% - 10%	No
Intangible Drilling Cost of Oil, Gas, and Geothermal	Expensed	Assigned to 10-year depreciation class
Treatment of Depletion of Oil, Gas, and Goethermal	Cost depletion for integrated oil companies, percentage depletion for mineral producers and independent oil companies	Assigned to 10-year depreciation class
R&D Credit	Yes	No
Targeted Jobs Tax Credit	Yes	No
Rehabilitation Credit	Yes	No
Excess Bad Debt Credit	Yes	No
Employee Stock Ownership Plan	Yes	No
Depreciation	Accelerated Cost Recovery System	"Open Accounts" based on modified ADR asset lives[a]
	CORPORATE INCOME TAX	
Tax Rates		
Regular	15%-40% on first $100,000, 46% thereafter	30%
Capital Gains	28%	30%
Add-On Minimum Tax	15%	Repealed
Deductions		
Capital Losses	Limited to capital gains	Current Law

Individuals

For individuals, the Fair Tax Act establishes three tax rates of 14%, 26%, and 30%.[44] Single taxpayers with incomes of $25,000 or less will be taxed at the 14% base rate.[45] Income between $25,000 and $37,500 is taxed at a combined rate of 26%.[46] This combined rate consists of the 14% base rate, plus a 12% surtax on amounts exceeding the base rate amount of $25,000.[47] Income in excess of $37,500 is taxed at a 30% rate.[48] For married taxpayers filing jointly, the 14% base rate will apply to the first $40,000 of income.[49] The 26% rate will apply to amounts greater than 40,000, but less than $65,000.[50] Amounts exceeding $65,000 are taxed at the 30% rate.[51] Recent estimates indicate that over 70% of taxpayers will be taxed at the 14% rate.[52]

Although the additional exemptions for taxpayers with dependents and for elderly and blind taxpayers will be retained at the $1,000 level,[53] the personal exemption will be increased to $1,600 for taxpayers and their spouses, and to $1,800 for a single head of household.[54] The bill also increases the zero-bracket amount from the current $2,300[55] to $3,000[56] for single taxpayers, and from $3,400[57] to $6,000[58] for married taxpayers filing jointly. This parity in the zero-bracket amounts for single and married taxpayers will substantially decrease the "marriage penalty."[59]

The Act repeals most itemized deductions, credits, and exclusions.[60] Those deduction provisions which are most widely used by the broadest spectrum of taxpayers, however, are retained. The deductions that remain include home mortgage interest,[61] other consumer interest not exceeding investment income[62], charitable contributions,[63] State and local income and property taxes,[64] medical expenses in excess of ten percent of adjusted gross income,[65] and IRA[66] and Keogh contributions.[67] The Act would also retain the Code's current treatment of

Excess Capital Losses	Carryback 3 years, carryforward 5 years	Current Law
Charitable Contributions	Deducted	50% deduction

*See *infra* note 84 and accompanying text.

44. H.R. 800, *supra* note 5, § 101(a)-(d).
45. *Id.* § 101(b). Since the single taxpayer with income of $25,000 or less does not reach the level at which any surtax is charged, the only tax imposed is the 14% "normal tax" imposed under subsection (b).
46. *Id.* § 101(b). This tax is arrived at by adding the 14% "normal tax" imposed under section (b) to 12% "surtax" imposed on incomes in this range under subsection (c).
47. *Id.* § 101(c),(d).
48. *Id.* § 101(c),(d). This tax rate is arrived at by adding the 14% "normal tax" to the 16% "surtax" imposed on all taxpayers with income above $37,500.
49. *Id.* (b).
50. *Id.* (c),(d).
51. *Id.* (c),(d).
52. Office of Senator Bradley, D-N.J., Press Release 5 (April 14, 1983).
53. H.R. 800, *supra* note 5, at § 112. Those deductions are set forth at I.R.C. §§ 151(e),(c) and (d), respectively. I.R.C. § 151 (1982).
54. H.R. 800, *supra* note 5 at § 111.
55. I.R.C. § 1(c) (1982).
56. H.R. 800, *supra* note 5, at § 112.
57. I.R.C. § 1(a) (1982).
58. H.R. 800, *supra* note 5, at § 112.
59. *See* R. HALL & A. RABUSKA, LOW TAX, SIMPLE TAX, FLAT TAX 22 (1983).
60. H.R. 800, *supra* note 5, at §§ 201, 211, 231, 233.
61. *Id.* at § 232. (amending I.R.C. § 163 (1982)).
62. *Id.*
63. *Id.* at § 234. (amending I.R.C. § 170(a) (1982)).
64. *Id.* at § 233. (amending I.R.C. § 164 (1982)).
65. *Id.* at § 235 (amending I.R.C. § 213 (1982)).
66. I.R.C. § 404 (1982).
67. *Id.* § 408.

