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## A Consumption Tax versus a Federal Income Tax in the United States

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# A CONSUMPTION TAX VERSUS A FEDERAL INCOME TAX IN THE UNITED STATES

by

SHELLY-ANN TOMLINSON

(Under the Direction of David Brennan)

## ABSTRACT

This thesis makes a comparison between a consumption tax and the current Federal Income Tax in order to establish which would be fairer, simpler, more efficient and feasible for the United States. Issues such as which of the two tax systems would be easier to apply, and which would yield enough revenue for the fiscal budget are addressed. The Thesis argues that a consumption tax would be more suitable for the United States and in particular makes reference to the Fair Tax plan which is a proposal to replace the current federal income tax with a national retail sales tax. This paper concludes that the Fair Tax plan would be more suitable for the United States than the current Federal Income Tax.

**INDEX WORDS:** Consumption tax, Federal Income tax, Fair Tax Act, Fair Tax Plan, national retail sales tax, global system, schedular system, American family tax system, tax evasion, taxing corporations, alternative minimum tax, economic efficiency, horizontal equity, vertical equity, marginal rate, capital gains, corporate tax, double taxation, estate and gift taxes, fiscal efficiency, neutrality, multi-stage taxes, Value Added Tax (VAT), Flat Tax, gross income, International Tax Law, tax burden, foreign tax credit, inbound transaction, outbound transaction.

A CONSUMPTION TAX VERSUS A FEDERAL INCOME TAX IN THE UNITED STATES

by

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A Thesis Submitted to the Graduate Faculty of The University of Georgia in Partial Fulfillment  
of the Requirements for the Degree

MASTER OF LAWS

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2007

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A CONSUMPTION TAX VERSUS A FEDERAL INCOME TAX IN THE UNITED STATES

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## DEDICATION

I dedicate this thesis paper to my parents, Maureen and Ainsley Tomlinson, and to my nieces Taniel and Mary Franks.

## ACKNOWLEDGEMENTS

I give foremost thanks to the omnipotent, omnipresent, and omniscient God Jesus because without Him I can do nothing. I wish to acknowledge the invaluable help and support received from Professor Gabriel Wilner who I believe is a true example of what a teacher ought to be. I would like to thank Professor Brennen, my major Professor for his guidance and insight. I thank my friend Shelley-Ann Irons who encouraged me to never give up.

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Statement of Thesis

This paper proposes to make a comparison of a consumption tax and the current United States federal income tax seeking to establish which would be fairer, simpler, more efficient and feasible. The question of feasibility looks at which would be easier to apply in the society, but more importantly it contemplates which would be fairer and whether such a tax regime could adequately yield enough revenue for the government's fiscal budget. Clearly, there will be competing interests since the controversy lies between the people's interest (the populous) and those who govern.<sup>1</sup> The controversy is that those who govern do not put the people's interest first, nor do they protect the people's interest.<sup>2</sup> In an ideal society no such controversy ought to exist since the role of the government is to protect the people and to put the people's needs and interests first.<sup>3</sup> However, as history and experience have shown, the sad reality suggests otherwise.<sup>4</sup>

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<sup>1</sup> See, e.g., Robert E. Hall et al, *The Flat Tax*, 16 (Hoover Institution Press 2<sup>nd</sup> ed) (1995) (1985) (the author urges the American people to not believe that Congress has their interests at heart); Tax Analysts *Tax Notes Today*, Gingrich says Assess Government Before Considering Tax Increases, Available at Lexis 93 TNT 33-96 \*1420 (1993) (Mr. Newt Gingrich urged his colleagues to assess the government's handling of revenues before considering tax increases. Mr. Gingrich stated that the Government was not using the money wisely or efficiently because Congress was not using the money as the American people wanted it to be used)

<sup>2</sup> Robert E. Hall et al, *The Flat Tax*, 16 (Hoover Institution Press 2<sup>nd</sup> ed) (1995) (1985)

<sup>3</sup> See Ken Hoagland, *The Legacy of Boston Harbor*, (2006), <http://www.fairtax.org/PDF/TheLegacyofBostonHarborHoagland063006.pdf>

<sup>4</sup> Id.

A consumption tax taxes individuals when they spend.<sup>5</sup> It penalizes the spendthrift and rewards the miser.<sup>6</sup> A flat or progressive tax that taxes the consumption of individuals is easy to apply since taxation becomes mechanically based on the taxpayer's consumption needs. By comparison, the federal income tax is not as easy to administer due to the inherent uncertainties in the law such as the complexity of the rules making it difficult for the average taxpayer to understand it, and the high tax bill which leads to a low compliance rate.<sup>7</sup> There is an argument that administration of a consumption tax would be fairer and less burdensome than the administration of the federal income tax. Advocates of the Fair Tax Act, for example, suggest that administration of a consumption based tax would be fairer<sup>8</sup> than the current Federal Income tax because individuals would be given an incentive to work since they will be taxed less, thus giving a boost to the economy.<sup>9</sup>

A consumption tax can be advantageous to the American society because it would create a fair<sup>10</sup> tax regime as a result of it being simpler.<sup>11</sup> A consumption tax would attain the major objectives of a good tax system, such as, horizontal and vertical equity, and economic efficiency, and equity.<sup>12</sup> It would also be advantageous on an international level since it would increase the competitiveness of the of U.S. businesses operating abroad and it would be

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<sup>5</sup> Am. Enter. Inst. for Pub. Policy Research, *Reforming the Income Tax System*, 39 (1981)

<sup>6</sup> W. Cleon Skousen, *The History of the 16<sup>th</sup> Amendment*, [http://www.salestax.org/library/skousen\\_16history.html](http://www.salestax.org/library/skousen_16history.html).

<sup>7</sup> See Tax Analysts Tax Notes Today, New York CPAs Propose Set Tax as Reform Option, Available at LEXIS 2005 TNT 214-63 (2005) (this article speaks to the problems inherent in the United States' tax system such as the complexity of the rules making it hard for the average taxpayer to understand, and when complied with, the tax bill is high and this will inevitably lead to a low compliance rate).

<sup>8</sup> See Fair Tax Act, *Executive Summary: The Fair Tax*, 2 (2006), <http://www.fairtax.org/PDF/FairTaxExecutiveSummary.pdf>

<sup>9</sup> Arduin, Laffer & Moore, *A Macroeconomic Analysis of the Fair Tax Proposal*, 36 (2006), <http://www.fairtax.org/PDF/MacroeconomicAnalysisofFairTax.pdf>

<sup>10</sup> See e.g., Am. Enter. Inst. for Pub. Policy Research, *Reforming the Income Tax System*, 37 (1981); Scott Burns, *Single Flat Sales Tax is Fair, and it Solves Some Problems*, (2006) [http://www.fairtax.org/site/PageServer?pagename=news\\_feature\\_101806](http://www.fairtax.org/site/PageServer?pagename=news_feature_101806)

<sup>11</sup> Laurence J. Kotlikoff, *The Case for the Fair Tax*, (2005), <http://www.fairtax.org/PDF/TheCasefortheFairTaxKotlikoff030705.pdf>

<sup>12</sup> Am. Enter. Inst. for Pub. Policy Research, *Reforming the Income Tax System*, 33 (1981)

simpler.<sup>13</sup> Notwithstanding this, the federal tax system practiced in the United States does have its advantages in that it is a progressive tax and it is a good indicator of the taxpayers' 'ability to pay.'<sup>14</sup> A progressive tax is usually considered to be fair because of the general consensus that taxpayers who earn more should pay more. But the federal tax system carries with it "bandages"<sup>15</sup> that a society may be all too reluctant to repair. That is, where there are instances of controversy and uncertainty in the law, there is the tendency to make new laws to clarify or change the former law which makes the system even more complicated. A comprehensive consumption tax would offer another option for the society with fewer problems.

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<sup>13</sup> Research Inst. of Am., Tax Planning and Practice Guide, 18 (1996) (One suggestion made by Stephen Entin is that whatever tax reform system is used it should have a less complicated code and it has enormous costs of compliance and enforcement and raises little revenue. This encourages U.S. businesses to make their investments abroad and not reinvest in America.

<sup>14</sup> Am. Enter. Inst. for Pub. Policy Research, Reforming the Income Tax System, 34-7 (1981). There is also the counterargument that consumption is a better indicator of the person's well-being than income.

<sup>15</sup> As explained in following sentence, the tax system is uncertain and by implication it is not simple. See, e.g., Am. Enter. Inst. for Pub. Policy Research, Reforming the Income Tax System, 38 (1981); Tax Analysts Tax Notes Today, New York CPAs Propose Set Tax as Reform Option, Available at LEXIS 2005 TNT 214-63 (2005)

## Chapter 2: A History of the Two Tax Systems

### A History of the Federal Income Tax

Initially, in the United States taxes were applied to the different states based on the size of the population.<sup>16</sup> The founding fathers of the United States initially did not favor the levy of income taxes unless they were apportioned to the states according to the population.<sup>17</sup> In *Pollock*,<sup>18</sup> the United States Supreme Court held that an unapportioned income tax contravened Article 1 section 8 of the Constitution.<sup>19</sup> Some report that the United States income tax arose from the Democrats' desire to publicly embarrass the Republicans who were thought of as being in favor of the rich.<sup>20</sup> It was thought that the Republicans favored affluent individuals. In order to not be viewed in this light, President William Howard Taft acknowledged in political speeches that income taxes may be acceptable in principle.<sup>21</sup>

Because of a fear of being perceived as a “party of the rich,” Republicans, including President Theodore Roosevelt approved the income tax bill that was proposed by the

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<sup>16</sup> U.S. Const. art. I, § 3

<sup>17</sup> W. Cleon Skousen, *The History of the 16<sup>th</sup> Amendment*, [http://www.salestax.org/library/skousen\\_16history.html](http://www.salestax.org/library/skousen_16history.html)

<sup>18</sup> *Pollock v Farmer's Loan & Trust Co.*, 157 U.S. 429 (1895)

<sup>19</sup> U.S. Const. art I § 8. After the *Pollock* case Congress attempted to circumvent the Supreme Court's decision and so it proposed the Sixteenth Amendment on July 12, 1909. This was ratified by the states on February 29, 1913. It authorizes Congress to tax incomes “from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.” In 1913 the first legal income tax was enacted and provided for a \$3000 exemption for single persons and \$4,000 for married couples. The tax rate structure began at 1% on the first \$20,000 of taxable income. It imposed six “super tax” brackets of 1% each on additional chunks of taxable income, reaching a top rate of 7% on taxable income over 1%. Robert E. Hall et al, *The Flat Tax*, 20-1 (Hoover Institution Press 2<sup>nd</sup> ed) (1995) (1985).

<sup>20</sup> W. Cleon Skousen, *The History of the 16<sup>th</sup> Amendment*, [http://www.salestax.org/library/skousen\\_16history.html](http://www.salestax.org/library/skousen_16history.html) (In April 1909, Senator Bailey, conservative democrat opposed income taxes and decided to embarrass the Republicans by forcing them to openly oppose an income tax bill similar to those which had been introduced in the past. He introduced the bill expecting it t get the usual opposition. He was amazed when Republican Teddy Roosevelt and a growing number of liberals in the Republican party came out in favor of the bill and it looked as if it was going to be passed.)

<sup>21</sup> Id.

Democrats. In 1913 the states ratified the Sixteenth Amendment,<sup>22</sup> which gave Congress the power to lay and collect taxes by whatever means it saw fit.<sup>23</sup> Adoption of the Sixteenth Amendment<sup>24</sup> marked the beginning of the modern federal income tax,<sup>25</sup> which taxed individuals based on the income that they earned.<sup>26</sup> In addition to the individual income tax, in 1909 President Taft proposed that there be a tax on corporation and business income.<sup>27</sup> He proposed that the tax for corporate income be 1% on profits that exceeded \$5000.<sup>28</sup>

President Taft's corporate tax received judicial approval in *Flint v. Stone Tracy Company*.<sup>29</sup> In *Flint*,<sup>30</sup> the directors of a corporation refused to comply with a Federal corporation tax. The Court held in part that "public service corporations represented at bar" were not exempted from the federal tax corporation.<sup>31</sup> The Petitioner corporations challenged the validity of the Corporation Tax Law because it was contended that real and personal estates should be taxed directly and was to be apportioned according to the population among the states.<sup>32</sup> The issue in *Flint*<sup>33</sup> was whether imposing an excise on the carrying on or the doing of business in a corporate or quasi corporate capacity invalidated the tax. The Court held that since the only limitation on the power of Congress is uniformity in laying the tax, it did not require the

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<sup>22</sup> U.S. Const. amend. XVI

<sup>23</sup> Tax Analysts Tax Notes Today, Ways and Means Releases 1990 Tax Green Book, Available at LEXIS 90 TNT 123 (1990)

<sup>24</sup> U.S. Const. amend. XVI

<sup>25</sup> The first Federal Income Tax was implemented in 1861 and it granted a \$600 exemption and imposed a 3% charge on income below \$10,000 and 5% on income above that level.

<sup>26</sup> See e.g., Tax Analysts Tax Notes Today, Ways and Means Releases 1990 Tax Green Book, Available at LEXIS 90 TNT 123 (1990). This occurred in July, 1909 and was unanimously agreed on by the Senate in a vote 77-0 and in the House voting 318 to 14; W. Cleon Skousen, *The History of the 16<sup>th</sup> Amendment*, [http://www.salestax.org/library/skousen\\_16history.html](http://www.salestax.org/library/skousen_16history.html)

<sup>27</sup> W. Cleon Skousen, *The History of the 16<sup>th</sup> Amendment*, [http://www.salestax.org/library/skousen\\_16history.html](http://www.salestax.org/library/skousen_16history.html)

<sup>28</sup> *Id.*

<sup>29</sup> *Flint v. Stone Tracy Company*, 220 U.S. 107 (1911)

<sup>30</sup> *Id.* at 107

<sup>31</sup> *Id.* at 172

<sup>32</sup> *Id.* at 147

<sup>33</sup> *Id.* at 107



equal application of the tax to all persons or corporations who came within its operation.<sup>34</sup> Mr. Justice Day opined that the tax that was under consideration was an excise on ‘the particular privilege of doing business in a corporate capacity.’<sup>35</sup> Eleven state circuit courts upheld the tax as being constitutional.<sup>36</sup> The Supreme Court in *Flint*<sup>37</sup> upheld the decisions of the lower courts and opined that Congress had the power to lay the tax.<sup>38</sup>

In the first few years of the applicability of the federal income tax, few citizens qualified to pay the tax because it only applied to the very wealthy.<sup>39</sup> As noted by Cleon Skousen,<sup>40</sup> in 1939 only 5% of the population were required to pay Federal income taxes. Today more than 80% of the American society is required to pay Federal income taxes.<sup>41</sup>

### History of the Consumption Tax in the U.S.A

There is not a national sales tax in the United States.<sup>42</sup> Each state determines the amount of tax that it will apply to property and services.<sup>43</sup> Initially, states used an excise tax and this was applied to tobacco and gasoline.<sup>44</sup> Oregon was the first state to impose a tax on gasoline and by 1929 all other states followed suit and this later proved to be a substantial source of the states’ revenue.<sup>45</sup> States were reluctant to impose sales taxes because of fears that businesses would move out-of-state. The Depression forced states to try the unknown and

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<sup>34</sup> *Flint v. Stone Tracy Company*, 220 U.S. 107, 158 (1911)

<sup>35</sup> *Flint*, 220 U.S. at 151

<sup>36</sup> *Id.* at 107

<sup>37</sup> *Id.* at 107

<sup>38</sup> *Id.* at 157

<sup>39</sup> Robert E. Hall et al, *The Flat Tax*, 21 (Hoover Institution Press 2<sup>nd</sup> ed) (1995) (1985)

<sup>40</sup> See e.g. W. Cleon Skousen, *The History of the 16<sup>th</sup> Amendment*,

[http://www.salestax.org/library/skousen\\_16history.html](http://www.salestax.org/library/skousen_16history.html); Michael J. Graetz, *The Decline (and Fall?) of the Income Tax*, 196 (1997) (the income tax applied mainly to the rich and not to the masses)

<sup>41</sup> W. Cleon Skousen, *The History of the 16<sup>th</sup> Amendment*, [http://www.salestax.org/library/skousen\\_16history.html](http://www.salestax.org/library/skousen_16history.html)

<sup>42</sup> Mary E. Forsberg, NJPP Reports, *You’re 40; Now Get To Work: Making the State Sales Tax Pull its Weight*, (2006), [http://www.njpp.org/rpt\\_salestax.html](http://www.njpp.org/rpt_salestax.html). (Last visited on January 10, 2007).

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

implement a sales tax.<sup>46</sup> Mississippi was the first state to charge 2% on retail sales. In 1938 twenty-nine states implemented a retail sales tax. By 1944 the retail sales tax was a vital source of revenue for state governments.<sup>47</sup>

Proponents of the Fair Tax Act propose a sales tax with a flat rate of 23% which will replace the current Federal Income Tax. It is contended that due to the weaknesses of the current tax system, this is an opportune time to make improvements by replacing the current Federal Income Tax with a national retail sales tax.<sup>48</sup> In retrospect, most states in the United States of America implemented a sales tax because of the need for additional revenue.<sup>49</sup> Today, proponents of the Fair Tax Act<sup>50</sup> propose this sales tax because of the need for a better tax system that is fairer,<sup>51</sup> simpler,<sup>52</sup> and a tax that offers lower rates because of the likelihood for greater compliance.<sup>53</sup>

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<sup>46</sup>Id.

<sup>47</sup>Id.

<sup>48</sup> Scott Burns, *Single Flat Sales Tax is Fair, and it Solves Some Problems*, (2006) [http://www.fairtax.org/site/PageServer?pagename=news\\_feature\\_101806](http://www.fairtax.org/site/PageServer?pagename=news_feature_101806) (some weaknesses in the present system is that the tax is not progressive, not equitable, it is inefficient and the tax rates are too high).

<sup>49</sup> Mary E. Forsberg, NJPP Reports, *You're 40; Now Get To Work: Making the State Sales Tax Pull its Weight*, (2006), [http://www.njpp.org/rpt\\_salestax.html](http://www.njpp.org/rpt_salestax.html). (Last visited on January 10, 2007).

<sup>50</sup> The Fair Tax Act of 2007, *H.R. 25, 109<sup>th</sup> Cong. (2007) plain English summary*, [http://www.fairtax.org/PDF/PlainEnglishSummary\\_TheFairTaxActof2005.pdf](http://www.fairtax.org/PDF/PlainEnglishSummary_TheFairTaxActof2005.pdf)

<sup>51</sup> Am. Enter. Inst. for Pub. Policy Research, *Reforming the Income Tax System*, 37 (1981).

<sup>52</sup> Laurence J. Kotlikoff, *The Case for the Fair Tax*, (2005), <http://www.fairtax.org/PDF/TheCasefortheFairTaxKotlikoff030705.pdf>

<sup>53</sup> Robert E. Hall et al., *The Flat Tax*, 43 (Hoover Institution Press 2<sup>nd</sup> ed) (1995) (1985)

A Look at how the Federal Income Tax is applied to income

All Americans who work are subjected to the Federal Income Tax. The Federal Income Tax is applied progressively, that is, the greater the amount that an individual earns the greater the percentage of income that is deducted from his or her pay.<sup>54</sup>

Section 61 of the Internal Revenue Code<sup>55</sup> imposes a tax on individuals in whatever form and from whatever source derived. The gain that is realized is not limited to income earned.<sup>56</sup> The issue in *Glenshaw Glass Co.*<sup>57</sup> was whether or not money received by settlement as exemplary damages for fraud or for punitive damages was to be included in the individual's gross income under section 61 of the Internal Revenue Code.<sup>58</sup> The Supreme Court held that money received as exemplary damages for fraud or punitive damages and for antitrust violations constituted taxable income. The rationale behind the decision was that the money received for damages was not included as a tax exemption.<sup>59</sup> To illustrate the point further, in

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<sup>54</sup> For further information kindly refer to Table 1.1.

<sup>55</sup> I.R.C. § 61 (2007)

<sup>56</sup> *Commissioner of Internal Revenue v. Glenshaw Glass Company*, 384 U.S. 426 (1955)

<sup>57</sup> *Id.* at 426

<sup>58</sup> I.R.C. § 61 (a) (1984) is the provision that addresses gross income and defines gross income as gains, profits and income derived from salaries, wages, or compensation for personal service of whatever kind in whatever form paid, or from professions, vocations, trades, businesses, commerce or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. *CIR v Glenshaw Glass Co.* 384 U.S. 426, 429 (1955) (The Court also contemplated whether the payments were "comprehended by s.22 (a)" of the Code.) I.R.C. § 22 (a) (1939) states that in the case of a qualified individual, there shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to 15% of such individual's section 22 amount for such taxable year.

<sup>59</sup> *Commissioner of Internal Revenue*, 384 U.S. at 429-31. Some transactions exempted from being taxed are, (1) Food and lodging for the employer's benefit (§ 119), group term life insurance (§ 79), medical insurance and payments (§§ 105 (b) and 106) and fringe benefits for example, qualified employee discounts, de minimis fringes, qualified transportation and moving expenses (§ 132).

*Cesarini v U.S.*<sup>60</sup> the District Court of Ohio opined that taxpayers were required to pay a tax where they found \$4500 in a piano despite the fact that they had purchased the piano for only \$15 seven years before the money was discovered in the piano.<sup>61</sup> Though the taxpayers contended that if a tax was due to be paid it would be due in the year that the piano was purchased because the statute of limitations had run, the Court held the tax was properly included as gross income in the year the money was found.<sup>62</sup>

Calculating whether income is taxable creates uncertainties in the law.

To a large extent the uncertainty often arises because it is sometimes difficult to determine whether income should be taxed as capital gain or ordinary income. Uncertainties also arise where an individual follows the letter of the law, but creates “sham transactions” clearly defeating Congress’ objective in creating the law. For example, in the case of *Gregory v Helvering*<sup>63</sup> the taxpayer, Mrs. Gregory, was the owner of all the shares of a company called United Mortgage Corporation (“UM”). UM owned 1000 shares of stock of a company called Monitor Securities Corporation (“Monitor”). Mrs. Gregory created a new company called Averill Corporation (“Averill”), and, three days after creating Averill, she had United transfer its monitor stock to Averill and she had Averill issue all of its shares to herself.<sup>64</sup>

Mrs. Gregory then dissolved Averill and had all of its assets distributed to her. The Monitor shares were later sold to a third party for a gain of \$76,007.88.<sup>65</sup> Mrs. Gregory then claimed that the profit gained was not to be taxed but was to be treated as a tax-free corporate reorganization under section 112 (g) of the Internal Revenue Code (“IRC”).<sup>66</sup>

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<sup>60</sup> *Cesarini v U.S.*, 18 Ohio Misc. 1 (1969)

<sup>61</sup> *Cesarini*, 18 Ohio Misc. at 8

<sup>62</sup> *Id.* at 8

<sup>63</sup> *Gregory v Helvering*, 293 U.S. 465 (1935)

<sup>64</sup> *Gregory*, 293 U.S. at 465

<sup>65</sup> *Id.* at 467

<sup>66</sup> I.R.C. § 112 (g) (1996)

The court did not recognize the transaction, because the transfer shares was not “in pursuance of a plan of reorganization”<sup>67</sup> under section 112 (g)<sup>68</sup> of the Internal Revenue Act of 1928. The Court ruled that the taxpayer’s case was distinguished because it was a transfer of assets from one corporation to another in pursuance of a plan having no relation to the business of either.<sup>69</sup> The taxpayer argued that despite the fact that her motive for reorganizing the corporation was to escape paying an exorbitant amount of tax, she complied with the letter of the statute and the transaction should therefore be honored.<sup>70</sup> The court rejected her arguments and ruled that she had not complied with the intent of the statute. The new corporation did not have a legitimate business purpose but instead was nothing short of a “contrivance”<sup>71</sup> or a sham.

