Memorandum

September 26, 2003

TO: Honorable Chaka Fattah
Attention: William T. Miles

FROM: Erika Lunder
Legislative Attorney
American Law Division

SUBJECT: Legal Analysis of the Transactions Fee Proposal

This memorandum is in response to your inquiry regarding the legal issues surrounding the implementation of a system that collects fees on financial transactions. It accompanies a memorandum written by Maxim Shvedov, an analyst in the Government and Finance Division, that analyzes the proposal's economic issues. As understood from Mr. Shvedov's memorandum, the proposal would replace the existing federal taxes with a system that imposes a fee on all transactions that involve a payment instrument, with an exception for the receipt of wages. The fee would be a percentage of each transaction's value. The constitutionality of this proposal depends on whether the transactions fee is characterized as a direct or indirect tax.[1] As explained below, it seems likely that the proposal would be a constitutionally-permissible indirect tax. This memorandum also includes a list of issues that could arise because of the way the proposal would differ from current tax law. The memorandum does not take a position on whether the listed issues should be addressed in the proposal.

Constitutional Issues

Congress could implement the proposed transactions fee under its taxing powers.[2] While these powers are broad, they are subject to several restrictions. The two limitations that are relevant for this memorandum are the uniformity and apportionment requirements.[3]

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[1] While the proposal refers to a transactions fee, the distinction between a tax and a fee would not be relevant for this legal analysis. The distinction between a tax and a fee could be important for determining whether an enacting bill is required to originate in the House of Representatives. All tax bills must originate in the House. U.S. Const. Art. 1, § 7, cl. 1.

[2] U.S. Const. Art. I, § 8, cl.1.

[3] The uniformity clause reads, in part, "all Duties, Imposts and Excises shall be uniform throughout the United States." U.S. Const. Art. I, § 8, cl. 1. The apportionment clause reads, "No Capitation, (continued...)

A tax is subject to only one of the two requirements: the uniformity requirement applies to indirect taxes and the apportionment requirement applies to direct taxes. All taxes are characterized as indirect or direct and a tax must be subject to one of the rules.

Thus, the first step in analyzing the constitutional implications of the proposal is to determine whether the transactions fee is an indirect or direct tax. The precise definitions of these terms are unclear. The term "direct" is used in the apportionment clause but is not defined beyond including a capitation (per-person) tax. The uniformity clause does not contain the term "indirect," but the clause explicitly references duties, imposts, and excises, which distinguishes these taxes from direct ones. Since duties and imposts are generally recognizable as such, determining the proper treatment of a tax usually means characterizing it as an excise or as a direct tax. While judicial interpretation is sparse, the Supreme Court has generally found that federal taxes are indirect excises, with the exception of property taxes (including a tax on the income from property).[4] The Court generally reasons that a direct tax is on the property itself and an indirect tax is on the privilege to use or transfer the property.[5]

The transactions fee proposal should be characterized as an excise tax (i.e., a tax on the use or transfer of property). It is not a tax on property and merely owning property would not give rise to the fee. It is also not a tax on income. Thus, it appears to be an indirect tax and subject to the uniformity clause. This clause has consistently been interpreted to mean that taxes may not be imposed in a way that discriminates between taxpayers based on their geographical location.[6] Uniformity does not mean that taxpayers may not be treated differently on the basis of non-geographical characteristics. For example, under the estate tax, taxpayers could not be taxed at different rates according to the location of an estate, but could be taxed at different rates depending on the amount of the transferred estate (i.e., a progressive rate structure). Here, the rate of the proposed fee, according to Mr. Shvedov's

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[3] (...continued)
or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." U.S. Const. Art. I, § 9, cl. 4. These requirements will be further explained.

[4] Examples include *New York Trust Co. v. Eisner*, 256 U.S. 345 (1921), holding that the federal estate tax is an excise tax, and *Billings v. United States*, 232 U.S. 261 (1914), holding that an annual tax assessed on foreign built yachts was an excise tax on the use of the yachts. In *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), the Court struck down the income tax after finding that a tax on income from property was an unapportioned direct tax. This case was the impetus for the adoption of the Sixteenth Amendment, which allows Congress to impose an income tax without apportionment.