Social Security[68] and Veteran's benefits.[69] Expenses incurred for household and dependent care services necessary for employment, a credit under the current law,[70] would be allowed as a deduction under the Fair Tax Act.[71]

With the exception of home mortgage interest, and other consumer interest, the retained deductions could only be taken against the 14% rate.[72] In other words, the maximum value of all the deductions is 14%. This limitation will substantially decrease the motivation of those in the upper income brackets to expend time and money looking for tax deductions. Home mortgage interest and other consumer interest, unlike the other deductions, are deductible against the surtax rate to the extent they do not exceed investment income.[73]

As discussed earlier, tax preferences are at the root of much of the current Code's inequity. Accordingly, the Fair Tax Act eliminates many of the provisions which preferentially fail to tax, or which impose a lower tax on certain types of income. Most important among these changes, the Fair Tax Act repeals the exclusion of employer-provided fringe benefits.[74] Because of the favorable treatment currently accorded fringe benefits, they have become increasingly popular. The exemption of employer-paid health insurance premiums will cost about $20 billion in 1985, while life insurance premiums will cost another $2 billion.[75] This revenue loss will continue rising as new types of fringe benefits, such as day care[76] and legal services,[77] become more commonplace. Not only is the current exclusion costly, but it also discriminates against taxpayers who do not receive such benefits. By eliminating this exclusion, the Fair Tax Act will enhance the horizontal equity of the tax system.

The Fair Tax Act also repeals the provision excluding from income 60% of long term capital gains.[78] Thus, all income from long term capital gains will be taxed at the same rate as short term capital gains and other types of income. The current Code's favorable treatment of long term capital gains overwhelmingly favors wealthy taxpayers.[79] In addition, because the percentage excludable is an arbitrary figure, it rarely, and then, only coincidentally, achieves its goal of compensating for the impact of inflation.[80] More typically, it simply shields from taxation gains representing profits which should legitimately be taxed at the regular tax rates.

In addition, it remains unclear whether the investment-encouraging effect of the favorable tax treatment for long term capital gains actually aids or hinders the growth of the economy. Clearly, where such investment is made in economically sound enterprises, it does contribute to the country's general economic health.

68. *Id.* § 22(d).
69. *Id.* § 22(d).
70. *Id.* § 21.
71. H.R. 800, *supra* note 5, at § 202.
72. *Id.* §§ 1(b), 232.
73. I.R.C. § 163 (1982).
74. H.R. 800, *supra* note 5 §§ 211, 212, 216.
75. Bradley and Gephardt, *Fixing the Income Tax with the Fair Tax*, 15 TAX POLICY: NEW DIRECTIONS AND POSSIBILITIES 19, at 21 (1984).
76. I.R.C. § 21 (1982).
77. I.R.C. § 120 (1982).
78. I.R.C. § 1202 (1982); H.R. 800, *supra* note 5 § 241(a)(2).
79. Long-term capital gain is defined in I.R.C. § 1202 (1982). That section provides a deduction for 60% of a capital gain; so that only 40% is subject to taxation. The Revenue Act of 1978 increased the special deduction for a long term capital gain from 50% to the present 60%. Pub. L. No. 95-600, § 402(a), 92 Stat. 2867 (1978). Since wealthy taxpayers are more likely to have enough wealth to purchase, acquire, and hold assets for over a year they are deriving essentially all the benefit of the preferential treatment. Lower income individuals are not likely to have very much long term capital gain. Their income is more likely to be "ordinary" income, which is taxed fully, without a deduction.
80. *Id.*