**Table 1**<sup>72</sup>

<sup>67</sup> Gregory, 293 U.S. at 469. Definition of reorganization under I.R.C. § 112 (g) is a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred.

<sup>68</sup> I.R.C. § 112 (g) (1996). This section deals with the distribution of stock on reorganization. It states “If there is distributed, in pursuance of a plan of reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distribute from the receipt of such stock of securities shall be recognized.”

<sup>69</sup> I.R.C. § 112 (g) (1996).

<sup>70</sup> Gregory, 293 U.S. at 467-9

<sup>71</sup> Id. at 470

<sup>72</sup> Table 1.1

<b>If taxable income is</b>	<b>The Tax is</b>
Not over \$7,150	10% of the taxable income
Over \$7,150 but not over \$29, 050	\$715 plus 15% of the excess over \$7,150
Over \$29, 050 but not over \$70, 350	\$4000 plus 25% of the excess over \$29, 050
Over \$70, 350 but not over \$146, 750	\$14, 325 plus 28% of the excess over \$70, 350
Over \$146, 750 but not over \$319, 100	\$35, 717 plus 33% of the excess over \$146, 750
Over \$319, 100	\$92, 592.50 plus 35% of the excess over \$319, 100

Table 1.1 shows how progressive the Federal Income Tax is. William A. Klein et al, Federal Income Taxation, 599 (14<sup>th</sup> ed., USA 2006). Compare table 1.1 with Table 1.2 which shows how progressive is the Fair Tax Act. See infra p. 35 and note 236.

## Problems with the Present Federal Income Tax

There are several problems with the present tax system that need to be resolved. Before these are discussed, one must first discuss the components of any good tax system. There are approximately seven features that need to be implemented for a tax system to work effectively.<sup>73</sup> These are that the tax applied should be (1) simple, (2) fair (3) neutral (4) visible (5) stable (6) efficient<sup>74</sup> and (7) it should foster economic growth.<sup>75</sup>

A good tax system should foster economic growth so that taxpayers are encouraged to work and save.<sup>76</sup> A good tax system should portray features of equity or fairness so that all citizens are treated fairly.<sup>77</sup>

The concept of equity can be further subdivided into vertical and horizontal equity.<sup>78</sup> Horizontal equity assures that individuals earning the same amount of money pay the same amount of tax.<sup>79</sup> Vertical equity ensures that individuals earning more pay more in taxes.<sup>80</sup> A good tax system should be simple so that an average taxpayer can understand its provisions.<sup>81</sup> Neutrality is an essential component of a good tax system.<sup>82</sup> Neutrality is achieved when the revenue needed to support a government does not interfere with the economic choices of individuals, corporations or businesses.<sup>83</sup>

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<sup>73</sup> Research Inst. of Am., Flat Tax Proposals, 23 (1996)  
( Six are noted in the book Flat Tax Proposals. Research Inst. of Am., Flat Tax Proposals, 23 (1996). Roy Bahl lists the seventh feature which is efficiency in the Jamaican Tax Report. Lincoln Inst. of Land Policy, The Jamaican Tax Reform, 63 (Roy Bahl ed., 1991).

<sup>74</sup> Lincoln Inst. of Land Policy, The Jamaican Tax Reform, 63 (Roy Bahl ed., 1991)

<sup>75</sup> Research Inst. of Am., Flat Tax Proposals, 23 (1996)

<sup>76</sup> Id. at 23

<sup>77</sup> Id. at 23

<sup>78</sup> Joseph M. Dodge et. al., Federal Income Tax: Doctrine, Structure and Policy, 21-2 (2<sup>nd</sup> ed. Lexis Law Publishing 1999) (1995).

<sup>79</sup> Lincoln Inst. of Land Policy, The Jamaican Tax Reform, 63-64 (Roy Bahl ed., 1991)

<sup>80</sup> Id. at 63-64

<sup>81</sup> Research Inst. of Am., Flat Tax Proposals, 23 (1996)

<sup>82</sup> Id. at 23

<sup>83</sup> Lincoln Inst. of Land Policy, The Jamaican Tax Reform, 63-4 (Roy Bahl ed., 1991)

Visibility in a tax system means that everyone is able to ‘get an honest accounting of government’s cost.’<sup>84</sup> There should be stability and certainty in the tax system so that each person knows the amount of tax he should pay and can make plans toward a bright future.<sup>85</sup> Fiscal efficiency is achieved when the cost of collecting revenue is relatively low for the government and when taxpayers do not have to spend exorbitant amounts of money to comply with the tax nor is it a time consuming procedure.<sup>86</sup> Economic efficiency is present in a tax system when taxes do not ‘divert scarce resources from higher-to-lower yielding uses,’ do not inhibit the achievement of a satisfactory rate of economic growth, nor does it ‘distort’ the taxpayer’s choice between work and leisure, consuming and saving, buying different forms of consumer goods or investing in different kinds of property.<sup>87</sup>

The present federal income tax system does not conform to the proposed ideals as listed above and therefore needs to be revised or replaced with a tax system that fits the basic needs of an effective tax system. The problems with the present tax system are: (1) high marginal rates<sup>88</sup> that tend to weaken an individual’s incentive to work.<sup>89</sup> Because of these high rates some individuals may not feel rewarded for the work that they do. Such individuals would therefore refuse to work because high tax rates provide a disincentive to work. This would inevitably lead to a decrease in productivity.<sup>90</sup>

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<sup>84</sup> Research Inst. of Am., Flat Tax Proposals, 23 (1996)

<sup>85</sup> Research Inst. of Am., Flat Tax Proposals, 23 (1996)

<sup>86</sup> Lincoln Inst. of Land Policy, The Jamaican Tax Reform, 64 (Roy Bahl ed., 1991)

<sup>87</sup> *Id.* at 63-64

<sup>88</sup> Robert E. Hall defines marginal rate as the amount of tax applied to the last dollar earned. For example if the person earns \$10,000 and gets an additional \$1000, so that he now has a total of \$11,000 and pays \$1200 in taxes. If the tax on the extra \$1000 is \$200 then the marginal rate is 20%. This is computed by dividing \$200 by \$1000. A taxpayer’s average tax rate is the fraction of income paid in taxes. To calculate the average tax rate, divide the taxes paid by the income. If a person pays taxes of \$1000 on income of \$10,000, then the percentage tax rate is \$10,000/\$1,000 which gives a 10% average rate. Other names for the average tax rate are tax level or tax burden.

<sup>89</sup> Research Inst. of Am., Flat Tax Proposals, 20 (1996)

<sup>90</sup> *Id.* at 20

History shows that as marginal tax rates decrease, then, tax compliance increases and taxpayers become more honest.<sup>91</sup> This is largely in part because with lower tax rates, tax evasion becomes less rewarding.<sup>92</sup> Tax avoidance also declines<sup>93</sup> because taxpayers in the highest income brackets usually shift money from consumption or tax sheltered investments to more productive, taxable investments, and, since taxpayers are rewarded by higher after tax returns, they worked harder.<sup>94</sup> (2) Secondly, the present tax system taxes an individual's savings, work, and investment, and, by extension, it taxes new capital for investments.<sup>95</sup>

It is thought that multiple taxation creates a bias against saving and investment.<sup>96</sup> To illustrate this point, a scenario is painted of a family that earns \$1000 and has an after tax return of \$720. This family has the option of investing or spending the cash.<sup>97</sup> In the first instance where the family decides to invest the after tax returns of \$720 in stocks, the returns that the family earns as a result of investing in a company's stock will be taxed at a rate of 35%.<sup>98</sup> If the company pays dividends, the family will pay a 28% tax on the dividends they receive. If on the other hand the company decides to retain the after tax income for reinvestment, or, if it finds another way to boost future earnings, the stock price will rise, and, again, the future earnings will be taxed. If the family sells the stock, it will pay a capital gains tax at a rate of 28%.

If the family decides to spend the after tax returns of \$720 then the money is not subject to any other form of taxation. But if the family decides to invest in stocks and holds the proceeds of the sale until death (assuming that the \$720 was invested and they

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<sup>91</sup> Robert E. Hall et al., *The Flat Tax*, 43 (Hoover Institution Press 2<sup>nd</sup> ed) (1995) (1985).

<sup>92</sup> *See id.* at 43

<sup>93</sup> *See* Hall et al., *supra* at 43

<sup>94</sup> Robert E. Hall et al., *The Flat Tax*, 43 (Hoover Institution Press 2<sup>nd</sup> ed) (1995) (1985). (Lawrence B. Lindsay compared taxes paid by high income earners before and after the 1964 rate reductions.)

<sup>95</sup> Research Inst. of Am., *Flat Tax Proposals*, 20 (1996)

<sup>96</sup> *Id.* at 28

<sup>97</sup> *Id.* at 28

<sup>98</sup> *Id.* at 28



received dividends), then they will be subject to an estate tax of a maximum rate of 55%. By this scenario, it is easy to see how unfair it is for the present federal income tax to tax investment, work, savings and new capital for investment.

(3) A tax on capital gains prohibits capital formation.<sup>99</sup> The United States imposes a rate of 28% on long term capital gains<sup>100</sup> unindexed for inflation.<sup>101</sup> When this tax on capital gains is compared to other industrialized countries that have either a lower tax rate or a zero tax rate on capital gains, it calls for a change in the tax system so that the bias against investment is eliminated. France applies a 16% tax rate on capital gains,<sup>102</sup> while Japan applies a 1% rate and a zero tax rate on capital gains is applied in Hong Kong, Germany, South Korea, Singapore, and Malaysia. Essentially, when a country refuses to tax capital gains it refuses to punish risk-taking and to deprive individuals who aspire to become entrepreneurs.<sup>103</sup> President Kennedy in 1963 stated that a tax on capital gains directly affects investment decisions and could affect the ease or difficulty that new investors experienced in creating new ventures. In addition to this, a tax on capital gains encourages individuals to establish businesses in foreign countries where no tax is applied to capital gains.

(4) The alternative minimum tax (“AMT”) that is imposed on businesses is very costly and dwindles the businesses’ resources which could be put to better use.<sup>104</sup> Due to perceived problems that corporations were not paying the amount of tax due, Congress implemented the corporate AMT in 1969, and in 1986 adopted the corporate AMT in

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<sup>99</sup> Research Inst. of Am., Flat Tax Proposals, 20 (1996)

<sup>100</sup> 26 U.S.C.A § 1222 (1984) (long term capital gains means the gain from the sale or exchange of a capital asset held for more than one year).

<sup>101</sup> I.R.S. Notice, Notice 97-9, 1997-45 I.R.B. 7, 1997 WL 693669 (1997)

<sup>102</sup> Research Inst. of Am., Flat Tax Proposals, 20 (1996)

<sup>103</sup> Id. at 20

<sup>104</sup> Research Inst. of Am., Flat Tax Proposals, 20 (1996)

its current form.<sup>105</sup> Changes were made to the corporate AMT in 1997 due to problems that Congress had with its depreciation rules, which did not conform to the rules for regular taxable income.<sup>106</sup> The current corporate AMT requires affected corporations to first calculate their tax liability under the regular corporate income tax.<sup>107</sup>

Secondly, it must calculate its tax liability under the corporate AMT. The corporation pays the greater of its regular tax liability, or its liability under the AMT.<sup>108</sup> If the corporation's tax liability is greater under the AMT, it pays the regular tax liability. If its liability under the AMT is greater than its liability under the regular tax, it should pay the regular tax and make an additional payment of the difference. The corporate AMT rate is 20%, which is lower than the regular tax rate of 35%.<sup>109</sup> But the corporate AMT has weaknesses, for example, it is considered to be an inefficient way to collect taxes from corporations because it raises little revenue and "misallocates resources."<sup>110</sup>

Creating a "distortion free" environment where corporate taxpayers cannot take too much tax preferences is one of the AMT's advantages, but, the negative effect is that applying the corporate AMT is too costly.<sup>111</sup> A better solution would be to reduce tax preferences.<sup>112</sup> The AMT is unfair because the economic burden of the corporate AMT falls on

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<sup>105</sup> Michael S. Knoll, The Case for Repealing the Corporate Alternative Minimum Tax, 56 SMU L. Rev. 305, 308 (2003)

<sup>106</sup> Knoll, supra, at 309

<sup>107</sup> Knoll, supra, at 309

<sup>108</sup> Id. at 309

<sup>109</sup> Id. at 309

<sup>110</sup> Id. at 315

<sup>111</sup> Id. at 316

<sup>112</sup> See, e.g., Michael S. Knoll, The Case for Repealing the Corporate Alternative Minimum Tax, 56 SMU L. Rev. 305, 316 (2003). (Tax preferences are tax benefits or deductions that Congress allows the taxpayer to take); Linda M. Beale, Congress Fiddles while America Burns: Amending the AMT (and Regular Tax), 6 Fla. Tax Rev. 811, 849-50 (2004).

workers, customers and investors.<sup>113</sup> Corporations do not pay taxes, and fairness issues arise when provisions of a tax system appear to be regressive and not progressive.<sup>114</sup>

(5) Double taxation of corporate income discourages investment in businesses and encourages companies to take on extra debt.<sup>115</sup> Double taxation occurs when an individual invests in a company and the company pays tax at a rate of 35% on the returns on the amount invested. In addition to this tax that is applied at a 35% rate, the shareholders are taxed at a rate of 28% on the dividends they receive. Companies therefore obtain loans so that there are no shareholders who have to pay a tax at a 28% rate, and the company is able to take a deduction as a result of the debt that is created. This is advantageous to the shareholders because they get to keep their money and avoid paying the tax on dividends. This therefore encourages companies to take on extra debt instead of focusing on ways to invest in businesses and creating more wealth.

(6) Estate and gift taxes encourage families to sell their estates, family farms and businesses in order to escape the burden imposed by these taxes.<sup>116</sup> Death taxes are viewed by some individuals as a form of unfair taxation because it restricts the individual from freely passing on their assets to their children without being subjected to this tax. These taxes are considered to be 'confiscatory taxes'<sup>117</sup> since individuals resort to selling their farms or businesses to escape the draconian effects these taxes. One other reason why individuals do not favor the estate and gift taxes is because these taxes generate little or no revenue, since they account for less than 1% of the federal revenues.<sup>118</sup> All the above tend to destroy the economy

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<sup>113</sup> Michael S. Knoll, The Case for Repealing the Corporate Alternative Minimum Tax, 56 SMU L. Rev. 305, 316 (2003)

<sup>114</sup> Id. at 316

<sup>115</sup> Research Inst. of Am., Flat Tax Proposals, 20 (1996)

<sup>116</sup> Id. at 20

<sup>117</sup> Id. at 20

<sup>118</sup> Id. at 29

since a tax that is anti-work, anti-saving and anti-investment does not promote growth but instead it promotes and creates stagnancy within the economic society.<sup>119</sup>

(7) The tax code is overly complex and difficult for the average U.S. citizen to understand its provisions. For example, one needs to only look at how judges have struggled with this issue in the past. For example, in the case *Donahue's Accounting and Tax Service S.C. v Ryno*<sup>120</sup> the issue was whether expert testimony was required in a lawsuit against a tax accountant who allegedly prepared his client's return negligently. The plaintiff, Donahue, sued Ryno for \$460 to recover fees earned for filing the defendant's 1999 federal and state tax returns. Ryno denied owing Donahue fees for services rendered when he filed her tax returns. Instead, Ryno counterclaimed and sought to recover her entire federal and state tax returns for 1999 in the amount of \$3,272. This amount was applied to her ex-husband's unpaid taxes.

Ryno claimed that Donahue committed malpractice when her returns were filed prior to the filing of a request for 'innocent spouse' status. Ryno did not present expert testimony and only she and Donahue, on behalf of the accounting firm, testified at trial. The trial court found in Ryno's favor for the full amount of her counterclaim. The Wisconsin appellate court reversed and held that the law of professional negligence required the presentation of expert testimony regarding the standard of care to which the accounting professional should be held,<sup>121</sup> and that Donahue breached that standard of care.<sup>122</sup> The appellate court ruled that expert testimony was required because the professional's (Donahue's) activities presented unusually complex and esoteric issues.<sup>123</sup>

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<sup>119</sup> *Id.* at 29

<sup>120</sup> *Donahue's Accounting and Tax Service S.C. v Ryno* , 674 N.W 2d. 681(2003), 2003 W.L. 22956235

<sup>121</sup> *Donahue's Accounting and Tax Service S.C. v Ryno* , No.03-1891, 2003 W.L. 22956235 at \*1 (Wis. App. Dec.17, 2003)

<sup>122</sup> *Id.* at \* 1

<sup>123</sup> *Id.* at \*1

Under section 6013 (d) (3) of the IRC, if a joint return is filed by a husband and wife, any tax liability that is derived from the return is joint and several. Imposing joint and several liability on certain spouses was considered to be unfair, and so a spouse could seek relief (this relief was referred to as “innocent spouse relief”) under 6013 (e) from the harsh consequences of joint and several liability.<sup>124</sup> The appellate court referred to section 6013(e)<sup>125</sup> of the code which relates to innocent spouse relief after certain conditions are met, and determined that it was obvious that the code was “incomprehensible without the assistance of a qualified tax law expert.”<sup>126</sup> Also, Justice Jackson in his dissenting opinion in *Arrowsmith v. Commissioner of Internal Revenue*,<sup>127</sup> refers to the federal taxation as ‘a field beset with invisible boomerangs.’<sup>128</sup>

(8) The IRS is considered to be an overly intrusive organization and is generally feared and hated by U.S. citizens.<sup>129</sup> A former Commissioner of the I.R.S. stated that the I.R.S. was unfair to many people because it is intrusive, and oppressive, and has become a symbol of the most non-democratic institution in a democratic society.<sup>130</sup>

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<sup>124</sup> *Donahue’s Accounting and Tax Service S.C. v Ryno*, No.03-1891, 2003 W.L. 22956235 at \*1 (Wis. App. Dec.17, 2003) (conditions to be met were: (i) the joint return contained a substantial understatement of tax attributable to “grossly erroneous” items of the other spouse; (ii) in signing the return, the spouse seeking relief did not know, and had no reason to know, of the substantial understatement; and (iii) under the circumstances, it would be inequitable to hold the spouse seeking relief liable for the substantial understatement.)

<sup>125</sup> 26 U.S.C § 6013 (e) (1983). Current version at 26 U.S.C § 6015 (b) (2001).

<sup>126</sup> *Donahue’s Accounting and Tax Service S.C. v Ryno*, No.03-1891, 2003 W.L. 22956235 at \*2 (Wis. App. Dec.17, 2003)

<sup>127</sup> *Arrowsmith v. Commissioner of Internal Revenue*, 344 U.S. 6 (1952)

<sup>128</sup> See e.g., *Arrowsmith v. Commissioner of Internal Revenue*, 344 U.S. 6, 12 (1952); Shop Talk, Courts agree: The Code is incomprehensible! 101 J. Tax’n 64, 2004 WL 1490281 (2004)

<sup>129</sup> Former Treasury official Ernest Young stated that he thought the IRC was a national disgrace and that it was among other things, meddlesome, overbearing, mean and hurtful. See Research Inst. of Am., Flat Tax Proposals, 21 (1996).

<sup>130</sup> Research Inst. of Am., Flat Tax Proposals, 21 (1996) (former Commissioner Fred Goldberg stated these words).

## *Chapter 4: Principles of Taxation*

In evaluating how to effectively reform the tax system of a country, several principles are to be taken into consideration.<sup>131</sup> The first test is based on a good ability-based tax system which looked at the theoretical aspect. This aspect looked at equity (horizontal and vertical) and efficiency (this looked at fiscal and economic) and finally the practical aspect which looked to neutrality, simplicity, certainty and liquidity. One proposed view is that a tax system should be fair, its operation should not require an excessive amount of time or money and in achieving this objective, and it should make the best possible use of the nation's economic resources.<sup>132</sup>

One primary goal in imposing a tax on society is to ensure that it closely reflects the taxpayers' ability to pay. Horizontal equity speaks to the rule that individuals with equal abilities to pay equal taxes. Vertical equity ensures that individuals who earn more and therefore have the ability to pay more indeed pay more taxes. Fiscal efficiency is achieved when tax collection costs are low for the government and when taxpayers can comply with the law without undue expenditure of money and time. Economic efficiency is achieved when taxes do not 'divert scarce resources from higher-to-lower yielding uses' do not inhibit the achievement of a satisfactory rate of economic growth, nor does it<sup>133</sup> 'distort' the taxpayer's choice between work and leisure, consuming and saving buying different forms of consumer goods or investing in different kinds of property.<sup>134</sup> Neutrality requires that revenue required to support

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<sup>131</sup> Lincoln Inst. of Land Policy, *The Jamaican Tax Reform*, 63 (Roy Bahl ed., 1991)

<sup>132</sup> *Id.* at 63-64

<sup>133</sup> *Id.* at 64

<sup>134</sup> *Id.* at 64

the government interfere as little as possible with the economic choices of individuals, businesses and consumers.

Complexity in a tax system defeats the purpose of any well designed system of taxation. If the tax system cannot be administered efficiently by the government, or if the majority of individuals paying a tax cannot understand how the tax is administered, all the labor, time and effort invested in formatting legislation and regulation for the implementation of the tax is in vain. One point of view that is proposed is that, with all such negative factors present it is the perfect recipe for a source of frustration and will undoubtedly invite deception and an unwillingness to comply with the law. 'It depends ...on the economic circumstances and conditions of the time and place in which it is to operate.'<sup>135</sup> When a tax system is imbalanced with the environment it is supposed to operate in, it is counterproductive.

This suggests that not all tax systems although it is effectively implemented in one country does it necessarily mean that it will work in all countries. Therefore all countries should seek to implement the best system suitable to its country and taxpayers. Certainty in the 'nature and size of all applicable tax liabilities' is the taxpayer's 'protective shield' from paying more than he or she should pay or from paying more than someone in a similar or better circumstance is paying. There is the opinion that the argument for certainty or simplicity does not appear to be intellectually glamorous as the arguments for efficiency and equity. Yet despite this argument, it is not disputed that an efficient or equitable system sometimes does not serve its purpose as well as a simple or certain system.

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<sup>135</sup> Id. at 64

## Consumption Tax

A consumption tax is a tax paid “in respect of the enjoyment of final goods and services in the country in which they are consumed.”<sup>136</sup> This definition assumes that consumption taxes are taxes on final consumption in the country where the products (goods and services) were consumed. However, there are consumption taxes that are not taxes on final consumption in the country where the products or services are consumed:<sup>137</sup> For example, export taxes are not applied in the country where the products are consumed and a tax on investment goods are not taxes on final consumption.<sup>138</sup> Examples of taxes on final consumption of goods and services are selective consumption taxes on particular products or services,<sup>139</sup> single sales stage taxes which may be levied on sales from manufacturers to wholesalers (manufacturer sales taxes), or from wholesalers to retailers (wholesale sale taxes) or retailers to consumers (retail sales taxes),<sup>140</sup> general consumption taxes,<sup>141</sup> and multi-stage taxes.<sup>142</sup>

A multi-stage tax is a consumption tax that is levied each time goods or their components are sold. This tax is sometimes referred to as the VAT (Value Added Tax) and deductions may be made for taxes that are applied at earlier stages.<sup>143</sup> VAT is employed in all the OECD<sup>144</sup> countries except the United States.<sup>145</sup> Although taxes imposed on

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<sup>136</sup> OECD, *Taxing Consumption*, 23-25 (1988)

<sup>137</sup> This is referred to as Selective consumption. OECD, *Taxing Consumption*, 25 (1988)

<sup>138</sup> *Id.* at 23-25

<sup>139</sup> *Id.* at 25. Excises on alcohol drinks, tobacco products and motoring (this includes mineral oil products and the vehicles themselves are the most important in a selective consumption tax.)

<sup>140</sup> *Id.* at 25

<sup>141</sup> *Id.* at 25. These are broad-based taxes on most goods and a varying number of services, that have become of increased importance during the last two decades especially in Europe.

<sup>142</sup> *Id.* at 25. This tax is levied each time goods or their components are sold. Deductions may be made for taxes paid at earlier stages as under the value added tax system.

<sup>143</sup> *Id.* at 25. France and Finland were the first two countries to have elements of a VAT system. This system was mixed with features of both single stage sales taxes (this system may employ a manufacturer, wholesale, or retail sales tax) and cascade taxes (a multi-stage tax for which no credit is given to traders for tax paid on the purchase of their inputs).

<sup>144</sup> Organization for Economic Co-Operation and Development

<sup>145</sup> Victor Thuronyi, *Comparative Tax Law*, 305 (2003).



real property would normally be classified as a capital tax, there is a suggestion that it is a tax on the consumption on the use of accommodation.<sup>146</sup>

There is a proposal put forward which states that if individuals were not taxed on their savings what would effectively remain is a tax on consumption.<sup>147</sup> A formula is created<sup>148</sup> in the form “ $Y = C + S$ .” The letter “Y” represents income, “C” stands for consumption and “S” represents savings.

The formula for a consumption based tax would equate to “ $C = Y - S$ .”<sup>149</sup> Thus, the more a person spends, the more the individual is taxed if a consumption tax were to be applied. The benefit in taxing consumption as opposed to taxing wealth or income is that a person who has saved for future consumption for themselves and their heirs is not punished by being taxed for providing for their future.<sup>150</sup> There is one point of view that a consumption tax is intermediate, since, although it taxes savings, it only does so indirectly because tax is imposed on the return on invested savings but not imposed on the investment itself.<sup>151</sup> For example, if A decides to invest in stocks and bonds using money that has already been taxed (for example \$500), the return or profit that A receives from the \$500 is taxed but not the actual \$500.

As to whether or not a consumption tax is a fair method of taxing individuals depends on one’s priority. For example, if a consumption tax was imposed on Suzanne and Paul and they earn the same amount of money, and if Suzanne is a better saver than Paul and she saves more money than he does, then, an income tax will penalize Suzanne because

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<sup>146</sup> This is referred to as Selective consumption, see OECD, *Taxing Consumption*, 26 (1988)

<sup>147</sup> Daniel N. Shaviro, William A. Klein & Joseph Bankman, *Federal Income Taxation*, 320 (2006).

<sup>148</sup> *Id.* at 320

<sup>149</sup> *Id.* at 320

<sup>150</sup> *Id.* at 320

<sup>151</sup> *Id.* at 320

she is taxed on her savings. Paul will be better off because he is not taxed when he consumes. This is so because under the federal income tax, where income is taxed once and the taxpayer decides to spend the after tax money, the money is not subject to any other form of taxation.<sup>152</sup> Such a tax seems unfair to Suzanne if both she and Paul are equals, since a principle of fairness would mean that equals are treated equally.<sup>153</sup>

Some individuals who are in favor of an income tax may say that such a tax is fair because Suzanne is wealthier than Paul and so should be taxed on her wealth.<sup>154</sup> Their reasoning is that since her savings make her wealthier than Paul for much of her life, then Suzanne and Paul are not equals.<sup>155</sup> They further argue that there is no strong empirical evidence to show that the income tax reduces savings significantly or moderately.<sup>156</sup> This argument is usually challenged because of the belief that an income tax does reduce savings.<sup>157</sup>

There is also the point made that there is no empirical evidence to suggest that an income tax reduces savings much more than a consumption tax does.<sup>158</sup> Also, individuals who propose an income tax make the point that because individuals with higher incomes save more than those with lower incomes, a consumption tax is less progressive than an income tax.<sup>159</sup> However true this may be, the point must be made that a consumption tax can be as progressive as a person wants it to be.<sup>160</sup> Since income can be defined as “income = consumption + savings,” then, under a consumption tax the taxpayer could easily compute

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<sup>152</sup> Research Inst. of Am., Flat Tax Proposals, 28 (1996)

<sup>153</sup> Daniel N. Shaviro, William A. Klein & Joseph Bankman, Federal Income Taxation, 320 (2006).

<sup>154</sup> *Id.* at 320

<sup>155</sup> *Id.* at 320

<sup>156</sup> *Id.* at 320. Proponents of an income tax may say this because for the most part, there have been numerous arguments which suggest that a person would save more under a consumption tax but hardly, if any, hard core evidence based on observation or experience (not mere argument or theory) which prove that this argument is true.

<sup>157</sup> Joseph Bankman et. al., Is the Debate between an Income Tax and a Consumption Tax a Debate about Risk? Does it Matter? 47 Tax. L. Rev. 377, 386 (1992)

<sup>158</sup> Daniel N. Shaviro, William A. Klein & Joseph Bankman, Federal Income Taxation, 320 (2006).

<sup>159</sup> Am. Enter. Inst. for Pub. Policy Research, Reforming the Income Tax System, 38 (1981)

<sup>160</sup> *Id.* at 38

income and deduct savings.<sup>161</sup> The residual would be consumption, and a progressive rate structure would be applied to this amount,<sup>162</sup> allowing an individual to make the consumption tax as progressive as he or she wants it to be.

### The Value Added Tax (VAT)

The VAT was first implemented after World War II.<sup>163</sup> The income tax is older than this fairly new tax. Most OECD and IMF<sup>164</sup> countries have developed a VAT tax or a tax similar to the VAT.<sup>165</sup> It is believed that most countries will adopt the VAT.<sup>166</sup> The VAT is similar to a retail sales tax but they differ primarily in their administration.<sup>167</sup> A retail sales tax is collected at the very final stage of distribution, whereas a VAT is collected at all stages of production and distribution.<sup>168</sup> The VAT taxes transactions and the tax base is equal to domestic consumptions.

The VAT taxes the supply of goods or services made within the jurisdiction by a taxable person. Goods are usually deemed to be tangible; however, land and property are not classified as such. The supply of goods is defined as “the transfer of ownership of the good for consideration.” The taxable value of the good supplied is the consideration, exempting instances where the taxpayer withdraws items for his or her personal use, or withdraws items to supply the employee either at a reduced price or free of charge. The taxable value in this instance would be the fair market value of the good. Where such transfers to

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<sup>161</sup> Id. at 38

<sup>162</sup> Id. at 38

<sup>163</sup> Victor Thuronyi, *Comparative Tax Law*, 305 (2003)

<sup>164</sup> International Monetary Fund (United Nations)

<sup>165</sup> Id. at 305

<sup>166</sup> Id. at 305. But it is believed that a VAT tax may not be suitable for smaller countries. Victor Thuronyi, at 305 n4. Also, for political reasons, the United States may never implement a VAT tax. Victor Thuronyi, at 305 n5.

<sup>167</sup> Victor Thuronyi, *Comparative Tax Law*, 306 (2003)

<sup>168</sup> Id. at 306

employees take place, questions arise as to whether it is taxable because it is a benefit to the employee, or whether it is not taxed because it is a fringe benefit.

Usually VAT systems define services more comprehensively and abstractly than it does the supply of goods. A supply of services is defined as anything done or not done by a taxable person acting (or refusing to act) for consideration. Financial services are usually exempt from the VAT tax because of the difficulty experienced in taxing these services. The VAT base is comparable to that of the domestic consumption because of the invoice credit mechanism. Where a taxpayer produces an invoice that shows that VAT was already paid on a good or for services rendered, he or she is allowed a credit for VAT paid to their supplier. The purpose of the invoice credit mechanism is to relieve the intermediate goods or services from being taxed. A credit is usually allowed for goods or services acquired for use in a business that produces taxable supplies. Generally, the rule is that inputs made to exempt activities are not eligible for an input credit. Where, however, an individual is engaged in a business that exports goods and receives a monthly electricity bill for which he paid VAT, he is eligible to receive a credit from the government.

Exports do not bear a tax burden.<sup>169</sup> With respect to the credit that is applied to exports because they are exempted from tax liability, some countries instead apply a zero rate of tax. The reasoning behind this action is that some countries wish to be consistent and since the rule is that exports are exempted from taxation, tax rate is zero.<sup>170</sup> To illustrate how the VAT is applied, if Suzanne supplies taxable services to a computer manufacturing store (LAN Co.) for \$100, and the VAT to be applied is 20%, then Suzanne

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<sup>169</sup> Victor Thuronyi, *Comparative Tax Law*, 308 (2003)

<sup>170</sup> *Id.* at 308

should charge \$120 for her services.<sup>171</sup> Assuming that Suzanne has no inputs,<sup>172</sup> she would remit \$20 to the government. LAN Co. produces computers and sells these computers to its final customer Compustart for \$1000 plus \$200 VAT. But, LAN Co. incurred costs such as material used to build the computer in the amount of \$100, and therefore, the VAT that LAN Co. should remit to the government is \$80 (\$200-\$120).<sup>173</sup> LAN Co. deducted the \$20 it paid to Suzanne and the \$100 that it paid to purchase material in order to build the computers.

### The Flat Tax

A flat tax system is defined as a tax system where one marginal tax rate is applied either to an income or consumption tax base.<sup>174</sup> The difference between the “consumption-based” and “income-based” flat tax is the treatment of “savings.”<sup>175</sup> What a taxpayer under the income-based flat tax earns on his or her savings would be included in the tax base.<sup>176</sup> That is, the taxpayer’s economic return on his or her savings is also taxed whereas,<sup>177</sup> in the case of the consumption- based flat tax, a taxpayer’s savings are not taxed.<sup>178</sup> There was a flat tax or what is otherwise referred to as the Freedom and Fairness Restoration Act<sup>179</sup> that was introduced to Congress as well as the USA Tax Act of 1995.

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<sup>171</sup> Id. at 311

<sup>172</sup> These are “goods or services that are acquired for use in a business of making taxable supplies.” Where such goods are purchased, the taxpayer is entitled to a credit. See Victor Thuronyi, *Comparative Tax Law*, 308 (2003)

<sup>173</sup> Victor Thuronyi, *Comparative Tax Law*, 311 (2003)

<sup>174</sup> American Bar Association section of taxation, Tax Systems Task Force, A Comprehensive Analysis of Current Consumption Tax Proposals, 161 (1997).

<sup>175</sup> Id. at 161

<sup>176</sup> Id. at 161

<sup>177</sup> Id. at 161

<sup>178</sup> Id. at 161

<sup>179</sup> This consumption based flat tax (H.R. 2060 and S. 1050) was sponsored by Congressman Richard Armey and Senator Richard Shelby. The USA Tax Act of 1995, S.722 was sponsored by Senator Sam Nunn and Senator Pete Domenici.

The Arney-Shelby flat tax rate<sup>180</sup> has a separate taxing structure and a single tax rate for individuals and businesses.<sup>181</sup> A consumption-based flat tax is then arrived at when there is a combination of the tax base for individuals and the rate for businesses.<sup>182</sup> This consumption-based flat tax is the equivalent of a “subtraction-method” value-added tax with the exception that the consumption tax provides a ‘standard deduction’ for individuals<sup>183</sup>. This flat tax also provides a deduction for the purchase of materials and capital<sup>184</sup>. Employee compensation that is taxed to the employee can also be deducted<sup>185</sup>. The Flat Tax allows companies to make deductions for compensations and contributions expenses to qualified plans.<sup>186</sup>

The Nunn-Domenici “USA Tax Act” would apply a broad-based income tax with an unlimited deduction for “new net savings” and a graduated rate structure with three levels.<sup>187</sup> The USA Tax Act would apply a subtraction-method VAT on all businesses at a rate of 11%.<sup>188</sup> This proposal is said to include both a cash-flow tax on individuals and a VAT on businesses.<sup>189</sup> The two major differences between the Arney-Shelby Flat Tax and the Nunn-Domenici “USA Tax Act” are that (1) the USA Tax Act applies a tax to individuals at progressive rates (for joint filers) of 8% on income up to \$5400, 19% on income up to \$24,000, and 40% on income over \$24,000.<sup>190</sup> By contrast the Arney-Shelby has a single rate of 17% and

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<sup>180</sup> Reference is made to the Arney-Shelby consumption-based flat tax rate

<sup>181</sup> American Bar Association section of taxation, Tax Systems Task Force, A Comprehensive Analysis of Current Consumption Tax Proposals, 162 (1997).

<sup>182</sup> Id. at 162

<sup>183</sup> Id. at 162

<sup>184</sup> Id. at 162

<sup>185</sup> Id. at 162

<sup>186</sup> Id. at 162

<sup>187</sup> Id. at 163

<sup>188</sup> Id. at 163

<sup>189</sup> Id. at 163

<sup>190</sup> Id. at 163

24% if it is made revenue neutral<sup>191</sup> and (2) the USA Tax Act applies to businesses does not allow deductions for wages to employees but the Flat Tax allows for this deduction.<sup>192</sup>

The USA Tax defines “gross income” as: Salaries, wages, pension distributions, most fringe benefits, annuities, life insurance proceeds, alimony, child support, dividends, distributions from partnerships and proprietorships, includable social benefits, and, with some exceptions, proceeds from the sale of assets.<sup>193</sup> The individual is allowed to deduct “net savings” during the year.<sup>194</sup> Net savings is defined as the ‘the taxpayer’s additions to ‘qualified savings assets’ during the taxable year over taxable withdrawals during the year.<sup>195</sup> A decrease in net savings is taxable income but an increase in net savings allows for a deduction.<sup>196</sup> “Qualified savings assets” include stocks, bonds, securities, certificates of deposit, interest in proprietorships, partnerships and money market investments.<sup>197</sup> It does not include investments in land, collectibles or “cash on hand.”<sup>198</sup> The USA Tax Act would continue to allow for deductions for qualified home mortgage interest and charitable contributions.<sup>199</sup> The latter would be taken as itemized deductions as well as a standard deduction.<sup>200</sup> Deductions for state and local taxes and medical expenses would be allowed.<sup>201</sup> The USA Tax Act would also allow a new

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<sup>191</sup> Id. at 163

<sup>192</sup> Id. at 163

<sup>193</sup> Id. at 163

<sup>194</sup> Id. at 164

<sup>195</sup> Id. at 164

<sup>196</sup> Id. at 164

<sup>197</sup> Id. at 164

<sup>198</sup> Id. at 164

<sup>199</sup> Id. at 164

<sup>200</sup> Id. at 164

<sup>201</sup> Id. at 164

deduction for certain qualified educational expenses limited to \$2000 per year for eligible students.<sup>202</sup>

There is yet another flat income tax proposal which claims to be a more progressive, simple and efficient tax.<sup>203</sup> It proposes to apply a low tax rate of 19% on consumption because it will be a broad based tax hence raising the same amount of revenue as the present tax system.<sup>204</sup> The poor pay no tax at all, and the rates of taxation are progressive since the amount that a family pays increases as the family's income increases.<sup>205</sup> The tax system is simple and easy to understand. Taxpayers are taxed only once on what they earn and later take out of the economy, and, fringe benefits are never taxed.<sup>206</sup> The psychological effect of applying one flat and low tax rate is that studies show that there is a tendency for high-paying taxpayers to not avoid or evade taxes under such conditions.<sup>207</sup>

Like the Armev-Shelby flat tax system there is one single flat rate that is applied to individuals and businesses,<sup>208</sup> but there are two separate tax forms. The business that is referred to here is not limited to corporations, but also includes services supplied by professionals such as lawyers and doctors.<sup>209</sup> Income is calculated by subtracting investment from income.<sup>210</sup> According to computations made by the U.S. National Income and Product

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<sup>202</sup> Id. at 164

<sup>203</sup> This is the flat tax proposed by Robert E. Hall and Alvin Rabushka. See Robert E. Hall et al, *The Flat Tax*, 52 (Hoover Institution Press 2<sup>nd</sup> ed) (1995) (1985).

<sup>204</sup> Id. at 52

<sup>205</sup> See Hall et al., supra at 52

<sup>206</sup> See Hall et al., supra at 52

<sup>207</sup> See Hall et al., supra at 54. But see a different view where it is shown that during Ronald Reagan's tenure as President of the U.S.A., where the highest rate of taxes were lowered from 70% to 50% in 1981. Many people said that lowering the tax rate would end the 'tax shelter phenomenon.' It was shown that the number of tax shelters tripled or even quadrupled from 1981 to 1983. Michael J. Graetz, The Decline (and Fall?) of the Income Tax, 179 (1997).

<sup>208</sup> Robert E. Hall et al, *The Flat Tax*, 54 (Hoover Institution Press 2<sup>nd</sup> ed) (1995) (1985).

<sup>209</sup> Id. at 55

<sup>210</sup> See Hall et al., supra at 55



Accounts for 1993, the revenue from the corporate income tax using a tax rate of 35% was \$118 billion.<sup>211</sup> However when computations are made to determine the amount of revenue that a flat tax would yield at a rate of 19%, the figure arrived at is \$362 billion.<sup>212</sup> This is because most deductions that are normally allowed under the present corporate income tax would be disallowed if a flat tax were to be applied.

The theory behind this is that most income generated from business goes to the rich. This is considered to be unfair, and makes the flat tax fairer than the present corporate income tax. The wage tax however would yield less than the present personal income tax.<sup>213</sup> The personal income tax yielded \$510 billion as opposed to the \$265 billion dollars that a flat tax at 19% would yield.<sup>214</sup> This wage tax that would be applied at a rate of 19% applies only to wages, salaries, and pensions. By comparison the personal income tax is applied to unincorporated business income, dividends, interest, and rent.<sup>215</sup> As one proponent for the flat income tax has stated, there is the possibility that computations made may either over-estimate or under-estimate how effective the flat tax would be on the United States' economy.<sup>216</sup> Although projections are made for unreported income, and although some calculations are overstated, for

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<sup>211</sup> See Hall et al., supra at 55

<sup>212</sup> See Hall et al., supra at 56-7. The reasons why the flat tax rate would yield more revenue is because more than half of business income is from noncorporate businesses such as professional partnerships, proprietorships etc. Secondly, the business tax does not allow for a deduction of interest paid by businesses. This is not the case with the present income tax. Thirdly, the business tax put a tax on fringe benefits which is not usually taxed applying the present corporate income tax.

<sup>213</sup> See Hall et al., supra at 58

<sup>214</sup> See Hall et al., supra at 58

<sup>215</sup> See Hall et al., supra at 58

<sup>216</sup> See Hall et al., supra at 58

example, the amount of family allowances, there it is difficult to predict how the economy would respond to a tax reform.<sup>217</sup>

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<sup>217</sup> See e.g., Hall et al., *supra* at 58; Michael J. Graetz, The Decline (and Fall?) of the Income Tax, 179-80(1997) (Michael Graetz thinks the best thing is to admit uncertainty).

### What is the Fair Tax Act?

The Fair Tax Act<sup>219</sup> is a proposal to replace the current federal income tax with a national retail sales tax.<sup>220</sup> It seeks to establish a fair tax regime for the United States. This Act, if implemented, would replace the Internal Revenue Service,<sup>221</sup> the Alternative Minimum Tax,<sup>222</sup> corporate,<sup>223</sup> capital gains, gift and inheritance taxes<sup>224</sup> to name a few. The national retail sales tax would be imposed once at the final point of purchase on all new goods and services.<sup>225</sup> The proposed plan would provide a rebate<sup>226</sup> to citizens and legal residents of households for the amount of tax they spend on sales up to the poverty level.<sup>227</sup> It is this rebate that makes this proposed tax system progressive and could result in a tax burden of zero or less. Business-to-business purchases for the production of goods are not taxed.<sup>228</sup> The sales tax rate would be 23% and would be tantamount to a 30% traditional sales tax.<sup>229</sup>

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<sup>218</sup> The Fair Tax Act of 2007, H.R. 25, 109<sup>th</sup> Cong. (2007)

<sup>219</sup> The Fair Tax Act of 2007, H.R. 25, 109<sup>th</sup> Cong. (2007)

<sup>220</sup> Fair Tax Act, <http://www.fairtax.org/fairtax/faqs.htm> (last visited May 16, 2007)

<sup>221</sup> With the implementation of the Fair Tax Act there will not be a need for the Internal Revenue Service since the collection of the tax will be done by the states. Sales tax return preparers and administrators, lawyers and IRS employees will therefore have to find alternative employment.

<sup>222</sup> H.R. 25, 109<sup>th</sup> Cong. (2007), Title 1 § 101

<sup>223</sup> Id.

<sup>224</sup> H.R. 25, 109<sup>th</sup> Cong. (2007), Title 1 § 103

<sup>225</sup> H.R. 25, 109<sup>th</sup> Cong. (2007), Chapter 1 § 101.

<sup>226</sup> H.R. 25, 109<sup>th</sup> Cong. (2007), Chapter 3 § 304

<sup>227</sup> H.R. 25, 109<sup>th</sup> Cong. (2007), Chapter 3 § 303. Please see table 1.2 for further information. How much individuals will receive as a rebate will depend to a large extent on the Department of Health and Human Services' poverty level guideline multiplied by the tax rate. The poverty level calculation includes (but is not limited to) clothing, shelter, food, transportation, and medical care. It should be noted that the present tax credit applied to individuals who have children would be compensated for since as the number of children per household increases, so does the value of the rebate.

<sup>228</sup> H.R. 25, 109<sup>th</sup> Cong. (2007), Chapter 2 §§ 201-203

<sup>229</sup> The Fair Tax Act's tax inclusive quote is 23%. Therefore, for every \$100 earned, \$23 is paid in taxes. Sales taxes are usually quoted tax-exclusive, for example, "Mary bought a \$77 blouse and had to pay the same \$23 in sales taxes. This is a 30% sales tax. I spend \$0.77¢ for a sweet but the tax paid on the sweet is 23¢. This rate when programmed into a point-of-purchase terminal is 30%. Under an income tax rate of 23%, an individual has to earn \$130 to spend \$100. If this individual spends the same \$100 under a sales tax, he pays the same tax of \$30 and the

The formula used to calculate rebate amounts would be adjusted to account for inflation. To become eligible for this rebate, households would register once per year with their sales tax administering authority. Names and social security numbers for each member of the household would be submitted.<sup>230</sup> The Social Security Administration would disburse the funds either by check via the U.S. mail,<sup>231</sup> electronic funds transfer or a smartcard that can be used like a bank credit card. The Beacon Hill Institute estimates the rebate to amount to \$489 billion, which is a much smaller amount when compared to the amount paid out by the IRS in refund checks for 2005.<sup>232</sup>

In 2005 the IRS paid out \$270 billion dollars in refund checks, and, another \$945 billion dollars was paid out for income tax deductions, tax preferences, loopholes and credits as estimated by the Joint Committee and taxation. Proponents of the Fair Tax argue that the tax would broaden the tax base and that the tax burden would shift to those who currently do not pay tax.<sup>233</sup> It is suggested that the Fair Tax would apply to all 300 million Americans and in addition would apply to the many foreign tourists. Thus, the Fair Tax Act would double the present U.S. tax base.