Investors primarily interested in sheltering income do not, however, selectively invest in economically productive enterprises. One commentator noted that "the reduced rate of capital gains tax also encourages investments in land, gold, and collectibles, none of which are directly productive of income or employment."[81] As noted earlier, while this special tax rate encourages investment, it also creates pressure to tax wages at a higher rate and thereby reduces the incentive to work.

Government cannot continue to provide favorable tax treatment for long term capital gains while simultaneously reducing tax rates on wages without aggravating the already oversized deficit. The special tax treatment for capital gains promotes inequity and economic inefficiency; an overall lower tax rate will promote equity and economic efficiency.

Corporations

Under the Fair Tax Act, corporations will pay taxes at a flat 30% rate.[82] The other most significant change affecting corporations is in the system of depreciation. The Act replaces the Accelerated Cost Recovery System[83] with a new class-life depreciation system.[84]

The proposed system divides equipment into six classes based on its Asset Depreciation Range (ADR) midpoint. An open ended account will be established for each asset class and each class will be given a class life. Each year taxpayers write off a percentage of the balance in the account computed using the class life and the 250% declining balance method. Additions to each account will be made each year for purchases of assets in that class and subtractions will be made for dispositions of assets and for that year's depreciation deduction. Structures will be classified in the sixth asset class. The asset classes and depreciation rates for equipment are prescribed in the following table:

ADR Midpoint	Class Life
Under 5	4
5.0 to 8.5	6
9.0 to 14.5	10
15 to 24	18
25 to 35	28
Over 35 and structures	40

Thus, for example, equipment with an ADR life of 10 years will be in the 10 year class. The first year's write-off will be 25% of the cost (2.5/10 - .25), the second year's write-off will be 18.75% (25% of 75%) and so forth. This system of open accounts, although not as liberal as the present system, provides depreciation periods much closer to the asset's actual life.

The Fair Tax Act would eliminate most existing business tax deductions, credits, and exclusions, which tend to distort investment decisions.[85] Among the provisions that the Act will repeal are those permitting percentage depletion and expensing for intangible drilling costs for oil, gas, and geothermal wells, and for mineral exploration and development costs.[86] Instead, drilling costs will be "de-

81. Calkins, *A Federal Income Tax Designed For Tax Revenue Only*, 23 TAX NOTES 201, at 210 (1984).
82. H.R. 800, *supra* note 5, § 102(a).
83. I.R.C. § 168 (1982).
84. H.R. 800, *supra* note 5, § 168(c).
85. These include deductions for personal exemptions I.R.C. §§ 151-153 (1982); itemized deductions for individuals and corporations, *Id.* § 161-196 and §§ 211-223,; special deductions for corporations, *Id.* §§ 241-50; nonrefundable personal credits, *Id.* § 21; foreign tax credit, *Id.* §§ 31-35; general business credit, *Id.* §§ 38-41; credit for investment in certain depreciable property, *Id.* §§ 46-50; credit for employment of certain new employees, *Id.* §§ 51-52; exclusions from gross income, *Id.* §§ 101-134.
86. I.R.C. § 263(c) (1982); H.R. 800, *supra* note 5, § 311(1).