Some claim that this tax would actually hurt the poorer class of the U.S society since they normally spend the most.<sup>234</sup> Therefore, this view would suggest that the tax plan would be regressive instead of being progressive.<sup>235</sup> As is expected, supporters of the Fair

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rate is quoted as 30%. Information is available at [http://www.fairtax.org/site/PageServer?pagename=about\\_faq\\_answers#47](http://www.fairtax.org/site/PageServer?pagename=about_faq_answers#47)

<sup>230</sup> H.R. 25, 109<sup>th</sup> Cong. (2007), Chapter 3 § 305

<sup>231</sup> It is estimated by the National Taxpayers Union that the average amount per year to mail the monthly rebate checks by the U.S Post Office will be \$225 million.

<sup>232</sup> Fair Tax Act, *Excerpts from the Fair Tax response to the Mack/Breaux tax Panel report and recommendations*, [http://www.fairtax.org/PDF/Excerpts\\_from\\_response\\_to\\_tax\\_panel-103006.pdf](http://www.fairtax.org/PDF/Excerpts_from_response_to_tax_panel-103006.pdf) (last visited May 16, 2007)

<sup>233</sup> Scott Burns, *Single Flat Sales Tax is Fair, and it Solves Some Problems*, (2006)

[http://www.fairtax.org/site/PageServer?pagename=news\\_feature\\_101806](http://www.fairtax.org/site/PageServer?pagename=news_feature_101806)

<sup>234</sup> Id.

<sup>235</sup> Id.

Tax Act argue differently. They are of the view that this national retail sales tax increases purchasing power. Food and medicine would not be exempted since economists have shown that this would benefit the wealthy to a larger extent than it does the poor. The wealthy spend much more on unprepared foods, clothing, housing and medical care than the poor. Furthermore, it is argued, presently these goods are not exempted from federal taxation and exempting one product and service over another merely opens the door for the wealthy to use their power and influence to lobby for tax breaks in their favor.

The Fair Tax Act proponents claim that a 23% tax imposed on spending would effectively raise the same amount of federal funds as is raised by the current system, pay the universal rebate and pay the collection fees to retailers and state governments.<sup>236</sup> Collection of taxes would be done in the same way that the states of the United States today collect their sales tax.<sup>237</sup> Retail businesses would collect the tax from the consumer and send it to the taxing authority. The businesses that act as collection agents as well as the states will receive a collection fee.

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<sup>236</sup> Information found on the Fair Tax website. The Fair Tax Act, <http://www.fairtax.org/fairtax/faqs.htm> (Last retrieved on January 20, 2007)

<sup>237</sup> H.R. 25, 109<sup>th</sup> Cong. (2007), Chapter 4 § 404

**Table 2<sup>238</sup>**

Disadvantages of the Fair Tax Act

The Fair Tax plan<sup>239</sup> was created by Americans for Fair Taxation.

This is an advocacy group that coined the name “*Fair Tax*” based on interviews, polls, and focus groups of the general public.<sup>241</sup> The Fair Tax Bill was first introduced in 1999 at the 109<sup>th</sup> United States Congress by John Linder, a Georgia Republican.<sup>242</sup> The Bill has not been voted on by any committee in either the House or the Senate despite the apparent interest by members of the House and Senate in 2004 and 2006.

**Figure 1: 2006 Rebate calculation for the 48 contiguous states<sup>1</sup>**

One-adult household				Two-adult household			
Family size	Annual consumption allowance <sup>2</sup>	Annual rebate	Monthly rebate	Family size	Annual consumption allowance	Annual rebate	Monthly rebate
1 person	\$ 9,800	\$2,254	\$188	N/A	N/A	N/A	N/A
and 1 child	\$13,200	\$3,036	\$253	couple	\$19,600	\$4,508	\$376
and 2 children	\$16,600	\$3,818	\$318	and 1 child	\$23,000	\$5,290	\$441
and 3 children	\$20,000	\$4,600	\$383	and 2 children	\$26,400	\$6,072	\$506
and 4 children	\$23,400	\$5,382	\$449	and 3 children	\$29,800	\$6,854	\$571
and 5 children	\$26,800	\$6,164	\$514	and 4 children	\$33,200	\$7,636	\$636
and 6 children	\$30,200	\$6,946	\$579	and 5 children	\$36,600	\$8,418	\$702
and 7 children	\$33,600	\$7,728	\$644	and 6 children	\$40,000	\$9,200	\$767

<sup>1</sup> Alaska and Hawaii have different poverty levels and different FairTax rebates. See last page of FAQ's.

<sup>2</sup> Federal Register: Jan. 24, 2006 (Vol. 71, No. 15, pp. 3848-3849).

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<sup>239</sup> Fair Tax Plan, Fair Tax Act and Fair Tax Bill are names used interchangeably and all refer to the same proposed consumption tax that seeks to repeal the federal income tax. See John Steinberger, *Fair Tax Aids Middle Class*, (2006), <http://www.fairtax.org/PDF/FairTaxAidsMiddleClassSteinberger050406.pdf>

<sup>240</sup> Fair Tax Act, *Executive Summary: The Fair Tax* (2006), <http://www.fairtax.org/PDF/FairTaxExecutiveSummary.pdf>

<sup>241</sup> Fair Tax Act, *Executive Summary: The Fair Tax*, (2006) <http://www.fairtax.org/PDF/FairTaxExecutiveSummary.pdf>

<sup>242</sup> Fair Tax Act, *Americans for Fair Taxation: Weekly Feature* (2007), [http://www.fairtax.org/site/PageServer?pagename=news\\_feature\\_010507](http://www.fairtax.org/site/PageServer?pagename=news_feature_010507)

Despite the level of enthusiasm displayed by those who propose a national retail sales tax<sup>243</sup>, there are those who are reluctant to change. Objectors of the Fair Tax Act claim that a national sales tax would not raise enough money. Furthermore, since individuals in the past have found ways to not pay their taxes, they claim the Fair Tax Act creates an opportunity to fuel a black market.<sup>244</sup> The Fair Tax Act objectors claim that consumers will be taxed on basic necessities such as milk, rent on an apartment and health care expense.<sup>245</sup> Economist William Gale of the Brookings Institution is of the opinion that a tax imposed at a 30% rate would not be correct because of applying consumption would lead to a budget deficit.<sup>246</sup> Gales states that a more realistic rate is 31%.

Proponents of the Fair Tax Act expect that this method of taxation will have a positive effect on the tax system in the United States because it will promote savings and investment which are not taxed, it will create an atmosphere of transparency since the tax that is imposed will be visible, there will an ease of compliance since tax planning will not be necessary. Expected advantages include economic growth, “international business locality,” since businesses will be attracted to produce in the United States because of the more favorable tax regime and furthermore, there is the expectation that the United States will become more competitive internationally since it will have a decreased production cost.

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<sup>243</sup> Two popular proponents of a national retail sales tax are Neal Boortz and Republican congressman John Linder of Georgia. See Pat Regnier, *Just how fair is the 'FairTax'? The push to scrap income taxes -- and the IRS -- is gaining fans. But the plan has a lot of holes.* Money Magazine, (2005), [http://money.cnn.com/2005/09/06/pf/taxes/consumptiontax\\_0510/](http://money.cnn.com/2005/09/06/pf/taxes/consumptiontax_0510/). (Last retrieved January 18, 2007).

<sup>244</sup> Id.

<sup>245</sup> Id.

<sup>246</sup> The Fair Tax Act's tax inclusive quote is 23%. Therefore, for every \$100 earned, \$23 is paid in taxes. Sales taxes are usually quoted tax-exclusive, for example, “Mary bought a \$77 blouse and had to pay the same \$23 in sales taxes. This is a 30% sales tax. I spend \$0.77¢ for a sweet but the tax paid on the sweet is 23¢. This rate when programmed into a point-of-purchase terminal is 30%. Under an income tax rate of 23%, an individual has to earn \$130 to spend \$100. If this individual spends the same \$100 under a sales tax, he pays the same tax of \$30 and the rate is quoted as 30%. Fair Tax Act, [http://www.fairtax.org/site/PageServer?pagename=about\\_faqs\\_answers#47](http://www.fairtax.org/site/PageServer?pagename=about_faqs_answers#47).

*Chapter 6: A look at how the Fair Tax Act Affects Corporations, Tax Evasion, The AMT, Estate and Gift Taxes, and International Tax Law.*

Of great interest to individuals who are skeptical as to whether a consumption tax will be advantageous to the American society or for those who are convinced that a consumption tax will not work in the American society is what can the Fair Tax Act do for the economy.

### Corporations

With regard to corporations, the Fair Tax Act proposes to abolish imposing taxes on corporations.<sup>247</sup> The rationale for taking this stance is that imposing a tax on corporations only makes cost of living for the poorer class higher. It is believed that the poorer class who work and pay income taxes will pay more for the goods that these corporations produce.<sup>248</sup> This is because the principle of vertical equity is offended under the present federal income tax system because the burdens of this system are not distributed among the members of society in a fair manner.<sup>249</sup> That is, those who are supposed to pay the corporate tax in reality do not pay the tax because it is shifted to the consumers who more often than not are the poorer individuals of society.

This is so because when a tax is imposed on a corporation, the corporation often has the ability to shift the burden of the corporate tax from itself to other sectors of the

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<sup>247</sup> H.R. 25, 109<sup>th</sup> Cong. (2007), Title 1 § 101, plain English summary. Available at [http://www.fairtax.org/PDF/PlainEnglishSummary\\_TheFairTaxActof2005.pdf](http://www.fairtax.org/PDF/PlainEnglishSummary_TheFairTaxActof2005.pdf)

<sup>248</sup> William Burnham, *Introductions to the Law and Legal Systems of the United States*, 627 (3<sup>rd</sup> ed., 2003).

<sup>249</sup> *Id.* at 627



economy.<sup>250</sup> The corporation passes the burden on to its workers so that they earn lower wages,<sup>251</sup> or, the burden is shifted to its suppliers who obtain lower prices for the raw materials that they provide,<sup>252</sup> or, its shareholders may receive lower returns on their investment.<sup>253</sup> Therefore, the Fair Tax Act will not tax corporations that reinvest to create jobs, build factories, or develop new technologies.<sup>254</sup> One improvement in the federal income tax that is presently imposed on corporations is that companies now have the option of passing income to its shareholders and skipping the entity level. Prior to 1996 the Federal Income Tax imposed a tax of 35% on corporations.<sup>255</sup> Since 1996<sup>256</sup> many corporations who meet certain criteria<sup>257</sup> can now elect to skip the entity level by “checking the box” so that income and losses now pass through to the shareholders.<sup>258</sup>

The framers of the Fair Tax Act understand that vertical equity may be offended if a tax is imposed on corporations and will altogether eliminate the tax on corporations.<sup>259</sup> Eliminating double taxation by allowing for corporations who meet certain criteria to be able to “check the box” is good, but, the Fair Tax Act intends to take it a step

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<sup>250</sup> Burnham, *supra*, at 627

<sup>251</sup> Burnham, *supra*, at 627

<sup>252</sup> Burnham, *supra*, at 627

<sup>253</sup> Burnham, *supra*, at 627

<sup>254</sup> Information found on the Fair Tax website. Last retrieved on January 20, 2007 at <http://www.fairtax.org/fairtax/faqs.htm>

<sup>255</sup> Karen C. Burke, *Federal Income Taxation of Corporations and Stockholders*, 1 (West Group 5<sup>th</sup> ed.) (2003)(1978)

<sup>256</sup> Treas. Reg. 301.7701-1

<sup>257</sup> For example, “S” corporations are eligible to “check the box” and skip the entity level. To be an eligible “S” corporation, the corporation must (1) be an eligible entity (a domestic corporation, a partnership or a single-member or multiple member limited liability company), (2) have more than 100 shareholders, (3) Shareholders must be U.S. citizens or residents, and must be natural persons, so corporate shareholders and partnerships are to be excluded, (4) Must have only one class of stock, (5) Profits and losses must be allocated to shareholders proportionately to each one's interest in the business. 26 USCA §§ 1361.

<sup>258</sup> 26 USCA §§ 1361

<sup>259</sup> H.R. 25, 109<sup>th</sup> Cong. (2007), Title 1 § 101, plain English summary. Available at [http://www.fairtax.org/PDF/PlainEnglishSummary\\_TheFairTaxActof2005.pdf](http://www.fairtax.org/PDF/PlainEnglishSummary_TheFairTaxActof2005.pdf)

further by eliminating a tax system that offends the principle of vertical equity.<sup>260</sup> Therefore, a tax will not be applied to corporations.

A good tax system ensures that the principle of horizontal equity is not offended when a tax is imposed on a corporation.<sup>261</sup> Horizontal equity allows for individuals who are in similar situations to be taxed in the same way.<sup>262</sup> However, should one observe how the federal income tax of the United States is applied to corporations, arguably there is no horizontal equity in some instances. Double taxation of corporate income offends the principle of horizontal equity because a taxpayer is taxed twice; once at the corporate level and a second time at the shareholder's level. Compare two taxpayers who are entrepreneurs and both have a hair salon business. One is taxed twice while the other is taxed once because that owner uses a corporate form or debt financing.<sup>263</sup> This situation demonstrates a lack of horizontal equity hence and likewise the lack of fairness in the present federal income tax system.

There is the issue of double taxation<sup>264</sup> and, to further illustrate, a hypothetical taxpayer Jim will be used. If Jim is the sole owner of a restaurant and he is the sole owner, he will be taxed on the net income. Assuming that he is taxed at the maximum rate<sup>265</sup> for individuals (40%), and he makes a profit of \$100, 000, his tax liability will be \$40, 000. If however another taxpayer James opens a restaurant as sole shareholder, and uses the corporate form to run the restaurant, and he is the sole shareholder, the corporation will be taxed on its net income. After distributing earnings as dividends to James, James will then be taxed on them. If both taxpayers are placed in similar situations, and it is assumed that James' corporation makes a

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<sup>260</sup> William Burnham, *Introductions to the Law and Legal Systems of the United States*, 627 (3<sup>rd</sup> ed., West Group 2003).

<sup>261</sup> *Id.* at 626

<sup>262</sup> Burnham, *supra*, at 626

<sup>263</sup> Burnham, *supra*, at 627-28

<sup>264</sup> Karen C. Burke, *Federal Income Taxation of Corporations and Stockholders*, 5 (West Group 5<sup>th</sup> ed) (2003)(1978)

<sup>265</sup> Burnham, *supra*, at 626. For ease in calculation the rate used is 40% which is the actual rate.

profit of \$100, 000, then, applying the maximum amount of tax that a corporation may be subjected to, James' corporation has a tax liability of \$35, 000. Thus, after distributing the income to James, he pays a tax of 40% on the remaining \$65, 000 which amounts to \$26, 000. The total amount that is deducted from the net income of James' company is \$61, 000, leaving James with \$39, 000. This example illustrates that the present federal income tax offends the principle of horizontal equity. Double taxation makes the system unfair and promotes inequity in the society. For this reason the Fair Tax Act's proposal to eliminate the tax on corporations is a wise decision.<sup>266</sup>

Vertical equity is the phrase used to define the situations where two taxpayers are not in similar circumstances but the tax system is set up in a way so as to fairly tax each taxpayer. As William Burnham puts it,<sup>267</sup> "The principle of vertical equity in simple form requires that the burdens of a system be distributed among the members of society in a fair manner." One way in which the federal income tax addresses the issue of vertical equity is by making the tax progressive.<sup>268</sup> That is, as income increases, the tax burden also increases. The Fair Tax Act proposes to make its federal income tax progressive by implementing a system where individuals are rebated up to the poverty level. As Burnham explains in his book,<sup>269</sup> vertical equity is not achieved in applying the federal income tax where a corporation, although subject to paying a 35% tax on net income shifts its burden to its workers by paying them less,

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<sup>266</sup> H.R. 25, 109<sup>th</sup> Cong. (2007), Title 1 § 101, plain English summary. Available at [http://www.fairtax.org/PDF/PlainEnglishSummary\\_TheFairTaxActof2005.pdf](http://www.fairtax.org/PDF/PlainEnglishSummary_TheFairTaxActof2005.pdf)

<sup>267</sup> William Burnham, *Introductions to the Law and Legal Systems of the United States*, 627 (3<sup>rd</sup> ed., West Group 2003).

<sup>268</sup> Where corporate tax shifts to labor or consumers, it makes a progressive income tax regressive. That is taxpayers who earn less will pay more. See Karen C. Burke, *Federal Income Taxation of Corporations and Stockholders*, 5 (West Group 5<sup>th</sup> ed) (2003)(1978)

<sup>269</sup> Burnham, *supra*, at 627

and ultimately on consumers who buy the goods produced by the corporation at a high price. The Fair Tax Act proposes to address this issue by abolishing the tax on corporations.<sup>270</sup>

Market neutrality is eliminating situations where taxes force taxpayers to make market decisions.<sup>271</sup> For example, if there are two products in a store and one will be taxed and the other will not be taxed, there presents a situation void of market neutrality since taxpayers will be inclined to buy the product exempted from tax liability.<sup>272</sup> The illustration shown above with Jim and James is an example of the federal income tax not providing for market neutrality since taxpayers would be inclined to create a situation that does not comply with the corporation form. The corporate income is not neutral because the burden that is imposed by the corporate tax would naturally force an individual to avoid the corporate form.<sup>273</sup> Another area that does not make the corporate tax market neutral is debt-based financing. When a corporation takes out a loan, the interest payment on the loan is deductible under the Internal Revenue Code,<sup>274</sup> but dividend payments made to shareholders are not deductible.<sup>275</sup>

Market neutrality comes into play because the corporate income tax puts a burden on equity financing in the capitalization of the corporation over debt financing.<sup>276</sup> Because a tax burden is imposed on one activity (equity financing) over the other

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<sup>270</sup> H.R. 25, 109<sup>th</sup> Cong. (2007), Title 1 § 101, plain English summary. Available at [http://www.fairtax.org/PDF/PlainEnglishSummary\\_TheFairTaxActof2005.pdf](http://www.fairtax.org/PDF/PlainEnglishSummary_TheFairTaxActof2005.pdf)

<sup>271</sup> William Burnham, *Introductions to the Law and Legal Systems of the United States*, 627 (3<sup>rd</sup> ed., West Group 2003).

<sup>272</sup> *Id.* at 627

<sup>273</sup> Burnham, *supra*, at 627

<sup>274</sup> 26 U.S.C.A §163

<sup>275</sup> Burnham, *supra*, at 628

<sup>276</sup> Burnham, *supra*, at 627

(debt financing), then inevitably taxpayers will avoid one activity (equity financing) over the other (equity financing), hence not making the federal income tax market neutral.<sup>277</sup>

Economic efficiency is present where the tax burdens imposed on individuals or corporations do not force them to act in such a manner to avoid taxation.<sup>278</sup> The federal income tax does not create an economically efficient environment because corporations are more inclined to borrow rather than paying dividends to shareholders.<sup>279</sup> Interest payments on debts are deductible by a corporation<sup>280</sup> but dividend payments made to shareholders are not deductible.<sup>281</sup> Economically it is more efficient for the corporation to raise funds by borrowing than by seeking more investment capital.<sup>282</sup> For example, if Roy forms a corporation that needs \$100,000 worth of capital to operate efficiently, and he provides this amount of money from his personal savings to the corporation as paid-in capital, the corporation will pay a tax of \$3,500 if the company generates income in the amount of \$10,000. In addition to this, Roy will be taxed again on the \$6500 that will be distributed to him as a dividend. At the highest marginal rate of 40%, Roy will have an after-tax return of \$3,900. If instead Roy decided to put in \$1 of paid-in capital, and borrow \$99,000 at an interest rate of 10% the corporation's gross income of \$10,000, it will pay Roy \$9999.90 of interest and get a deduction.<sup>283</sup> Roy still has to pay income tax<sup>284</sup> but he will be able to keep a larger portion of the dividend for himself.<sup>285</sup>

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<sup>277</sup> Burnham, *supra*, at 627

<sup>278</sup> Burnham, *supra*, at 628

<sup>279</sup> Burnham, *supra*, at 628

<sup>280</sup> 26 U.S.C.A §163

<sup>281</sup> Burnham, *supra*, at 628

<sup>282</sup> Burnham, *supra*, at 628

<sup>283</sup> 26 U.S.C.A §163

<sup>284</sup> 26 U.S.C. §61 (a)(4)

<sup>285</sup> Burnham, *supra*, at 628

## Tax Evasion

Tax evasion is considered to be a criminal activity and is the equivalent of tax fraud.<sup>286</sup> Tax avoidance on the other hand is defined as “the reduction of tax liability by preventing the satisfaction of the required tax condition.”<sup>287</sup> Simply put, when an individual engages in an act that minimizes his tax liability and it is legally available but the tax system did not contemplate such action, then it may be characterized as tax avoidance scheme.<sup>288</sup> Tax avoidance has an element of ambiguity<sup>289</sup> because although the law permits the taxpayer to carry out the act without having any criminal liability,<sup>290</sup> when analyzed, the act is unfair.<sup>291</sup> Therefore courts may be inclined to not allow the taxpayer to enjoy the benefits he or she would normally enjoy because the act lacks a legitimate economic purpose and there is no “sound legal basis for doing it.”<sup>292</sup>

Yet still there is another term that further distinguishes a taxpayer who reduces his tax liability “and genuinely suffers the economic consequences that Congress intended to be suffered by those taking advantage of the option.”<sup>293</sup> This is referred to as tax mitigation. Tax mitigation differs from tax avoidance because although the taxpayer’s liability is reduced, it is not an economic consequence that Congress intended to suffer.<sup>294</sup> Tax mitigation therefore is “behavior that is legally effective in reducing tax liability.”<sup>295</sup>

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<sup>286</sup> Victor Thuronyi, Comparative Tax Law, 154 (2003).

<sup>287</sup> Tadao Okamura, The Japanese Tax System: Due Process and the Taxpayer, 11 Int’l Tax & Bus. Law. 125, 132 (1993)

<sup>288</sup> Id. at 132, (tax avoidance has three elements: (1) the taxpayer chooses an unusual legal formulation, instead of the normal one that the tax law contemplates; (2) the taxpayer achieves the same economic results as if he had conducted the transaction using the normal legal formulation; (3) the taxpayer reduces or removes the tax liabilities that are connected to the normal legal formulation.

<sup>289</sup> Thuronyi, supra, at 151

<sup>290</sup> The Black’s Law Dictionary, (8<sup>th</sup> ed. 2004)

<sup>291</sup> Thuronyi, supra, at 151

<sup>292</sup> Thuronyi, supra, at 151

<sup>293</sup> IRC v. Willoughby [1997] STC 995, 1003

<sup>294</sup> IRC v. Willoughby [1997] STC 995, 1003

<sup>295</sup> Victor Thuronyi, Comparative Tax Law, 156 (2003).

With the present federal income tax in place in the United States there have been many instances of tax evasion and one such instance occurred in the case *United States v Helmsley*.<sup>296</sup> In *Helmsley*,<sup>297</sup> the defendant, Leona Helmsley, was convicted of three counts of tax evasion, three counts of filing false personal tax returns and sixteen counts of assisting in filing false corporate and partnership returns. Mrs. Helmsley was indicted as a result of her instigating a scheme in which she charged her personal expenditures to several business enterprises that she and her husband owned. Mrs. Helmsley appealed on grounds that there was evidence to show that she made an overpayment of taxes and therefore the government had no basis to claim that she had a deficiency<sup>298</sup>. Mrs. Helmsley was convicted nonetheless of tax evasion under § 7201 of the IRC.<sup>299</sup>

The presiding judge in the *Helmsley*<sup>300</sup> case was of the view that Mrs. Helmsley did not evade her taxes nor did she commit mail fraud.<sup>301</sup> He was of the view that the government had not met its burden beyond a reasonable doubt that there was a tax deficiency, and therefore Mrs. Helmsley was wrongly convicted.<sup>302</sup> Although by her actions she had the intent to evade, there was not sufficient evidence to show that she evaded the tax because Judge Oakes was of the opinion that there was not a deficiency.<sup>303</sup> Some actions that Mrs. Helmsley engaged in that persuaded Judge Oakes that she had the intention to evade were: (1) filing false corporate and partnership returns, (2) engaging in a scheme to charge personal expenditures to various business enterprises that she and her husband owned or controlled, (3) engaging in a

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<sup>296</sup> *U.S. v Helmsley*, 941 F.2d 71 (1991)

<sup>297</sup> *Helmsley*, 941 F.2d at 71

<sup>298</sup> The elements of tax evasion are: (1) an amount due and owing/a tax deficiency, (2) a willful attempt to evade and defeat the tax system (3) willfulness.

<sup>299</sup> Internal Revenue Code

<sup>300</sup> *Helmsley*, 941 F.2d at 103-04

<sup>301</sup> *Helmsley*, 941 F.2d at 103-04

<sup>302</sup> *Helmsley*, 941 F.2d at 104

<sup>303</sup> *Helmsley*, 941 F.2d at 104

prior sales tax avoidance scheme by two jewelers where she had to appear before a state grand jury to give immunized testimony.<sup>304</sup> The *Helmsley*<sup>305</sup> case is evidence that taxpayers will attempt to evade taxes, therefore, it makes sense for the Fair Tax Act to take preventative action to minimize taxpayers' efforts to flout the law.

One such preventative action is putting procedures in place so that individuals do not pretend to have businesses so as to avoid paying the consumption tax. Purchasing items tax free for business purposes under the Fair Tax Act does not attract a consumption tax. In order for any person to purchase items tax free for business purposes, the business has to be a registered seller and have a registered seller certificate issued by the state sales tax authority. Registered sellers are expected to file monthly or quarterly sales tax returns with the state.<sup>306</sup> Also, registered sellers are subject to an audit by the state at which time they will have to produce the invoices for all the "business purchases" that they did not pay sales tax on, and will have to be able to show that they were bona fide business expenses. If they cannot prove this, then they will have to pay the taxes that should have been paid when the items were purchased, plus interest and penalties. The probability of being audited will be much greater than it is under the current system with its over 140 million tax filers.<sup>307</sup>

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<sup>304</sup> *Helmsley*, 941 F.2d at 104

<sup>305</sup> *Helmsley*, 941 F.2d at 71

<sup>306</sup> Fair Tax Act, [http://www.fairtax.org/site/PageServer?pagename=about\\_faq\\_answers#48](http://www.fairtax.org/site/PageServer?pagename=about_faq_answers#48) (last visited May 14, 2007)

<sup>307</sup> Fair Tax Act, [http://www.fairtax.org/site/PageServer?pagename=about\\_faq\\_answers#48](http://www.fairtax.org/site/PageServer?pagename=about_faq_answers#48) (last visited May 14, 2007)



The proponents of the Fair Tax Act do incorporate a significant degree of tax evasion in their calculations simply by using NIPA<sup>308</sup>-based projections of household consumption expenditures in forming the Fair Tax Act tax base.<sup>309</sup>

### Alternative Minimum Tax

The Fair Tax Act proposes to eliminate the Alternative Minimum Tax (“AMT”). The AMT is imposed under 26 U.S.C § 55 (of the Internal Revenue Code) and “imposes tax at a reduced rate on a broader base.”<sup>310</sup> It disallows many deductions and exemptions that would ordinarily be allowed under the regular tax liability.<sup>311</sup> The Internal Revenue Code has codified an individual’s regular tax liability at 26 U.S.C § 26(a) (1). The AMT was first introduced in 1969<sup>312</sup> and became effective in 1970. The original intent of this Internal Revenue Code provision was to limit the amount of tax benefits that high income earners could obtain.

The AMT was supposed to ensure that high income earners did not become completely exempt from paying tax. The AMT has not achieved this goal, however, since the majority of income earners who are subjected to this tax are middle-income earners. The AMT affects taxpayers who have “tax preference items,”<sup>313</sup> for example, long term capital gains, medical expenses, tax exempt income or child tax credits. The individual AMT requires

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<sup>308</sup> National Institute of Pension Administrators (a national association that represents the retirement and employee benefit plan administration).

<sup>309</sup> Paul Bachman et. al., Taxing Sales Under the Fair Tax, What Rate Works, 666 2006 TNT 219-51\* 26 (2006)

<sup>310</sup> Daniel N. Shaviro, William A. Klein & Joseph Bankman, Federal Income Taxation 588 (14<sup>th</sup> ed., Aspen Books 2006)

<sup>311</sup> See Id. at 588

<sup>312</sup> In 1969 the Treasury became aware of some high income earners who used various tax preferences and reduced their tax liability to zero, therefore not paying any taxes. As a result of this the AMT was introduced. See Shaviro et al., supra , at 589

<sup>313</sup> Black’s Law Dictionary, (8<sup>th</sup> ed. 2004) defines it as certain items that, even though lawfully deducted in arriving at taxable income for regular tax purposes, must be considered in calculating a taxpayer's alternative minimum tax.

that taxpayers file a FORM 6251. IRC §§ 55-59 set out the rules of the AMT. A taxpayer can be directly by having an AMT liability or indirectly by the AMT placing limitations on credits available under the parallel tax concept.<sup>314</sup>

The tentative minimum tax is the tax liability calculated using AMT income, the AMT exemption, the AMT tax rates, and allowable AMT credits.<sup>315</sup> Section 55 allows an exemption of \$45,000 from joint returns and \$33,750 for single individuals and heads-of-household to be subtracted from the AMT income before the tax rates are applied.<sup>316</sup> The phase-outs of the exemptions begin for each of these groups at the alternative minimum taxable income of \$150,000 and \$112,500 at a rate of \$0.25 per \$1 of AMT income respectively.<sup>317</sup> Income that does not exceed \$175,000 is taxed at 26% and income greater than \$175,000 is taxed at 28%.<sup>318</sup>

It can therefore be fairly stated that the AMT is one of the Achilles heels of the Federal Income Tax. Two cases which highlight this issue are *Klaassen v. Commissioner*<sup>319</sup> and *Prosman v Commissioner*.<sup>320</sup> In the *Klaassen*<sup>321</sup> case the taxpayers had 10 children and an adjusted gross income (“AGI”) of \$83, 056. The IRS said that the following preferences should be added back to taxable income: deductions for state and local taxes, medical expenses less than 10% of the AGI but more than 7.5%, and all personal and dependency exemptions.<sup>322</sup> This increased their AMTI<sup>323</sup> to \$68, 000 which was reduced by a

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<sup>314</sup> R. Jason Griffin, The Individual Alternative Minimum Tax: Is it Touching People that it Shouldn't Be?, 4 Hous. Bus. & Tax. L.J. 259, 265 (2004).

<sup>315</sup> *Id.* at 265

<sup>316</sup> 26 USC § 55 (d)

<sup>317</sup> 26 USC § 55 (d)(3)

<sup>318</sup> 26 USC § 55 (b)(1)(a)

<sup>319</sup> *Klaassen v CIR*, No. 11210-97, 1998 WL 352260, (U.S. Tax Ct., July 2, 1998)

<sup>320</sup> *Prosman v Commissioner*, No. 26560-96, 1999 WL 153744 (U.S. Tax Ct., March 23, 1999)

<sup>321</sup> *Klaassen v CIR*, No. 11210-97, 1998 WL 352260, (U.S. Tax Ct., July 2, 1998)

<sup>322</sup> *Id.* at \*2

<sup>323</sup> Alternative Minimum Taxable Income

\$45,000 exemption.<sup>324</sup> The difference was taxed at 26% and came up to \$1085 of their regular tax bill. The taxpayers did not dispute that the computations were incorrect, but that the AMT provisions did not apply to them. The taxpayers argued that Congress did not intend the AMT to apply to them but that the AMT applied only to high income taxpayers who claimed the tax preferences under §57. Where they had no §57 tax preferences, they argued that they were exempted from paying the AMT. The Court rejected the taxpayers' argument and opined that if Congress intended that the AMT apply only to individuals with §57 preferences, then, it could have easily drafted the statute to achieve this result.

In the *Prosman*<sup>325</sup> case, the issue was whether or not the taxpayers were subject to the AMT under §55. The taxpayer was a computer consultant for a corporation. His bids included his hourly rate and per diem allowance for travel meals and lodging. He requested that his employer separate his per diem allowance from his hourly rate but the company refused and included the total amount on his W-2 form. His AGI<sup>326</sup> was \$83,143. He claimed taxes paid and job expenses and miscellaneous itemized deductions above the 2% floor which totaled \$37,414. He reported a total taxable income of \$32,000 with a tax of \$4924. The IRS said the AMT tax was \$7612.

The Court held that in calculating the AMTI no deduction is allowed for miscellaneous itemized deductions and state and local taxes paid unless such amounts are deductible in determining AGI under §56(b)(1). The Court conceded that if the taxpayer's

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<sup>324</sup> *Klaasen v CIR*, No. 11210-97, 1998 WL 352260, at \*2 (U.S. Tax Ct., July 2, 1998); *Black's Law Dictionary*, (8<sup>th</sup> ed. 2004) defines an exemption as an amount allowed as a deduction from adjusted gross income, used to determine taxable income.

<sup>325</sup> *Prosman v Commissioner*, No. 26560-96, 1999 WL 153744 (U.S. Tax Ct., March 23, 1999)

<sup>326</sup> *Black's Law Dictionary*, (8<sup>th</sup> ed. 2004) defines adjusted gross income as gross income minus allowable deductions specified in the tax code.

employer had separated the amounts paid by the taxpayer as reimbursed employee business expenses rather than wages the AMT would not apply.<sup>327</sup> These cases illustrate the inequity in the law so that a tax (the AMT) that was initially formulated to curb high income taxpayers from not paying any tax at all instead hurts taxpayers it was never intended to apply to. The Fair Tax Act will eliminate such injustices by doing away with the AMT<sup>328</sup> since it presently does not solve the problem that it was intended to solve.<sup>329</sup>

The AMT is applied to corporations also so that they are not allowed to use tax preference items and thereby they will pay little or no tax.<sup>330</sup> A minimum tax is applied so that these corporations are prohibited from taking tax preference items that they would normally take under the regular tax.<sup>331</sup> The corporate taxpayer should make two calculations: (1) its regular tax liability or its taxable income, which is computed by subtracting the deductions that the corporation is entitled to take from the corporation's gross income (gross income-deductions)<sup>332</sup> and (2) its tentative minimum tax liability.<sup>333</sup> The corporation is obligated to pay its regular liability. However, where the tentative minimum tax exceeds the regular liability, then, the corporation must pay the excess in addition to its regular liability.<sup>334</sup>

To put it simply, the corporation will pay its tentative minimum tax liability. This excess is called the AMT.<sup>335</sup> To further illustrate the point, if Corporation Gamma computes its regular tax liability to be \$120,000 and its tentative minimum tax liability

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<sup>327</sup> *Prosman v Commissioner*, No. 26560-96, 1999 WL 153744 at \*2 (U.S. Tax Ct., March 23, 1999)

<sup>328</sup> H.R. 25, 109<sup>th</sup> Cong. Title I §101

<sup>329</sup> R. Jason Griffin, *The Individual Alternative Minimum Tax: Is it Touching People that it Shouldn't Be?*, 4 *Hous. Bus. & Tax. L.J.* 259, 265 (2004).

<sup>330</sup> Leandra Lederman, *Understanding Corporate Taxation*, 327 (2002)

<sup>331</sup> *Id.* at 327

<sup>332</sup> According to § 63 (a) of the Internal Revenue Code (IRC)

<sup>333</sup> Lederman, *supra*, at 327

<sup>334</sup> Lederman, *supra*, at 328

<sup>335</sup> See IRC § 55 (a)

is \$150,000, then the corporation will be obligated to pay \$150,000 because it will pay its regular tax liability which amounts to \$120,000, and it will pay its AMT which amounts to \$30,000.<sup>336</sup>

The AMT is not applied to corporations in their first year of existence nor does it apply to “small” corporations.<sup>337</sup> Only taxable years beginning after December 31, 1993 are taken into consideration and \$5,000,000 is used for the first three- year period because there is an exception for corporations that have an average annual gross receipt that is not in excess of \$7,500,000 for all three- taxable- year periods ending before the taxable year in question.<sup>338</sup>

### Estate and gift taxes

The Federal Estate Tax was first implemented in 1916 but was not the first excise tax imposed on transfers of wealth at death. The Federal Estate Tax was preceded by the stamp tax which Congress imposed on receipts for legacies and shares in intestate estates.<sup>339</sup>

Legislation for a tax to be imposed on gifts was first drafted in 1924.<sup>340</sup> There were, however, vulnerabilities in the tax due to a lack of consideration as to whether a donor had given previously.<sup>341</sup> The gift tax was implemented to “supplement the estate and income taxes<sup>342</sup> since individuals would give away their property during their lives as a means of tax avoidance.<sup>343</sup> The gift tax is imposed on wealth transfers during the transferor’s life while the estate tax is imposed on transfers made after the transferor’s death.<sup>344</sup> Both taxes are

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<sup>336</sup> Lederman, *supra*, at 328

<sup>337</sup> According to IRC § 55 (e) (1) (A), corporations that have an average gross receipt that is not in excess of \$7,500,000 for all three taxable year periods ending before the taxable year in question are exempted.

<sup>338</sup> 26 USC § 55(e)(1)(B).

<sup>339</sup> Charles L.B. Lowndes, *Federal Estate and Gift Taxes*, 5 (1962)

<sup>340</sup> Revenue Act of 1924, 43 Stat. 313-316, §§ 319-324.

<sup>341</sup> Lowndes, *supra*, at 563

<sup>342</sup> Lowndes, *supra*, at 564

<sup>343</sup> Lowndes, *supra*, at 564

<sup>344</sup> Knowlton v. Moore, 178 U.S. 41 at 56-59 (1900) (the death tax was viewed as a transfer tax by the Supreme Court and this gave weight to the estate tax being constitutional)

referred to as “transfer taxes.”<sup>345</sup> Transfer taxes also include the generation skipping transfer tax<sup>346</sup> (GSTT) and all three target affluent individuals whose contribution to the federal government’s revenue account for approximately 2% of total revenue collected. The gift tax is imposed under 26 U.S.C. § 2501. Congress unified the gift and estate taxes to prevent donors who were close to death from transferring gifts prior to death, hence, escaping the gift tax.<sup>347</sup>

The Fair Tax Act<sup>348</sup> proposes to repeal the Estates and Gift Tax under Subtitle B of the Internal Revenue Code, which includes the estate tax, the gift tax, and the tax on generation skipping transfers of wealth. In the past, courts in the United States have often battled with the question of what constitutes a gift.<sup>349</sup> For example, in *U.S. v. Harris*<sup>350</sup> the issue was whether money that was paid to a mistress should be considered income and therefore was subject to taxation under § 61 of the Code. What made the case unique is that the court was considering an issue that was novel, and therefore, in all fairness the defendant was not put on notice that her actions were considered to be illegal. In *Harris*,<sup>351</sup> An older gentleman who had died, Mr. Kritzik, had two young mistresses and the issue was did Kritzik give to Ann Conley (one of the young mistresses) gifts in the amount of \$500, 000 so that she was exempted from paying tax under 26 U.S.C. § 102, or was a gift tax to be imposed under 26 U.S.C. § 2501, therefore making Ann Conley liable for tax evasion<sup>352</sup> and failure too file a tax return.<sup>353</sup>

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<sup>345</sup> Lowndes , *supra* , at 566

<sup>346</sup> This is a tax imposed on transfers made either during one’s life or after death. The individuals who are taxed are removed by more than one generation from the transferor.

<sup>347</sup> This was achieved under the Estate and Gift Tax Reform Act of 1976. There now exists a unified credit so that a taxpayer can now apply either toward a gift tax during life or toward an estate tax after death under §§ 2010 (a) and 2505 (a).

<sup>348</sup> H.R. 25, 109<sup>th</sup> Cong. Title I sec 103

<sup>349</sup> This exemption is found in 26 U.S.C. § 102

<sup>350</sup> *U.S v Harris*, 942 F. 2d 1125 (1991)

<sup>351</sup> *Id.* at 1125

<sup>352</sup> 26 U.S.C § 7201

<sup>353</sup> 26 U.S.C. § 7203

The Court held that the government's evidence was insufficient to show that the money that Conley received was income or that she acted in knowing disregard of her obligations.<sup>354</sup> Failure to show Kritzik's intent which was critical was fatal to the government's argument. It should be noted that prostitution in and of itself created income, however, there was a lacuna in this case since the two mistresses could innocently believe that Kritzik was their lover since he did write Harris (the other young mistress) telling her of his love for her and that he got pleasure out of giving her things.

This case should be contrasted with *Commissioner v. Duberstein*<sup>355</sup> where Berman, president of Mohawk Metal Corporation<sup>356</sup> gave Duberstein a Cadillac for providing him with the name of a customer. Duberstein did not anticipate that he would be compensated for the information.<sup>357</sup> Berman deducted the Cadillac as a business expense. The Court's rationale was that a statutory gift<sup>358</sup> proceeds from "detached and disinterested generosity out of affection, respect, admiration, charity or like impulses."<sup>359</sup> The intention of the transferor is the most critical consideration.

The above cases show the difficulty courts have in determining what qualifies as a gift. The estate and gift tax is unfair because it forces individuals to sell their property prior to death in order to escape the tax. The Fair Tax Act<sup>360</sup> proposes to deal with this problem by eliminating these provisions in the Code so that individuals do not have to sell their estates to avoid paying an estate tax. In addition, courts will not have to struggle with the

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<sup>354</sup> U.S v Harris, 942 F. 2d 1125 (1991)

<sup>355</sup> Duberstein v CIR, 363 U.S. 278 (1960)

<sup>356</sup> Duberstein v CIR, 363 U.S. 278, 280 (1960)

<sup>357</sup> Duberstein v CIR, 363 U.S. 278, 280-81 (1960)

<sup>358</sup> 26 U.S.C.A. § 102 (a)

<sup>359</sup> Duberstein v CIR, 363 U.S. 278, 285 (1960)

<sup>360</sup> H.R. 25, 109<sup>th</sup> Cong. Title I § 103

question of what constitutes a gift, since this tax will be repealed and only goods and services that are consumed will be taxed.

### International Tax Law

The rules regarding International Tax Law in the United States can prove to be very complicated. One major objective of framers of the International Tax Code is to avoid double taxation. The issue of double taxation arises because where there is trade between individuals who reside in different countries; both governments may want to impose a tax.<sup>361</sup> To avoid double taxation,<sup>362</sup> the United States creates bilateral treaties<sup>363</sup> with other countries and grants a tax credit against US income taxes for taxes paid to a foreign government where that income was earned in that foreign country.<sup>364</sup> The general rule with regard to taxation is that the United States will impose a tax on United States citizens,<sup>365</sup> residents and companies incorporated in the United States regardless of where the income is earned.<sup>366</sup> A U.S. citizen who lives in Germany and earns income there may be subject to tax in Germany, and that income is also taxable in the U.S.<sup>367</sup> The U.S will therefore attempt to counteract this double taxation by allowing the taxpayer to offset the taxes due in the U.S. with the income taxes paid in

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<sup>361</sup> Richard L. Doernberg, International Taxation, 2 (2004).

<sup>362</sup> Id. at 3

<sup>363</sup> Id. at 3. Both bilateral tax treaties and unilateral double taxation are formulated to address issues where individuals and corporations are unfairly taxed twice.

<sup>364</sup> William Burnham, Introductions to the Law and Legal Systems of the United States, 638 (3<sup>rd</sup> ed., West Group 2003)

<sup>365</sup> *Cook v. Tait*, 265 U.S. 47 (where the United States imposed a tax on a United States citizen despite the fact that he was a resident of Mexico. The U.S. Supreme Court held that taxing the taxpayer's worldwide income did not violate the U.S. Constitution or international law).

<sup>366</sup> Richard L. Doernberg, International Taxation, 7 (2004).

<sup>367</sup> Id. at 11



Germany.<sup>368</sup> The German tax can be used only to offset the U.S. tax on German income.<sup>369</sup> The U.S. tax is not used to offset U.S. income.<sup>370</sup>

A foreign tax credit will only be applied for foreign income taxes that are imposed on foreign source income.<sup>371</sup> U.S. source rules are important since taxpayers want to maximize their foreign source income so that they will receive a maximum foreign tax credit.<sup>372</sup> This will reduce the potential amount of U.S. tax that will be imposed.<sup>373</sup> For this reason taxpayers plan ahead to maximize their foreign tax credit<sup>374</sup> since, although it is true that they will be taxed whether they engage in trade or business in the United States or abroad,<sup>375</sup> it is a fact that they can minimize the amount of U.S. tax paid by maximizing the foreign tax credit.<sup>376</sup>

To further illustrate this point, suppose that a company by the name of GenCorp earns \$100 million dollars of foreign source income in Canada and pays income tax there in the amount of \$60 million,<sup>377</sup> and \$100 million of U.S source income. For U.S. tax purposes if GenCorp declared \$200 million of taxable income, and faces a potential U.S. tax liability of \$70 million. GenCorp may be able to take a foreign credit for the foreign taxes paid but only to the extent of the U.S. tax that would be imposed on the foreign source income. The credit could not exceed \$35 million because it is the potential U.S. tax on the foreign source income.<sup>378</sup> In total GenCorp would pay \$35 million of U.S. tax and \$70 million of foreign tax.<sup>379</sup>

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<sup>368</sup> Doernberg, supra , at 13

<sup>369</sup> Doernberg, supra , at 13

<sup>370</sup> Doernberg, supra , at 13

<sup>371</sup> Doernberg, supra , at 13

<sup>372</sup> Doernberg, supra , at 13

<sup>373</sup> Doernberg, supra , at 13

<sup>374</sup> Doernberg, supra , at 13

<sup>375</sup> Doernberg, supra , at 13

<sup>376</sup> Doernberg, supra , at 12.

<sup>377</sup> See Doernberg, supra , at 13

<sup>378</sup> Doernberg, supra , at 13

If GenCorp can change the source of what is now the \$100 million of U.S. source income into foreign source income, and not have any further foreign tax liability, then, it would work to GenCorp's advantage. GenCorp may be able to use the full \$70 million of foreign taxes paid to offset the \$70 million potential U.S. tax on the foreign source income. By changing the source, GenCorp may be able to save \$35 million in U.S. tax.<sup>380</sup>

The United States taxes non-resident aliens and foreign corporations. The United States does not usually tax foreign corporations even if the shareholders are United States citizens. These foreign corporations are taxed when money is remitted to the United States in the form of a dividend. Countries usually decide on whether a person or corporation should be taxed based on nationality and territoriality.<sup>381</sup> International transactions can be grouped as outbound and inbound transactions.<sup>382</sup> An outbound transaction takes place where a U.S resident or citizen does business or makes an investment abroad.<sup>383</sup> An inbound transaction occurs when a foreign taxpayer partakes in a business transaction in the U.S.<sup>384</sup> or invests in the U.S.<sup>385</sup> U.S. taxpayers engaged in activities abroad generally compute taxable income in the same manner as U.S. taxpayers operating solely within the United States.<sup>386</sup>

Proponents of the Fair Tax Act state that the Fair Tax is automatically border adjustable.<sup>387</sup> Border adjustable means that as U.S-made products are exported, the tax is

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<sup>379</sup> Doernberg, supra , at 14

<sup>380</sup> Doernberg, supra , at 14

<sup>381</sup> Doernberg, supra , at 7

<sup>382</sup> Doernberg, supra , at 11

<sup>383</sup> A United States resident or citizen is taxed on their worldwide income under rates as outlined by § 1 of the Internal Revenue Code. Domestic corporations created in the U.S. (see 26 U.S.C. § 7701) are taxed on their worldwide income under the rates specified by § 11 of the Internal Revenue Code. U.S. individuals or corporations that have partnerships either in the U.S. or abroad are taxable on a worldwide income.