preciated" under the method applied to equipment having a ten-year class life.[87] Mineral exploration and development costs will be similarly deducted, but the assigned class life will be based on the mine's expected life.[88] Also repealed are the provisions excluding income from controlled foreign subsidiaries of United States corporations,[89] the investment tax credit,[90] and the research and development credit.[91] The corporate deduction of charitable contributions, while not repealed, is limited to one-half of the contribution.[92] The Act repeals the corporate minimum tax because most preferences which made that minimum tax necessary, are eliminated by the Act.[93]

Transitional Rules

The drafting of rules to govern the transition period to full implementation of the Fair Tax Act remains problematic. It clearly would be unfair to change over to the new system immediately. Taxpayers have planned transactions in reliance on the tax treatment available under the current code. Furthermore, an abrupt transition would create major capital dislocations. On the other hand, the current Code is too inequitable and creates too many economically inefficient investment decisions to be permitted to remain in effect for an extended period. An additional concern arises with regard to partial introduction of the Fair Tax Act. Such partial implementation will require careful orchestration to avoid short term negative effects on net tax revenues. The Fair Tax Act's lower tax rates on income will obviously not achieve revenue parity with the current system so long as the tax base remains as narrow as it presently is.

The Fair Tax Act's transitional rules attempt to accomodate each of these competing interests to the greatest possible extent. In general, the changes enacted under the Act will apply to taxable years beginning after December 31, 1986.[94] An exception is made for some provisions dealing with long-term transactions initiated prior to the effective dates.[95] For example, although the effective date of the provision changing the system of depreciation is December 31, 1986,[96] the new system will apply only to assets placed into service after December 31, 1986.[97] Assets placed into service prior to that date remain unaffected. Similar exceptions are made for the effective dates repealing the investment tax credit[98] and the changes in exclusions for interest from certain tax-exempt bonds.[99] Other rules are designed to prevent transition shock by effectively disregarding earlier years.[100] However, there remain numerous other complex changes for which transitional rules must be formulated. These rules will depend on the probable

87. I.R.C. §§ 611, 613A (1982); H.R. 800 *supra* note 5, §§ 302(c)(2)(B).
88. I.R.C. §§ 616,617 (1982); H.R. 800, *supra* note 5, §§ 302(c)(2)(A), 311(8),(9).
89. I.R.C. § 959 (1982). For a definition of "controlled foreign subsidiary" *see* I.R.C. § 957 (1982); H.R. 800, *supra* note 5, §§ 401, 987.
90. I.R.C. § 38 (1982); H.R. 800, *supra* note 23a, § 201(2).
91. I.R.C. § 130 (1982); H.R. 800, *supra* note 5, § 201(8).
92. I.R.C. § 170 (1982); H.R. 800, *supra* note 5, § 234.
93. I.R.C. §§ 55, 56 (1982); H.R. 800, *supra* note 5, § 121(a)(b).
94. H.R. 800, *supra* note 5, § 501(a).
95. H.R. 800, *supra* note 5, § 302(d)(2).
96. *Id.* § 301(g)(9)(A).
97. *Id.* § 501(f).
98. *Id.* § 501(c).
99. *Id.* § 501(e).
100. For example, although the Fair Tax Act will tax increases in the cash surrender value of life insurance policies, it will ignore increases which occured prior to the effective date. Thus, for purposes of computing the increase in the life insurance contract, the value is established as of December 31, 1986. *Id.* § 501(d).

impact that the changes will have, and what kind of transition will provide the greatest stability without frustrating the intent of tax reform.

CONCLUSION

We have reached the point where tax reform is not merely desirable, but crucial. We can no longer afford the inequities, the complexities, and the economic inefficiencies of the current system. Frustrated and resentful taxpayers increasingly express their dissatisfaction by evading taxes. Confidence in the Government is reaching unacceptably low levels. Fortunately, taxpayer reaction to proposed tax reform is generally favorable. Moreover, the bipartisan willingness of members of Congress to work together to achieve tax reform is highly encouraging. The Fair Tax Act is a sensible plan for comprehensive tax reform. It is a plan for a simpler, fairer, and more economically rational tax.