<sup>384</sup> Doernberg, supra , at 11

<sup>385</sup> Doernberg, supra , at 11

<sup>386</sup> Doernberg, supra , at 11

<sup>387</sup> Americans for fair Taxation, <http://www.fairtax.org/fairtax/faqs.htm>. Border adjustable means that as U.S-made products are exported, the tax is lowered (or in this case dropped) on the border to make them more globally

lowered (or in this case dropped) on the border to make them more globally competitive. One of the things hurting U.S. manufacturers is that foreign goods come to the U.S. with no embedded corporate taxes but U.S.-made products go out with corporate taxes. They suggest that the 17 percent competitive advantage<sup>388</sup> of foreign competitors will be eliminated.<sup>389</sup> This would by far increase the competitiveness of foreign corporations doing business overseas.<sup>390</sup> U.S. companies with plants abroad or those companies doing business abroad would not be subjected to an income tax since this is eliminated.<sup>391</sup> Exported goods would not be subject to the Fair Tax since they are not consumed in the United States<sup>392</sup> and, imported goods that are sold in the U.S would be subject to the Fair Tax since they are consumed in the U.S.<sup>393</sup> This would be of great importance to the American society since countries continually put strategies in place to increase their competitiveness.<sup>394</sup>

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competitive. One of the things hurting U.S. manufacturers is that foreign goods come to the U.S. with no embedded corporate taxes but the U.S.-made products go out with corporate taxes.

<sup>388</sup> Id.

<sup>389</sup> Id.

<sup>390</sup> Id.

<sup>391</sup> Id.

<sup>392</sup> Id.

<sup>393</sup> Id.

<sup>394</sup> Neil C. Hughes, *A Trade War with China?* (2005), <http://www.foreignaffairs.org/20050701faessay84407/neil-c-hughes/a-trade-war-with-china.html>.

*Chapter 7: Countries in the American Family Tax System*

In addressing the question as to whether a consumption tax or the federal income tax should be applied to the United States, it is only appropriate to do a comparative study of the countries that are presently applying either of the two tax systems or, have applied one of the two tax systems in the past. For convenience, the different tax regimes that have applied a system of taxation have been grouped into families.<sup>395</sup> The different families of taxation are: (1) the Commonwealth,<sup>396</sup> (2) American,<sup>397</sup> (3) French,<sup>398</sup> (4) Latin American,<sup>399</sup> (5) Transition and post-conflict countries,<sup>400</sup> (6) Northern European,<sup>401</sup> (7) Southern European,<sup>402</sup> (8) Japanese/Korean,<sup>403</sup> (9) Miscellaneous,<sup>404</sup> (10) European Union.<sup>405</sup>

The United States' definition of income is a global one.<sup>406</sup> The countries included in the American family are those whose tax laws closely resemble that of the United States. Although the United States' common law legal system resembles that of the countries in the Commonwealth group, the United States' income tax system is quite different from the aforementioned group. This is so because the United States' tax system was never influenced by the old U.K. scheduler system. Some country's tax system have been influenced by the U.S. tax system, however, as has been noted before, only those tax systems which were

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<sup>395</sup> Victor Thuronyi, *Comparative Tax Law*, 15 (Aspen Publishers) (2003).

<sup>396</sup> *Id.* at 25-28

<sup>397</sup> Countries in the American family include Liberia, Marshall Islands, Micronesia, Palau, Philippines, and the United States.

<sup>398</sup> Victor Thuronyi, *Comparative Tax Law*, 28 (2003).

<sup>399</sup> *Id.* at 30-32

<sup>400</sup> Thuronyi, *supra*, at 33-38

<sup>401</sup> Thuronyi, *supra*, at 38-39

<sup>402</sup> Thuronyi, *supra*, at 28

<sup>403</sup> Thuronyi, *supra*, at 40-42. The countries in this group are Japan and Korea.

<sup>404</sup> Thuronyi, *supra*, at 42. In this group are the countries of the Islamic state of Afghanistan, Bhutan, Egypt, Indonesia, Islamic Republic of Iran, Syrian Arab Republic, Thailand, Turkey and Yemen.

<sup>405</sup> Thuronyi, *supra*, at 42

<sup>406</sup> Thuronyi, *supra*, at 39-40

closely modeled after the U.S. system are considered to be apart of the American family tax system. With regards to capital gains, the United States has a global definition<sup>407</sup> of income and a comprehensive system for taxing capital gains. The United States has a single law for corporate and individual income tax, but with respect to international law and its definition of citizenship and residence, it takes a worldwide approach.

The United States' income tax laws are indeed highly developed but not without their complexities. The United States is said to have one of the most schedular tax system because it has so many distinctions of income than in most other countries.<sup>408</sup> For example, it has a different definition for employment income, capital gains, and passive activity income. It should also be noted that the United States is the only OECD<sup>409</sup> country that does not have a VAT tax. The countries included in the American family are Liberia, the Marshall Islands, Micronesia, Palau, Philippines, and the United States. The two countries in the American family whose tax system will be analyzed are Liberia and the Philippines.

### The Tax System of Liberia

Prior to Liberia's civil war from 1989 to 1996,<sup>410</sup> the tax system remained "incomplete and lacked a basic design,"<sup>411</sup> due mainly to the fact that it was late in

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<sup>407</sup> A global tax system treats a taxpayer's income, from whatever source derived, as a single mass of income, subject to a single rate structure. Some countries combine global and schedular treatment by superimposing a global tax on the overall net income of a set of schedular taxes. No pure schedular or global tax systems exist. Eric M. Zolt, The Uneasy Case for Uniform Taxation, 16 Va. Tax Rev. 39, 49-50 (1996)

<sup>408</sup> A schedular tax system is defined as those systems that subject various categories of income to separate tax rates or rate structures. Schedular tax systems tax a taxpayer's overall net income in a compartmentalized manner. Global tax systems treat the taxpayer's income as a single mass of income, subject to a single rate structure. Eric M. Zolt, The Uneasy Case for Uniform Taxation, 16 Va. Tax Rev. 39, 49-50 (1996)

<sup>409</sup> Organization for Economic Cooperation and Development ("...an international organization helping governments tackle the economic, social and governance challenges of a globalized economy. <http://www.oecd.org/>)

<sup>410</sup> Tax Analysts, News Analysis: Post-War Developments in the Liberian Tax System, Available at LEXIS 2001 WTD 90-8 (2001)

<sup>411</sup> Id.

formulating a Revenue Finance Law in 1977<sup>412</sup> and also because it limited the means by which it gained its resources.<sup>413</sup> In addition to the obvious weaknesses of the pre-war tax system in Liberia, the tax system lacked transparency,<sup>414</sup> neutrality<sup>415</sup> and there was not a clear relationship between the central government and the productive sector.<sup>416</sup> As a result of these weaknesses in the tax system, Liberia experienced significant decline in government tax revenue<sup>417</sup> and a general economic downturn.<sup>418</sup> The civil war caused a substantial amount of the population to be displaced and many professionals fled the country.<sup>419</sup> This depleted the country's expertise and capital.<sup>420</sup> As a result, Liberia's tax system was destroyed and whatever economic activity taking place up to that point was forced to stop.<sup>421</sup>

Liberia's GDP and the revenue tax system were decreased.<sup>422</sup> Government revenue declined by more than 88.7% from 1988 to 1997 from \$228.1 million U.S. to \$25.8 million U.S.<sup>423</sup> The country has received assistance from the International Monetary Fund as a means of rebuilding its economy. Natural commodities such as rice, cassava, wood and charcoal are not taxed due to an absence of technical and administrative expertise. The internal resource tax burden is supported by taxing crops like rubber and by also imposing taxes such as excise and customs duties.

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<sup>412</sup> Id.

<sup>413</sup> Id. Liberia gained its resources from easily attained groups such as rubber plantations, timber and import sectors, and registered employees).

<sup>414</sup> Id.

<sup>415</sup> Id.

<sup>416</sup> Id.

<sup>417</sup> Id.

<sup>418</sup> Id.

<sup>419</sup> Id.

<sup>420</sup> Id.

<sup>421</sup> Id.

<sup>422</sup> Id.

<sup>423</sup> Id.

After the war, there was a careful restructuring of the tax system in Liberia.<sup>424</sup> Tax reform was implemented piecemeal,<sup>425</sup> by the post war government.<sup>426</sup> The objective of the new tax system in Liberia mirrored that of IMF-supported developing countries whose main objective is to raise revenues.<sup>427</sup> The objective of the tax reform that took place in Liberia was to increase “buoyancy.”<sup>428</sup> Liberia introduced a broad-based consumption tax and a reformed business tax.<sup>429</sup> Reform also meant simplifying tax procedures and “rationalizing” the tax structure.<sup>430</sup> Direct and indirect taxes were reduced and conformed to international standards.<sup>431</sup> This meant decreasing discretionary exemptions which would inevitably lead to an improved tax compliance and administrative structure.

As a result of the measures taken for reform of the tax system, discretionary measures have been made such as a suspension of certain sections of the Revenue and Finance Law.<sup>432</sup> The provisions in the former tax code that were suspended were provisions that dealt with company taxes, including partnership and income taxes. These sections were replaced with a number of special tax measures under a temporary Emergency Tax Code,<sup>433</sup> and were replaced with a 4% turnover tax on gross receipts which included individual income taxes withheld.<sup>434</sup> There was a “consolidation” of all income and allowances into one assessable income.<sup>435</sup> One difficulty that the Government of Liberia faced was the inability of corporations

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<sup>424</sup> Id.

<sup>425</sup> Id.

<sup>426</sup> Id.

<sup>427</sup> Id.

<sup>428</sup> “The growth in revenues not adjusted for rate changes is often termed ‘buoyancy’ rather than ‘elasticity.’”

William F. Fox, *The Ongoing Evolution of State of State Revenue Systems*, 88 Marq. L. Rev. 19, 44 n.6 (2004).

<sup>429</sup> Tax Analysts, *News Analysis: Post-War Developments in the Liberian Tax System*, Available at LEXIS 2001 WTD 90-8 (2001)

<sup>430</sup> Id.

<sup>431</sup> Id.

<sup>432</sup> Id.

<sup>433</sup> Id.

<sup>434</sup> Id.

<sup>435</sup> Id.

to produce financial statements so that their income tax liability can be assessed.<sup>436</sup> This was due to the fact that past records were destroyed. As a result, the Government suspended all company, partnership and income taxes.<sup>437</sup> They were replaced by a 4 percent turnover tax on gross receipts that included individual income taxes withheld. A 5 percent tax was imposed on certain agricultural products.<sup>438</sup> The Government later mandated that all taxes were to be paid only in U.S. currency.

In order to attract foreign investment and to rehabilitate businesses and production property, exemptions and concessions were broadened. One feature of the tax structure that the government changed was the tax schedules which were restructured to decrease its complexity. The Revenue Collection Act was put in place so that all revenue collections would take place by the Ministry of Finance. This was done to increase administrative efficiency. There was also a change in the collection of revenue by the state agencies such as, changes in the hierarchy, procedures, and processes. The tax base was formerly limited to customs duties; however, in 1999 there was an increase in the tax base with the introduction of a new sales tax on petroleum products. In addition, the government attempts to broaden the tax base further by increasing the scope of the sales to include other consumer goods and services formerly exempted from taxation. The word “revenue” as defined by Chapter 1 S 1.1 of the Revenue and Finance Law is:

“..all money, payments in kind, and interests and rights in property of all kinds received by Liberia, including but not limited to: taxes, imposts and fees; fines, penalties and forfeitures; licenses; government leases and land sales, rents; escheats; postal service; government royalties and other rights connected with or arising out of mining and other industrial, agricultural

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<sup>436</sup> Id.

<sup>437</sup> Id.

<sup>438</sup> Id.



and commercial operations in Liberia. The term “customs revenue” includes receipts from taxes, tariffs, duties and imposts levied on imports and exports and from fees levied in connection therewith, and the term “internal revenue” includes receipts from all sources other than customs revenue.”

In Liberia, if taxes due are not paid within a thirty day period a warrant may be issued.<sup>439</sup> What distinguishes this tax procedure from the United States’ is that should the taxpayer pay the tax due within the thirty day period given, then interest is not applied from the time the notice is given to the time that the tax is paid.<sup>440</sup> In the United States, the period for filing a claim for refund of an overpayment is 3 years from the time that the tax was paid. In the event the claim is filed later than the thirty day expiration, an additional assessment may be made by the minister.<sup>441</sup> This time period for filing a claim for refund is very flexible as compared to that in the United States.’ The time period for filing a claim for refund in the United States is the later of three years from when the return was filed or two years from the time that an additional assessment was made.<sup>442</sup>

Gifts and bequests are excluded from gross income.<sup>443</sup> A deduction is made for any contribution or gift for public purposes that is made to the Government of Liberia or a political subdivision.<sup>444</sup> Contributions made to charitable, religious or educational organizations

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<sup>439</sup> Chapter 3 S. 3.10 subsection 2 of the Revenue and Finance Law. The Service does not issue a warrant but issues a 30-Day Letter or Preliminary Notice of Deficiency. The Service uses this as a means of informing the taxpayer of his or her right to appeal and has a summary of the agent’s report. See Camilla Watson et al, Federal Tax Practice and Procedure, 307 ( 2005).

<sup>440</sup> Chapter 4 S. 4.4 subsection 5. In the U.S. once the period for paying the tax has passed, then interest is applied.

<sup>441</sup> Chapter 5 S. 5.1 subsection 2 of the Revenue and Finance Law. The U.S.’s corresponding provision is codified at IRC § 6501 (a) of the Internal Revenue Code.

<sup>442</sup> IRC § 6501 (a)

<sup>443</sup> Chapter 11 Subchapter B S.11.22 subsection 2

<sup>444</sup> Chapter 11 Subchapter C S.11.32

accredited by the Minister also receive a deduction.<sup>445</sup> A contribution or gift made in property-like form and not made out in cash will be given the fair market value of the property, or the adjusted cost of the property to the donor.<sup>446</sup> The deductions for contributions or gifts made in a taxable year must not exceed 15% of the taxpayer's taxable income.<sup>447</sup>

### The Tax System of the Republic of the Philippines

The Republic of Philippines has an income tax as well as a consumption tax. Like Liberia, the Philippines has amended its consumption based tax<sup>448</sup> as proposed by the IMF and has seen a major reduction in inflation.<sup>449</sup> The national tax laws in the Philippines are enforced by the Bureau of Internal Revenue under the Tax Code of 1997.<sup>450</sup> Local taxes are imposed and collected by the local government.<sup>451</sup>

Like the tax system of the United States, the Congress of the Philippines may authorize the President to fix within certain limits, tariff rates, import and export quotas, tonnage and wharfage dues and other duties or imposts within the framework of the national development program of the Government.<sup>452</sup> There is a rule of taxation that the tax applied should be fair and uniform.<sup>453</sup>

Individuals' income tax rates are computed at a progressive rate at 5%, 10%, 15%, 20%, 25%,

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<sup>445</sup> Chapter 11 Subchapter C S.11.32

<sup>446</sup> Chapter 11 Subchapter C S.11.32

<sup>447</sup> Chapter 11 Subchapter C S.11.32

<sup>448</sup> IMF Executive Board Concludes the 2006 Article IV Consultation with the Philippines Public Information Notice (PIN) No. 07/14, February 7, 2007. Last retrieved February 10, 2007. <http://www.imf.org/external/np/sec/pn/2007/pn0714.htm> (national government deficit was achieved in 2004 and 2005 by expenditure compression. The IMF gives credit to the new VAT reform that was recently implemented. There was full implementation of the VAT reform in 2006).

<sup>449</sup> IMF Executive Board Concludes the 2006 Article IV Consultation with the Philippines Public Information Notice (PIN) No. 07/14, February 7, 2007. (Last retrieved February 10, 2007), <http://www.imf.org/external/np/sec/pn/2007/pn0714.htm>

<sup>450</sup> Information is obtained at the website for the Bureau of Internal Revenue (B.I.R.) for the Philippines. B.I.R., <http://www.bir.gov.ph/legalmatters/8757.htm>.

<sup>451</sup> Information is obtained at the website for the Bureau of Internal Revenue for the Philippines. <http://www.bir.gov.ph/legalmatters/8757.htm>

<sup>452</sup> Article VI, Section 29, paragraph 3

<sup>453</sup> Article VI, Section 28, paragraph 1

and 30%.<sup>454</sup> Individuals who earn in excess of \$500,000 pay at a rate of 32% as of January 1, 2000.<sup>455</sup> Married individuals should compute their taxes separately unless the income cannot be identified as income earned by exclusively one partner.<sup>456</sup>

Like Liberia, the Philippines applies a Value Added Tax (VAT)<sup>457</sup> which is a business tax that is applied and collected by the seller during trade or business on the sale of both real and personal property.<sup>458</sup> It also includes lease of goods or properties.<sup>459</sup>

In the Philippines a citizen is taxable on all income derived from all sources ‘within and without’ the Philippines.<sup>460</sup> A non-resident is taxable only on income earned from sources in the Philippines. A citizen of the Philippines who works abroad and obtains income from abroad as an overseas contract worker is taxable only on income that is derived from sources within the Philippines. Included in this rule also is a Philippine who is a seaman and obtains compensation for services given abroad as a member of the vessel. The seaman is also treated as a contract worker. An alien in the Philippines is taxable on income derived from sources within the Philippines. A domestic corporation is taxable on all income derived from sources in and outside of the Philippines. A foreign corporation on the other hand whether or not it is engaged in a trade or business in the Philippines is taxable on income derived from sources in the Philippines.<sup>461</sup>

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<sup>454</sup> Bureau of Internal Revenue, Republic of the Philistines. <http://www.bir.gov.ph/taxcode/1577.htm>

<sup>455</sup> Id.

<sup>456</sup> Section 51 (D). It should be noted that filing a joint return as a married couple in the U.S is not compulsory but the rates are so different so that it is not advantageous to file separately.

<sup>457</sup> Bureau of Internal Revenue, Republic of the Philistines, <http://www.bir.gov.ph/taxinfo/taxinfo.htm>

<sup>458</sup> Id.

<sup>459</sup> Id.

<sup>460</sup> s. 23C (A) of the National Internal Revenue Code, [http://www.bir.gov.ph/lumangweb/nirc/nir\\_tl02\\_ch02.html](http://www.bir.gov.ph/lumangweb/nirc/nir_tl02_ch02.html)

<sup>461</sup> s. 23C (E) of the National Internal Revenue Code. See [http://www.bir.gov.ph/lumangweb/nirc/nir\\_tl02\\_ch02.html](http://www.bir.gov.ph/lumangweb/nirc/nir_tl02_ch02.html)

## VAT in the Philippines

A sales tax called the VAT is applied in the Philippines.<sup>462</sup> This tax is levied on the sale of goods and services and on the imports of goods in the Philippines. A person or entity in the course of a trade or business sells or leases goods, properties and services is subject to the VAT if the aggregate exceeds five hundred and fifty thousand pesos (P 550,000) for any twelve month period. Professional practitioners are now subject to the VAT<sup>463</sup> although formerly they were only subject to the income tax under section 24 of the Code.<sup>464</sup> The output tax rates are 0% and 10%. The same rates apply for input tax rates and there are transitional input rates of 8% and 10%.

There is a presumptive tax rate of 1-1/2%. The output tax is the VAT due on the sale, lease or exchange of taxable goods, properties or services by a person who is registered or required to register under section 236 of the Tax Code. An input tax is the VAT paid by a VAT-registered person in the course of his trade or business on importation of goods or local purchase of goods or services, including leasing or using the property, from a VAT-registered person. This also includes transitional input tax determined according to section 111 of the Tax Code. A zero-rated sale is a sale, barter or exchange of goods, properties and/or services that are subject to a 0% VAT under sections 106 (A) (2) and 108(B) of the Tax Code. Sales that are subject to a 0% VAT are sale of goods which are directly shipped by a VAT-registered resident to a place outside of the Philippines, sale of goods which are “deemed” export sales by a VAT-registered person to certain entities who are also residents of the Philippines and sales

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<sup>462</sup> Bureau of Internal Revenue, Republic of the Philippines for further information on the VAT [http://www.bir.gov.ph/lumangweb/tax\\_vat.html](http://www.bir.gov.ph/lumangweb/tax_vat.html)

<sup>463</sup> Republic Act Nos. 7716 and 9010 which became effective as of January 1, 2003.

<sup>464</sup> National Internal Revenue Code (NIRC)

considered as exportation of goods under a special law such as Executive Order No.226 (Omnibus Investments Code of 1987) and Republic Act No. 7916 (PEZA Law).

### Tax on Corporations in the Philippines

Prior to 1998 an income tax of 35% was imposed on the taxable income of corporations earned during each taxable year<sup>465</sup> both in and outside of the Philippines. Effective January 1, 1998 the rate was reduced to 34%, and effective January 1, 1999 this rate further decreased to 33% with a further decrease of 1% in January 1, 2000.<sup>466</sup> As of January 1, 2000, the President, on the recommendation of the Secretary of Finance, may allow corporations the option to be taxed at a rate of 15% of the Gross National Product.<sup>467</sup> But there are four conditions that need to be met: (1) there should be a tax effort ratio<sup>468</sup> of 20% of the Gross National Product,<sup>469</sup> (2) a ratio of 40% of income tax collection to total tax revenues,<sup>470</sup> (3) a VAT tax effort of 0.4% on Gross National Product and finally,<sup>471</sup> (4) a 0.9% ratio of the Consolidated Public Sector Financial Position (CPSFP) to GNP.<sup>472</sup> Companies whose ratio of cost of sales to gross sales or receipts from all sources should not exceed 55%.<sup>473</sup> This election of the gross income tax option

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<sup>465</sup> S. 22 B of the NIRC. Bureau of Internal Revenue, Republic of the Philippines, [http://www.bir.gov.ph/lumangweb/nirc/nir\\_tl02\\_ch02.html](http://www.bir.gov.ph/lumangweb/nirc/nir_tl02_ch02.html) , (Last visited May 16, 2007)

<sup>466</sup> Bureau of Internal Revenue, Republic of the Philippines, (Last visited May 16, 2007), [http://www.bir.gov.ph/lumangweb/nirc/nir\\_tl02\\_ch02.html](http://www.bir.gov.ph/lumangweb/nirc/nir_tl02_ch02.html)

<sup>467</sup> Id.

<sup>468</sup> “tax effort ratio” is defined as the ratio of a country’s tax revenues to the Gross Domestic Product. This is of interest to Central banks, currency traders, ordinary investors and entrepreneurs because the size of a country’s debt as a percentage of gross domestic product is an indication of the strength or weakness of the economy. Stephen G. Utz, Tax Harmonization and Coordination in Europe and America, 9 Conn. J. Int’L. 767, 769 (1994).

<sup>469</sup> Bureau of Internal Revenue, Republic of the Philippines, [http://www.bir.gov.ph/lumangweb/nirc/nir\\_tl02\\_ch02.html](http://www.bir.gov.ph/lumangweb/nirc/nir_tl02_ch02.html), (Last visited May 16, 2007).

<sup>470</sup> Id.

<sup>471</sup> Id.

<sup>472</sup> Id.

<sup>473</sup> Id.

by a corporation is irrevocable for three consecutive taxable years that the corporation is qualified under the scheme.<sup>474</sup>

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<sup>474</sup> Id.

*Chapter 8: A Look at how Other Countries have Applied Tax by Consumption: Countries with a Comprehensive Consumption Tax*

In order to arrive at a conclusion as to which tax system is better for the U.S., either to tax income or to tax consumption, countries whose tax systems are known to have a comprehensive consumption tax will be analyzed and compared.

The Tax System in the U.K.

The taxes currently imposed on income in the United Kingdom are the income tax and National Insurance contributions.<sup>475</sup> Income tax was first implemented in Britain during the Napoleonic Wars but was not permanently and substantially introduced until 1842.<sup>476</sup> This tax system was imposed at a rate of 7*d.* in the £ (3%).<sup>477</sup> The mechanism of progressivity to the tax system was not introduced until 1909 when Lloyd George's 'people's Budget' came into effect. This people's Budget' brought along with it the proposal for a 'supertax' on income exceeding £ 5000 per annum. This led to an increase in the maximum tax rate from 7*d.* to 1*s.* 8*d.* (8%). With the emergence of the First World War there was an exorbitant increase in the tax to finance the war.<sup>478</sup> There were subsequent reductions in the tax although these amounts in rates and revenues exceeded the pre-war levels. The supertax remained and the only feature to the tax that changed was its name. It is now called the surtax.

Notwithstanding this, tax liability remained reserved for the few affluent minority. Married couples earning below £225 were not taxed until the need for greater revenue

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<sup>475</sup> J. A. Kay & M. A. King, *The British Tax System*, 21 (5<sup>th</sup> ed. 1990)

<sup>476</sup> *Id.* at 21

<sup>477</sup> See Kay et al., *supra*, at 21

<sup>478</sup> This tax was increased to over 50%. See Kay et al., *supra*, at 21

as a result of the Second World War.<sup>479</sup> In 1948 the National Insurance contributions were introduced as a universal tax. This tax is usually described as being a hypothecated tax because it is designed with the objective of financing specific government expenditures. For example, in the U.K. there was the vehicle excise duty tax which was imposed to finance highway construction and maintenance. The television license fee to this day finances the BBC. The Treasury in the U.K. usually opposes hypothecated taxes since they are viewed as “undermining its control of public expenditure.” Despite this stance by the Treasury, the National Insurance contribution today is used to pay a substantial amount of the retirement pensions and unemployment and sickness benefits.

#### Indirect taxes- a look at how the consumption tax (VAT) is applied in the U.K.

An indirect tax, as opposed to a direct tax,<sup>480</sup> is not levied on the person on whom it ultimately falls.<sup>481</sup> According to *Black’s Law Dictionary*,<sup>482</sup> an indirect tax is “a tax on a right or privilege, such an occupation tax or franchise tax. An indirect tax is often presumed to be partly or wholly passed on from the nominal taxpayer to another person.” There is one general sales tax in the U.K. (the VAT) and heavy duties are imposed on three primary commodities; they are tobacco, alcoholic drinks and petrol. There are two types of bases for the VAT tax:<sup>483</sup> an accounts basis<sup>484</sup> and an invoice basis.<sup>485</sup> The U.K. tax system uses an invoice

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<sup>479</sup> See Kay et al., *supra*, at 21-22

<sup>480</sup> *Black’s Law Dictionary*, (8<sup>th</sup> ed. 2004) (defines a direct tax as a tax imposed on property, as distinguished from a tax on a right or privilege. A direct tax is presumed to be borne by the person upon whom it is assessed, and not ‘passed on’ to some other person. Ad valorem and property taxes are direct taxes.”

<sup>481</sup> See Kay et al., *supra*, at 120

<sup>482</sup> *Black’s Law Dictionary*, (8<sup>th</sup> ed. 2004)

<sup>483</sup> See Kay et al., *supra*, at 128

<sup>484</sup> An account based method allows taxpayers to substantiate their input tax credits with their books of account. It relies on an enterprise’s books of account, and is considered to be less burdensome than an invoice-based method which relies on tax invoices. See Barry Freiman, *The Japanese Consumption Tax: Value-Added Model or Administrative Nightmare?* 40 Am. U. L. Rev. 1265, 1285-1304 (1991).



basis. The main advantage of a VAT tax is that it imposes a tax on consumption of all goods at all stages of the manufacturing process. However, where tax is imposed on a good or service for further processing, the manufacturer receives a refund of the tax that has been charged. The final consumers are taxed on the value added to the good or service.

VAT is a self-assessed tax where a form for paying the tax is completed, or in the alternative, a claim to receive a refund is made. One viewpoint taken is that a purchase tax that is used in Canada never achieves the type of yield as the VAT achieves,<sup>486</sup> and today, taxes which resemble the purchase tax are under pressure. There are two rates of tax: zero and 15%. There was also a 25% rate that was introduced in 1975, reduced in 1976 and finally abolished in 1979. A zero rate does not bear the same meaning as an exemption. The difference is that a taxpayer who is exempted does not have to pay taxes on his sales “output”<sup>487</sup> but, the zero rated taxpayer can reclaim the tax paid on his purchases “inputs”<sup>488</sup> as well. Therefore, there is a greater advantage in being a zero rated taxpayer than a taxpayer who is exempted.<sup>489</sup>

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<sup>485</sup> An invoiced based method relies on the taxpayer’s tax invoices as opposed to relying on the taxpayer’s or enterprise’s books. Although this method is considered more burdensome than the account-based method, its advantage is that it creates a trail, hence making tax evasion more difficult. See Barry Freiman, The Japanese Consumption Tax: Value-Added Model or Administrative Nightmare? 40 Am. U. L. Rev. 1265, 1285-1304 (1991).

<sup>486</sup> See Kay et al., supra, at 129

<sup>487</sup> Stacy Snowman, Avoiding the Potential Pitfalls in Licensing, 458 PLI/PAT 355, 391 (1996)

<sup>488</sup> Stacy Snowman, Avoiding the Potential Pitfalls in Licensing, 458 PLI/PAT 355, 391 (1996)

<sup>489</sup> J. A. Kay & M. A. King, The British Tax System, 129 ((5<sup>th</sup> ed. 1990) (author seems to suggest that a taxpayer with a zero rate can get a refund. This practice is not only seen in the U.K. system but also in the Japanese Retail Sales Tax (RST) where an enterprise that is engaged in zero rated activity may credit the VAT paid to its suppliers, which may entitle it to a net RST refund. See Laura Dale, The Economic Impact of Replacing the Federal Income Tax with a Federal Consumption Tax: Leveling the International Playing Field, 9-WTR Currents: Int’l Trade L.J. 47, 49 (2000)

Consumption on food is zero rated and does not rise in proportion to income. ‘The distributional impact of the VAT on food is therefore slightly progressive.’<sup>490</sup> In the U.K. most foods, domestic water supply, fuel for heating, books, newspapers and magazines, exports, public transport and children’s clothing are all zero rated.<sup>491</sup> In contrast, confectionery, industrial water supply, road fuel and most other commodities attract a VAT rate of 15%. Commodities that are exempt from tax are land, rent, insurance, postal services, betting, finance, education, and health and funeral services.

Taxes on alcohol and tobacco are imposed because of the view that taxing these types of consumption arouses ‘feelings of guilt’. Although there is a tendency to discourage smoking because individuals are put at a greater risk of dying prematurely, the reality is that in the U.K. the government cannot afford to discourage smoking because of the revenue obtained from consumption of tobacco.<sup>492</sup> There is much politics and economics in deciding whether the government in the U.K. will discourage smoking. One factor to bear in mind is that not only will the government’s budget be affected but also, there are secondary consequences that need to be taken into consideration. For example, discouraging smoking would mean a reduction in medical costs and in claims for sickness benefits. Because there would be a reduction in the consumption of cigarette, this would increase the life expectancy of individuals. Each increase would be good for income tax collections, but it would also mean that the costs of retirement pensions and medical treatment for individuals would increase. Although these would be offset by a decrease in the widows’ pensions, they might not be significantly offset.

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<sup>490</sup> See Kay et al., *supra*, at 129

<sup>491</sup> See Kay et al., *supra*, at 130 (info extracted from Table 8.2: Rates of VAT)

<sup>492</sup> See Kay et al., *supra*, at 131

In the U.K. it appears that the tax on tobacco is regressive,<sup>493</sup> that is, there is more tax that is imposed on the poorer class of people than from the rich. This is because tobacco consumption is least prevalent among individuals who are affluent. On the other hand when the consumption of alcohol is contrasted, it is found to be more progressive because individuals who are in higher income groups consume a lot more alcohol.<sup>494</sup> There is an incentive for taxing aggressively the petrol that motorists use.<sup>495</sup> The reason behind this is that motorists have the luxury of using road space which is costly to provide but it is also free of charge. One view is that a change from direct tax to indirect tax as a means of raising revenue in the U.K.<sup>496</sup> will not significantly alleviate the weaknesses of the direct tax system that is presently imposed on revenue in the U.K. It is without doubt that critics of this opinion believe that the indirect tax would experience less criticism than the present direct tax system and that the U.K. would actually do better with indirect taxes than with direct taxes. They conclude that it might be better to have two broadly based taxes (that is income and consumption) rather than one high and one low.

#### The Structure of the Tax Base in Jamaica prior to the Tax Reform

Prior to reform of the tax system in Jamaica, the income tax was Jamaica's primary and most productive means of gaining revenue.<sup>497</sup> The structure of the tax system was in dire need of reform because of the structural and administrative defects. The tax therefore did not yield its maximum potential and there was ample evidence of unfairness in the application of the tax system. Jamaica's tax system before reform was 'highly' progressive because of the

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<sup>493</sup> See Kay et al., *supra*, at 132

<sup>494</sup> See Kay et al., *supra*, at 132-33

<sup>495</sup> See Kay et al., *supra*, at 132-33

<sup>496</sup> See Kay et al., *supra*, at 133

<sup>497</sup> Lincoln Inst. of Land Policy, *The Jamaican Tax Reform*, 87 (Roy Bahl ed., 1991)

graduated rate structure and the amount of tax credits that were applied to the taxpayers' income depending on his or her special circumstances. The progressive element of the tax structure was diminished because of the numerous tax avoidance strategies that were employed by mainly middle and upper income residents. There was also the issue of the tax system being too complex. A major weakness of the system was its failure to tax allowances and to include this in the tax base as well as the fact that self-employed individuals were not taxed. Therefore, although the tax system was progressive, the base was narrow.

What aggravated the situation was the means that the government took to compensate for the deficiency in its budget. Instead of attempting to widen the tax base, the government applied pressure on taxpayers by increasing the tax rate. The rate increase fuelled the desire to carry out tax evasion and avoidance to escape the excruciating burden of the tax system. Understandably, even the Jamaican Government was apparently reluctant to impose such unfair measures on taxpayers.<sup>498</sup> The individual's income tax is applied comprehensively 'from any and all sources.'<sup>499</sup> But prior to the 1986 reform the income tax was not applied comprehensively. For example, capital gains were not taxed, the base was not adjusted for changes in the price level, and imputed income was not taxed, and, allowances and certain fringe benefits to employees were not taxed.

Tax evasion was common among individuals who were self employed and this reduced the tax base. There is evidence to suggest that one-third of the national income was included in the base. Because there were sixteen tax credits that were applied to the income of individuals who qualified, this meant that the income tax revenues of

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<sup>498</sup> *Id.* at 88

<sup>499</sup> Lincoln Inst. of Land Policy, *supra*, at 88

individuals were reduced, which impliedly meant that the tax base is reduced thus shifting the burden to a disproportionately smaller group of taxpayers. This was the case since the government would find other means of increasing revenue by imposing tax on some other source.

The statutory tax rates as of 1984 began with marginal tax rates of 30% on the first \$7,000 of statutory income. If the taxpayer earned \$7,001-\$10,000 the taxpayer was taxed at a rate of 40%. Taxpayers earning \$10,001-\$12,000 were taxed at 45%, taxpayers who earned income of \$12,001-\$14,000 were taxed at 50% and those earning \$14,001 and over were taxed at 57.5%. Individuals earning less than J\$5,080 and not having a credit claim or special credit were not taxed. Criticisms of this tax system are that it reached the 57.5% rate at the relatively low income of \$14,000 and it also provides a disincentive to not work for the individual whose pay is affected significantly by the tax. To counter this disincentive to work, the government implemented a maximum tax rate of 30% of overtime pay. The great advantage in implementing a tax system that has such a progressive rate is that the government can redistribute resources to the poor from the rich.

### The General Consumption Tax in Jamaica

Prior to the implementation of the General Consumption Tax in Jamaica, indirect taxes accounted for almost half of total tax revenue, and 12% of gross domestic product. Generally, this is the typical level for countries considered to be at the intermediate stage of development. Indirect taxes include a Caricom<sup>500</sup> Tariff with no duties on the approximately 14% of import value from Caricom territories. This tax initially yielded 21% of total tax revenue in 1976, but by 1984 it yielded 8% because of restrictions on importation of consumption goods.

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<sup>500</sup> Caribbean Community. See Lincoln Inst. of Land Policy, *The Jamaican Tax Reform*, 449 (Roy Bahl ed.,) (1991)

There is a stamp duty that is applied to many imports. Excises<sup>501</sup> in past years was the most lucrative source of obtaining domestic indirect taxes but in 1984 it accounted for only 1.4% of total tax revenues.<sup>502</sup>

With the need for tax reform came the proposal for a ‘manufacturers sales tax and its value-added feature.’<sup>503</sup> The name of the tax it was decided was the ‘general consumption tax.’ During the drafting stages of the tax, there was the need to ensure that the tax was ‘single in nature,’<sup>504</sup> that is, that the consumption tax has one flat rate.

### Reform policy

The United States Agency for International Development (USAID)<sup>505</sup> evaluators concluded that with regards to tax policy the reform project was successful. The tax base was broadened and the system was simplified. Rates were lowered and positive export incentives had been implemented. GDP captured through taxation were not lowered despite the lower tax rates. It was reported that the individual income tax and the system of indirect (excise) taxes were the most successful areas in the reform process. It is noted that according to the Tax Reform Commission<sup>506</sup> the payroll tax system, the company tax and the

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<sup>501</sup> This included five separate taxes (consumption duties, retail sales tax, excise duties, customs duties and stamp duties. These had separate administrations and different bases). See <http://www.fiscalreform.net/usaidtha/pdfs/casestudy--jamaica.pdf>

<sup>502</sup> Lincoln Inst. of Land Policy, *supra*, at 450

<sup>503</sup> Lincoln Inst. of Land Policy, *supra*, at 479

<sup>504</sup> Lincoln Inst. of Land Policy, *supra*, at 479

<sup>505</sup> USAID funded the Jamaican tax reform project which took place over a 4 year period (1983-1987). The project cost \$8 million U.S. The type of assistance that was given was Technical, material, facilities and equipment. Training was given on the job, In-country classroom, External degree, non-degree, In-country and External Special Topic Seminars. Areas of assistance included Tax Policy and Administration, Tax and General Economic Policy Analysis and Forecasting, Tax Information Systems and Institutional Development.

<sup>506</sup> The Tax Reform Commission was made up of highly respected leaders from all the principal, social, political and economic segments of the society.

property taxes were less successful.<sup>507</sup> One recommendation by the Commission was that the personal income tax rate be changed to 35% of taxable income over \$8,480.<sup>508</sup> There was also a proposal to eliminate all tax credits and of untaxed allowances in compensation packages. The Tax Reform Commission recommended that there be a withholding of 35% of interest income earned by depositors.

Legislation was passed in 1986 but the rate that was used for the personal income tax was a percentage point and a half below the recommended rate.<sup>509</sup> It eliminates most tax-free allowances. With respect to company income tax, the Tax Reform Commission recommended that incentives to undertake tax avoidance measures previously used by companies be eliminated. Recommendations included streamlining depreciation rules so that capital goods purchases were to be treated as current-year expenses in the year that they were acquired. A flat rate<sup>510</sup> was adopted for companies and a rate similar to that used for personal income tax. For fear that revenue would fall significantly, many of the recommendations made for companies by the Tax Reform Commission were not adopted.

After the reform, the yield in revenue obtained from personal income tax increased from 23% in 1986 to 30% in 1990. The PAYE (pay as you earn) employees 'component of the personal income tax' decreased because the threshold at which income was

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<sup>507</sup> USAID, USAID Assistance in Fiscal Reform: The Jamaica Tax Structure Examination Project, [http://www.fiscalreform.net/pdfs/jamaica\\_comprehensive\\_tax\\_reform.pdf](http://www.fiscalreform.net/pdfs/jamaica_comprehensive_tax_reform.pdf)

<sup>508</sup> The previous amount of income exempted from the income tax was \$7, 500. See USAID Assistance in Fiscal Reform: The Jamaica Tax Structure Examination Project, [http://www.fiscalreform.net/pdfs/jamaica\\_comprehensive\\_tax\\_reform.pdf](http://www.fiscalreform.net/pdfs/jamaica_comprehensive_tax_reform.pdf)

<sup>509</sup> The Income Tax Act of 1986 replaced the prior graduated rate structure. The Challenges of Tax Reform in a Global Economy, James Alm et al., Can Developing Countries Impose an Individual Income Tax? (2004), <http://isp-aysps.gsu.edu/academics/conferences/conf2004/Almwallace.pdf>. To view the present Income Tax Act of Jamaica see <http://www.moj.gov.jm/laws/statutes/The%20Income%20Tax%20Act.pdf>

<sup>510</sup> A flat rate was recommended in order to detect tax evasions more easily that were aimed at bracket shifting. See Fiscal Reform in Support of Trade Liberalization by USAID Contract No. PCE-I-03-00-00015-00 at [http://www.fiscalreform.net/pdfs/jamaica\\_comprehensive\\_tax\\_reform.pdf](http://www.fiscalreform.net/pdfs/jamaica_comprehensive_tax_reform.pdf)

initially taxed was increased. Thus, there were many employees who were exempted from paying tax. The General Consumption tax was made up of several taxes that taxed several goods. It applied different rates against varying quantities and *ad valorem*<sup>511</sup> bases. Taxes included in the GCT are excise duties, retail sales tax, consumption duties and additional stamp duties on some imports. Legislation adopting the GCT was formulated in 1991.<sup>512</sup> The recommendations made by the Commission were not complied with in their entirety. For example, there were a lot more items that were exempted from the tax and the number of zero rated items was extensive.<sup>513</sup> Despite the government's departure from what was viewed as the 'ideal GCT,' the tax was successful. Three months after the tax was implemented there was a 10% yield above the expected projections despite the fact that the government set that rate at 10% instead of the recommended 15%.

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<sup>511</sup> Black's Law Dictionary, 8<sup>th</sup> ed. (2004) (defines an ad valorem tax is a tax of a fixed proportion of the value of the property with respect to which the tax is assessed, and requires the intervention of assessors or appraisers to estimate the value of such property before the amount due from each taxpayer can be determined.)

<sup>512</sup> The General Consumption Tax Part II (3) (1) (a). The GCT was imposed after October 22, 1991 on goods and services by a registered taxpayer in the course or furtherance of a taxable activity carried on by the taxpayer.

<sup>513</sup> USAID, *Fiscal Reform in Support of Trade Liberalization by USAID Contract No. PCE-I-03-00*, [http://www.fiscalreform.net/pdfs/jamaica\\_comprehensive\\_tax\\_reform.pdf](http://www.fiscalreform.net/pdfs/jamaica_comprehensive_tax_reform.pdf)



The Tax System in the Bahamas

The Bahamas and Bermuda are two countries in the world that do not impose a tax on income<sup>514</sup>. Instead, the Bahamas is a country that is almost entirely dependent on tourism and its offshore banking sector.<sup>515</sup> The Bahamas is a stable<sup>516</sup> developing nation that has recently experienced a growth in GDP but has experienced a slowdown in growth due to the sluggish growth in the U.S economy.<sup>517</sup> Financial services is considered the second most important sector of the Bahamian economy.<sup>518</sup> Approximately 80% of the tourists who visit the Bahamas are from the United States. The Bahamas has indirect taxes such as motor vehicle taxes, import taxes, stamp, export and departure taxes to name a few.<sup>519</sup> The import tax generates 63% of tax revenue and 57% of combined tax and non-tax revenue.<sup>520</sup> Despite the argument that there is heavy taxation in the Bahamas, by world standards it is considered to be a ‘low tax’ jurisdiction.<sup>521</sup> Presently Bahamas is listed by the OECD member states as a country blacklisted as a tax shelter.<sup>522</sup> Bahamians pay approximately 20% of their income to the government by

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<sup>514</sup> Alvin Rabushka, Speech delivered to City Rotary Club, Nassau, Bahamas New Directions in the Bahamian Economic Policy: Some thoughts about taxation (May 13, 1997).

<http://www.stanford.edu/~rabushka/Tax%20Policy%20in%20The%20Bahamas%20Speech.pdf>

<sup>515</sup> Id.

<sup>516</sup> Public Information Notice (PIN) No. 03/87, July 23, 2003. *IMF Concludes 2003 Article IV Consultation with The Bahamas*, <http://www.imf.org/external/np/sec/pn/2003/pn0387.htm>

<sup>517</sup> Public Information Notice (PIN) No. 03/87, July 23, 2003. *IMF Concludes 2003 Article IV Consultation with The Bahamas*, <http://www.imf.org/external/np/sec/pn/2003/pn0387.htm>

<sup>518</sup> Alvin Rabushka, Speech delivered to City Rotary Club, Nassau, Bahamas New Directions in the Bahamian Economic Policy: Some thoughts about taxation (May 13, 1997).

<http://www.stanford.edu/~rabushka/Tax%20Policy%20in%20The%20Bahamas%20Speech.pdf>

<sup>519</sup> Alvin Rabushka, Speech delivered to City Rotary Club, Nassau, Bahamas New Directions in the Bahamian Economic Policy: Some thoughts about taxation (May 13, 1997).

<http://www.stanford.edu/~rabushka/Tax%20Policy%20in%20The%20Bahamas%20Speech.pdf>

<sup>520</sup> Id.

<sup>521</sup> Id.

<sup>522</sup> Tax Analysts, Tax Notes Today, OECD Releases Tax Haven Blacklist, Available at Lexis 2000 TNT 124-3 (2000)

some means or other, as compared to individuals in the United States and Western Europe who pay approximately 35%-60% of their incomes to their respective governments.<sup>523</sup>

The Bahamas is considered to be a tax haven because its tax system does not impose a direct tax.<sup>524</sup> There is not an income tax, capital gains tax, gift tax, wealth or estate tax.<sup>525</sup> There is a consumption tax. Consumption is the tax base in that island but the tax system is not void of its problems.<sup>526</sup> For example, the import duty in the Bahamas is so high that it is widely evaded.<sup>527</sup> As a result of such a high tax the cost of living in the Bahamas is very high and Bahamians travel with much regularity to Miami to purchase and stock up on basic commodities.<sup>528</sup> As a result of increasing pressure from the populous the government lowered tariffs.<sup>529</sup> The payroll tax, it has been argued, has led to a buildup in public debt that the government consumes.<sup>530</sup> Furthermore, where the National Insurance Board promises to pay pensions in the future, this promise will only be fulfilled on earnings that it obtains from the portfolio of government debt<sup>531</sup>. One point of view is that when the Bahamian economy becomes unable to afford paying this unduly burdensome tax the value of the pension benefit will decrease until it finally becomes bankrupt.

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<sup>523</sup> Alvin Rabushka, Speech delivered to City Rotary Club, Nassau, Bahamas New Directions in the Bahamian Economic Policy: Some thoughts about taxation (May 13, 1997).

<http://www.stanford.edu/~rabushka/Tax%20Policy%20in%20The%20Bahamas%20Speech.pdf>

<sup>524</sup> Id.

<sup>525</sup> Id.

<sup>526</sup> Id.

<sup>527</sup> Id.

<sup>528</sup> Id.

<sup>529</sup> Id.

<sup>530</sup> Id.

<sup>531</sup> Id.

In 1991 the Council of Economic Advisers to the Bahamas sought means to better the tax system in the Bahamas.<sup>532</sup> This Council of Advisers rejected the idea of a tax reform that imposed an income and a sales tax. Instead, it recommended a ‘recurrent’ revenue and expenditure. One tax critic is of the view that the Bahamian tax system would be vastly improved if capital expenditure were taken into consideration.<sup>533</sup> Also, although the tax burden is important to establishing good economic stability in a country, of great importance also is the rate that is applied to the taxes. The criticism is put forward that the Bahamas relies too heavily on one source; its import duty.<sup>534</sup> Import and stamp duties alone contribute to almost three quarters of the country’s tax revenue. The International Monetary Fund assisted the government of the Bahamas in revising its tariff schedule and an improved customs tax was introduced in 1996. Departure, property, motor vehicle and selective services account for the remaining source of income. Non-tax revenue includes fines, forfeits, and administrative fees. Income from public corporations that is paid into the central treasury is negligible, and this suggests that public enterprises are not being run on a commercial basis. That is, public corporations do not yield a ‘real market rate of return.’<sup>535</sup>

There are reasons why the Bahamas, should not rely too heavily on import duties. When there are not sufficient revenues raised from this source, it puts a drain on the public finances. Also, the country’s revenue system conflicts with its system of exchange control. The Central Bank sees the necessity for a minimum level of foreign reserves to maintain the exchange rate of US\$1=B\$1. Higher revenues from import duties mean that there is

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<sup>532</sup> Id.

<sup>533</sup> Id.

<sup>534</sup> Id.

<sup>535</sup> Id.

a conflict with the Central Bank's rate of exchange. If the country's resources decline, action has to be taken to decrease slow imports, which in turn will raise domestic interest rates. When this happens, the country's main source of income is decreased. In autumn of 1995 when foreign resources reduced to such an extent it would take a negative toll on the country's foreign reserves, the Central Bank issued a warning. As a result, there is now a suggestion that the Bahamian Government rely more heavily on payroll taxes. Any revenues obtained from this tax should take the form of general revenue and not as a means to buy more government debt. There is the suggestion that a VAT be applied as a substitute for the import tax duty. However, this remains a controversial viewpoint because there is the argument that a Value-Added Tax would increase the tax burdens on all Bahamians.<sup>536</sup>

### The Tax system in Bermuda

Bermuda, like the Bahamas thrives economically from tourism. Unlike the Bahamas, Bermuda does not have a large public debt because there is legislation enacted to ensure that the debt does not exceed 10% of the revenue.<sup>537</sup> Bermuda is considered to be a tax haven since it does not impose a tax on income, capital gains, wealth, gift or inheritance taxes. Transfer taxes are not imposed on non-resident entities. The primary source of revenue for Bermuda is Customs and then payroll taxes. The rates of customs duty are 0%, 8.5%, 10%, 15%, 22.5% and 33%.<sup>538</sup> The rate to be imposed depends on the specific good. The customs duty does not include insurance and freight but is imposed on cost plus packaging. Like the Bahamas, there

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<sup>536</sup> Nassau Institute, Value Added Tax versus Import Duty, (2004), <http://www.nassauinstitute.org/wmview.php?ArtID=403>

<sup>537</sup> The Government Loans Act of Bermuda (1978)

<sup>538</sup> Alvin Rabushka, New Directions in the Bahamian Economic Policy: Some thoughts about Taxation. (2001), <http://www.nassauinstitute.org/wmview.php?ArtID=227>

is a growing trend for the residents to do their shopping in Miami because of the rising burden of the import tax.

Bermuda implemented a payroll tax on April 1, 1995. The payroll tax was derived from a combination of the hospital levy and the employment tax. It is imposed at a rate of 11.5% on cash and benefits paid to employees and collected on a quarterly basis. Employers have the option of collecting up to 4% from employee's pay. Self-employed persons should self-assess their tax liabilities with respect to the payroll tax. It is estimated that the payroll tax will soon become the primary source of revenue in Bermuda. Bermuda implements a strategy to directly tax specific services in order to collect revenues. For example, a 4% gross fee is imposed on the income of individuals who provide corporate services to corporations that are exempted and do not have a physical presence in Bermuda. This gross fee is also imposed on banking license fees, professional licenses, land taxes that collect a portion of the capital gains on re-sales by non-citizens of Bermuda to other non-citizens of Bermuda. Because of the geographical composition of Bermuda and the relative simplicity of the tariff code, enforcement of the tariff code is relatively easy.

*Chapter 10: The Tax system in the Channel Islands*

A set of islands that impose an income tax and no consumption tax but do very well economically are the Channel Islands. The Channel Islands of Jersey and Guernsey obtain half their income from offshore financial services and the other half mainly from tourism. There is a flat tax<sup>539</sup> on income of 20% and this includes a substantial personal allowance to exempt low-income households from the tax instead of customs duties. This flat rate has been in place for the past fifty years. Compliance with the Islands' income tax is near universal and it is cheap to collect. The system is considered to be mildly progressive because of the substantial personal allowances. Neither of the islands imposes a sales tax, VAT, an estate, wealth, or capital gains tax. This evaluation merely highlights the point that a low tax regime may successfully apply an income tax regime, and that all tax systems should be customized to adequately and efficiently work within the society that it is implemented. Despite the 'one size fit all' notion that a model tax system may erroneously suggest, experience has suggested otherwise.

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<sup>539</sup> Alvin Rabushka is of the view that a flat tax would be ideal for the United States. See also Jeffrey Taylor et al, Tax Reform Tourguide, [http://www.taemag.com/issues/articleID.16499/article\\_detail.asp](http://www.taemag.com/issues/articleID.16499/article_detail.asp) (proponents for a flat tax for America)

*Chapter 11: Applying the facts to the American situation; would a Fair Tax Act be advantageous to the American society?*

As seen above, selecting the ideal tax system is a complicated process, and, even in societies where the economy is good, there problems always arise.<sup>540</sup> There is no certainty that the most logical and appealing tax method that is devised will achieve the desired result. However, that does not provide an incentive to not attempt to change a system that is regressive in nature. The question therefore is whether the Fair Tax Act if implemented would be ideal for the American society must be approached with the utmost care and analysis.

As already mentioned the ideal tax system contains certain components and they are: (1) simplicity, (2) fair/equity (3) neutrality (4) visibility (5) stability (6) efficiency and (7) it should foster economic growth. The immediate question therefore is does the Fair Tax Act contain all of these features? The Fair Tax Act is simple since it is calculated by applying a tax of 23% of all that is consumed.<sup>541</sup> It is fair because the principle of horizontal equity is not violated. Taxpayers paying a flat rate of 23% with an effective tax rate of 30% may not appear to be fair but considering a rebate that individuals receive it does make the tax progressive. But even if the argument that the Fair Tax Act is not progressive enough were to prevail, the point must be made that there is no tax system that does not have its problems. But where a tax system has so many problems that it is burdensome to society at large, and, where most of the components that make up an ideal tax system are missing, then, it is at that point that considerations have to be made in favor of revising or completely changing the tax system.

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<sup>540</sup> Am. Enter. Inst. for Pub. Policy Research, *Reforming the Income Tax System*, 40 (1981)

<sup>541</sup> There are exceptions to this since expenses for business-to-business purchases for the production of goods is not taxed.

The tax system is neutral because the revenue needed to support the government will not interfere with the economic choices of individuals, corporations or businesses. This is because the tax will be low so that taxpayers will more than likely comply and not try to flout the law. There is an argument that when the tax is low taxpayers who usually evade or avoid the tax no longer take part in such activities. For example, in March 1964 when President John F. Kennedy implemented a tax cut which reduced all brackets originally ranging from 20% to 91% to a range of 14% to 70%. In 1965 when an evaluation was done it was found that high income tax payers declared more taxable income and paid more in taxes than they would have paid under the old tax regime.

The Fair Tax Act is visible since an honest accounting of the government's cost will be readily available. This speaks to the issue of transparency, and the Fair Tax Act is transparent since there are no loopholes that can be created by lobbyists pursuing their own self-interests. The proposed tax will be stable and certain because it is so simple and easy to apply that it is unlikely that there will be provisions that will be in constant need of change or, that there will be lobbyists who can convince Congress to make exceptions to favor them. Furthermore, the Sixteenth Amendment will be repealed and Congress will be absolved from its duty to apply taxes by "whatever means necessary."<sup>542</sup> The Sixteenth Amendment states that "Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."<sup>543</sup> Changing the present federal income tax to a consumption tax means that

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<sup>542</sup> U.S. Const. amend. XVI

<sup>543</sup> Id.



Congress will no longer have the power to “lay and collect taxes as it sees fit,”<sup>544</sup> but instead, the new Fair Tax Act will control.

In reality the Fair Tax Act could be implemented without repealing the Sixteenth Amendment, but this would not be the case because the Sixteenth Amendment is the only true protection against Congress increasing tax rates by a simple 2/3 majority vote.<sup>545</sup> The system will be fiscally efficient because the cost of collecting revenue will be relatively low for the government.

As noted before, the Beacon Hill Institute estimated the rebate to amount to \$489 billion dollars and this figure is relatively low when compared to the amount paid out by the IRS in refund checks for 2005. In 2005 the IRS paid out \$270 million dollars in refund checks and another \$945 billion for income tax deductions, tax preferences, loopholes, and credits as estimated by the Joint Committee and taxation.<sup>546</sup> The Fair Tax Act will be economically efficient because it will not ‘distort the taxpayer’s choice between leisure and work, consuming and saving, buying different forms of consumer goods or investing in different kinds of property.’ Usually high marginal rates or the tax applied to ‘the last dollar’ is what provides an incentive for taxpayers to either stay home or work. Marginal rates will not be high and therefore the compliance rate will increase as studies have shown.<sup>547</sup> In addition to this, as a result of the marginal rate being low, tax evasion and avoidance rates will be low.

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<sup>544</sup> U.S. Const. amend. XVI

<sup>545</sup> Fair Tax, *A Fair Tax Rebuttal of Steve Forbe’s book entitled Flat Tax Revolution*, [http://www.fairtax.org/PDF/Forbes-Rebuttal\\_of\\_Flat\\_Tax\\_Revolution\\_2-9-06.pdf](http://www.fairtax.org/PDF/Forbes-Rebuttal_of_Flat_Tax_Revolution_2-9-06.pdf)

<sup>546</sup> Fair Tax Act, *Excerpts from the Fair Tax response to the Mack/Breaux tax Panel report and recommendations*, [http://www.fairtax.org/PDF/Excerpts\\_from\\_response\\_to\\_tax\\_panel-103006.pdf](http://www.fairtax.org/PDF/Excerpts_from_response_to_tax_panel-103006.pdf) (last visited May 16, 2007)

<sup>547</sup> Robert E. Hall et al., *The Flat Tax*, 43 (Hoover Institution Press 2<sup>nd</sup> ed) (1995) (1985).

All such changes will foster economic growth so that taxpayers will be encouraged to work and save. A consumption tax will foster economic growth because the tax base will be widened. This tax base will include individuals who usually evade or attempt to defeat the tax laws<sup>548</sup> such as gamblers who do not disclose income earned as a result of such activities or drug dealers who in order to cover up their illegal activities usually do not file a tax return. But these individuals must eat, purchase clothing and buy the basic necessities of life. Therefore, because a comprehensive consumption tax forces these individuals who usually flout the law to pay taxes on what they purchase; it is less likely that these individuals will be able to evade the tax laws. They must spend and purchase at the very least the basic necessities of life, and in doing this they pay a consumption tax. This also means more revenue for the government.

The question of fairness should be addressed because if a tax is fair then there is the likelihood that individuals will comply. What constitutes a fair tax is highly opinionated but there are some general views that should be examined. The question of who should bear the tax burden and whether it is too high or too low is a political issue.<sup>549</sup> Some questions relating to the tax policy are “How will the choice of items or activities to be taxed affect economic activity?” and “How will arguments of fairness affect these choices?” Fairness norms address questions such as “Who will actually bear the burden of the tax in question?”<sup>550</sup>

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<sup>548</sup> Under §7201 of the Internal Revenue Code (IRC), individuals who willfully evade or attempt to defeat the tax laws are guilty of tax evasion.

<sup>549</sup> Joseph M. Dodge et. al., *Federal Income Tax: Doctrine, Structure, and Policy*, 19 (2<sup>nd</sup> ed. 1999).

<sup>550</sup> See id. at 21

One point to bear in mind is that taxes are not always “borne”<sup>551</sup> by the persons that they were intended to be borne by.<sup>552</sup>

There are four norms of tax justice and each holds differing views with respect to the relationship of government and to citizens.<sup>553</sup> They are (1) the equal-sacrifice principle which would tax people in equal amounts and is based on the principle that since individuals benefit equally from the government they should be taxed equally.<sup>554</sup> Then there is the (2) the benefit principle which states that individuals should pay tax in proportion to the varying benefits that they receive from the government.<sup>555</sup> It is a *quid pro quo* relationship, and, the tax payment that an individual makes is the *quid pro quo* for the government services the individual receives. The (3) standard of living principle taxes people according to their standard of living which is evidenced by their level of consumption.<sup>556</sup> The largest consumers would pay the greatest amount of taxes. They would not be taxed on what they save. This seems to be very appealing to many individuals. Individuals may prefer this system because of ‘pure envy’. That is, individuals who live the best are seen by others as ‘tempting targets for leveling.’<sup>557</sup>

Another reason why this principle is viewed as appealing is that individuals may have a ‘Victorian public morality’<sup>558</sup> where savings and investment are

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<sup>551</sup> See Dodge et al., *supra*, at 21

<sup>552</sup> An example of this is where the Alternative Minimum Tax was intended to not allow very rich taxpayers who would usually avoid paying any taxes at all or substantially low amounts and yet there is the problem that it is middle class individuals who bear this burden. See *Klaassen v. Commissioner*, 182 F. 3d 932.

<sup>553</sup> See Dodge et al., *supra*, at 23

<sup>554</sup> See Dodge et al., *supra*, at 23

<sup>555</sup> See Dodge et al., *supra*, at 23

<sup>556</sup> See Dodge et al., *supra*, at 24

<sup>557</sup> See Dodge et al., *supra*, at 24

<sup>558</sup> See Dodge et al., *supra*, at 24

‘sacrosanct’ but not income which is available for pleasure and consumption.<sup>559</sup> Thirdly, its appeal is seen by the fact that an individual’s standard of living may be determined by examining their standard of living. And fourthly, the simple notion that government action should best be directed at the individual’s well being. That is, it is a “utilitarian”<sup>560</sup> approach.

Finally, there is the ability to pay principle, which is closely related to the standard of living principle. According to this principle, individuals should ‘sacrifice’<sup>561</sup> income they have currently acquired as well as what they have accumulated (wealth), in order to provide funds for government operation. One view is that the tax base<sup>562</sup> under the ‘ability to pay’ principle is broader because individuals are not only taxed on what they spend,<sup>563</sup> but, they are also taxed on what they save and earn.<sup>564</sup> However, the present Federal Income Tax does not have as wide a tax base as it could potentially have because of various factors. Such factors are exemptions,<sup>565</sup> deductions,<sup>566</sup> exclusions,<sup>567</sup> credits,<sup>568</sup> and loopholes.<sup>569</sup> Arguably therefore, a consumption tax could yield as much revenue as an income tax that has a narrow base would, since a consumption tax would include in its tax base income from individuals who would normally flout the law.

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<sup>559</sup> See Dodge et al., supra , at 24

<sup>560</sup> See Dodge et al., supra , at 24

<sup>561</sup> See Dodge et al., supra , at 24

<sup>562</sup> Black’s Law Dictionary, (8<sup>th</sup> ed. 2004) “The total property, income, or wealth subject to taxation in a given jurisdiction; the aggregate value of the property being taxed by a particular tax.”

<sup>563</sup> This refers to the standard of living principle referred to above.

<sup>564</sup> See Dodge et al., supra , at 24

<sup>565</sup> This is defined as an allowance for each member of a taxpaying household. See Robert E. Hall et al, The Flat Tax, 32 (Hoover Institution Press 2<sup>nd</sup> ed) (1995) (1985).

<sup>566</sup> Id. at 32. (This is defined as special provisions in the law for mortgage interest, charitable contributions, the standard deduction for those with few itemized deductions.)

<sup>567</sup> Examples of these are moving expenses and retirement contributions. See Hall et al, supra , at 32

<sup>568</sup> Amounts that can be credited toward against tax liabilities. See Hall et al, supra , at 32

<sup>569</sup> These are devices that allow taxpayers to reduce their taxes. See Hall et al, supra , at 32. Loopholes are also referred to as tax preference items or tax expenditures and these are taxes that the government does not collect perhaps as a response to pressure from interest groups or, as a way of attempting to influence certain behavior.

But there are reservations that individuals have with the Fair Tax Act that should be discussed so as not to give a distortion of the truth. Some reservations are that there is no certainty as to how the residents and citizens of the United States will react to a pure consumption tax system. There is the question as to whether or not a 23% rate can yield enough revenue for the fiscal budget. Will individuals stop buying goods and stop performing services in the United States in order to save money? For example, would a citizen go to another country (for example Mexico) in order to purchase goods that are cheaper, or, what if people were to decide that they would stop spending their money, would there still be a strong economy in the United States?

Proponents of the Fair Tax claim that the tax base is sufficiently adequate to provide for the fiscal budget. The base will include personal consumption expenditure and government consumption expenditure.<sup>570</sup> The Fair Tax has special provisions to tax housing, education, financial intermediation services and travel. With respect to housing, ‘explicit’ rental agreements are subject to taxation under the Fair Tax. Imputed rent on new homes will also be taxed when the home is finally sold.<sup>571</sup> Where a home is bought for investment purpose however, the Fair Tax will not be applied, but, it will apply when the occupants pay rent. With regards to education, tuition and job training expenditures are treated as an investment in human capital and do not make up a part of the tax base.

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<sup>570</sup> See Paul Bachman et. al., *Taxing Sales Under the Fair Tax, What Rate Works*, Lexis 2006 TNT 219-51\* 2-3 (2006), available at <http://www.fairtax.org/PDF/Tax%20Notes%20article%20on%20FT%20rate.pdf>

<sup>571</sup> *Id.* at \* 3-4

With regards to financial intermediation, the Fair Tax will apply a tax on both explicit and implicit financial intermediation services such as brokerage fees, banking, loan origination, mutual fund management and all other financial services. With regards to travel, the Fair Tax will apply to all retail purchases irrespective of the purchaser's nationality. Nonprofit institutions are treated as persons and so their consumption expenditures are included in the tax base.<sup>572</sup> The consumption expenditures of nonprofit institutions include their operating expenditures, and, this also includes the wages and salaries of the nonprofit workers, but, it does not include their sale of goods and services to others.

The Congressional Budget Office (CBO) gives estimates of some important economic statistics and tax revenues for the major federal taxes. In 2007 the estimated Fair Tax base would be \$11.244 trillion.<sup>573</sup> Personal consumption expenditure would be expected to be \$9.772 trillion and adjustments are made for housing by adding the purchase of new homes and the improvement of existing homes. The imputed rent for owner-occupied housing and farm dwellings would be removed because the tax due on the imputed rent will become "prepaid" when the dwelling is sold as a new home. An adjustment is made for education tuition,<sup>574</sup> financial intermediation, foreign travel, and other expenditures. The net effect of all such adjustments is estimated to reduce the private consumption base to \$9.235 trillion.<sup>575</sup> Government consumption is added at the state, local and federal levels to the base. As stated above, wages paid to government employees who provide education and training are subtracted. Capital allowance consumption is also subtracted. Spending for new buildings and equipment is added to the base. The adjusted state and local government consumption would

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<sup>572</sup> See Bachman et al., *supra*, at\* 7-8

<sup>573</sup> See Bachman et al., *supra*, at\* 13-14

<sup>574</sup> This is not taxed under the Fair Tax

<sup>575</sup> See Bachman et al., *supra*, at\* 12

amount to \$1.093 trillion. Federal government consumption would amount to \$916 billion. In total, this would amount to \$11.244 trillion dollars. This represents 81% of the 2007 gross domestic product as estimated by the CBO.<sup>576</sup>

These calculations do not account for an adjustment for the amount of revenue the federal government would save as a result of eliminating certain expenditures usually incurred by the administration and enforcement duties carried out by the IRS. Impliedly, this reduced spending would mean a lower tax burden on the private sector and also at the state and local government. This would increase their consumption levels, hence leaving the Fair Tax base unchanged. There is therefore some reason to believe that a rate of 23% would work if the Fair Tax were to be implemented in the United States. But there are no guarantees as to how the society will accept a tax system in the United States and taking into consideration that the United States would be the first industrialized nation in the 21<sup>st</sup> Century to implement a consumption tax only. The Bahamas and Bermuda are two countries mentioned above that have tax systems that rely on a consumption based tax system. But the United States is by far different from those countries since it does not heavily rely on tourism as those countries do. Some individuals have suggested that two major taxes should be implemented in a society.<sup>577</sup> But as Thomas Hobbes in 1651 suggested, a consumption tax is to be favored more than a tax on wages. As the philosopher Thomas Hobbes put it:

“Which considered, the equality of imposition consisteth rather in the equality of that which is consumed, than of the riches of the persons that consume the same. For what reason is there that he which laboureth much and, sparing the fruits of his labour, consumeth little should be more charged than he that, living idly, getteth little and spendeth all he gets;

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<sup>576</sup> See Bachman et al., *supra*, at\* 13-14

<sup>577</sup> J. A. Kay & M. A. King, *The British Tax System*, 133 (5<sup>th</sup> ed. 1990). (J. A. Kay et al suggest that there be two broadly based taxes instead of two medium taxes or even one high and one low tax.)

seeing the one hath no more protection from the Commonwealth than the other? But when the impositions are laid upon those things which men consume, every man payeth equally for what he useth; nor is the Commonwealth defrauded by the luxurious waste of private men.”<sup>578</sup>

As more and more countries apply a comprehensive consumption tax, it is only advisable that the United States also implement a consumption tax. As seen above, Liberia and the Philippines, who have tax system similar to the United States, have implemented a consumption tax. The IMF<sup>579</sup> has commended the Philippines for its VAT reform which has contributed to its economic improvement. Jamaica is another example of a country that required major tax reform in 1986, and, had it not been for the successful implementation of the General Consumption tax, the country would more than likely be in a more disastrous state. As noted above also, the United States is the only OECD<sup>580</sup> country that has not implemented a consumption tax.<sup>581</sup>

The Fair Tax Act is by far the fairest, most efficient and progressive and neutral tax system that has been proposed, and for the reasons discussed above, it is believed that the Fair Tax Act is better for the United States of America.

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<sup>578</sup> Thomas Hobbes, 1651. *Leviathan*, chapter 30,

<http://etext.library.adelaide.edu.au/h/hobbes/thomas/h681/chapter30.html>

<sup>579</sup> International Monetary Fund, commends Liberia for its implementation of a consumption tax that has boosted its economy, <http://www.imf.org/external/np/sec/pn/2007/pn0714.htm>, (Last retrieved February 10, 2007), (national government deficit was achieved in 2004 and 2005 by expenditure compression. The IMF gives credit to the new VAT reform that was recently implemented. There was full implementation of the VAT reform in 2006).

<sup>580</sup> Organization for Economic Cooperation and Development.

<sup>581</sup> Victor Thuronyi, *Comparative Tax Law*, 305 (2003)



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