[5] For example, in *Fernandez v. Wiener*, 326 U.S. 340, 352 (1945), the Court wrote, "Congress may tax real estate or chattels if the tax is apportioned, and without apportionment it may lay an excise upon a particular use or enjoyment of property or the shifting from one to another of any power or privilege incidental to the ownership or enjoyment of property. [citations omitted]"

Another distinction between direct and indirect taxes is that a direct tax is paid by the person upon whom it is levied while the burden of an indirect tax can be shifted to another person. The Court, however, has been reluctant to adopt this formal distinction. Pollock, 157 U.S. at 558; Eisner, 256 U.S. at 349.

[6] For example, in *United States v. Ptasynski*, 462 U.S. 74 (1983), the Court held that a tax that applied differently to oil from Alaska than to oil from other states did not violate the uniformity clause. The Court found that there was no discrimination since Congress was responding to weather conditions that made it more difficult to extract oil from Alaska.

memorandum, could possibly differ according to the transaction's value. However, there is no reference to discriminatory treatment based on the taxpayer's location or where the transaction occurs. Thus, the proposal would appear to meet the requirement of uniformity.

If the transactions fee was a direct tax and subject to the apportionment requirement, a serious constitutional issue would arise. The apportionment clause requires that a tax be imposed so that each state's tax burden is proportional to its share of the national population (e.g., a state with 10% of the national population must bear 10% of the tax burden). It appears highly unlikely that the transaction fee proposal would meet this requirement because the price of goods and services subject to the fee and the percentage of the population that participates in taxable transactions will differ for each state. It seems improbable that, with all of these differences, each state would collect a proportion of the total fees that correlates to the state's percentage of the national population.

However, as discussed above, it seems that the transactions fee proposal would be properly characterized as an excise tax. Therefore, it would only be subject to the uniformity clause and it appears to be uniform.

Non-Constitutional Issues

The transactions fee proposal may raise various issues due to the way the proposal differs from current federal and state tax laws. The purpose of this memorandum is to note the existence of several of these issues. This memorandum does not take a position on whether these issues should be addressed in the proposal.

Collection and noncompliance. It is unclear how the fees would be collected and who would be responsible for the collection. The collection could be similar to that required under state sales taxes, but the proposal would seem to shift some collection responsibilities from the federal government to the private sector. While the private sector currently plays an important role in the collection of federal taxes (e.g., withholding income and FICA taxes), it would appear that some entities, such as banks and merchants, would be more significantly involved in the fee collection. It also seems that the administrative burden under the proposal for the private sector could be greater then under the existing system. For example, there would appear to be a greater number of transactions that give rise to private sector involvement and the rate of transactions at any point in time could be unpredictable.

Additionally, in so far as the proposal would rely on consumers to report taxable transactions and pay the fees, it should be noted that the current levels of compliance with state laws imposing liability for use taxes are low. Similarly, it is unclear how the fees would be collected when the bank or selling party is foreign. That is, whether liability could be imposed on the foreign entity or if the burden would rest upon self-reporting by the consumer. This also raises the issue of whether the fees could be avoided by operating through foreign banks and purchasing goods and services from foreign sellers.

Double taxation. The avoidance of double taxation has been a consistent goal of the federal tax system. The proposal would create several situations where double taxation could occur. First, some individuals and entities would face double taxation during the transition from the current federal taxing structure to the proposed system. This is because income that has been taxed under the existing system would be taxed again as it is spent or transferred.

Furthermore, double taxation would likely exist after the transition period for various types of transactions. For example, dividends received by a corporation would be taxed upon receipt and taxed again when transferred to the shareholders. Under current law, corporations may generally deduct a percentage of received dividends from taxable income. Another example is that taxpayers could be taxed twice on foreign transactions: the fee plus any foreign income tax. Current law tries to prevent concurrent foreign and U.S. taxation of foreign income through the foreign tax credit.

Employee retirement and health benefit plans. The transactions fee proposal could impact retirement and health benefit plans. Currently, the federal government offers tax benefits to employers and employees in order to encourage them to maintain and contribute to these plans. The proposal, by replacing the income tax, would appear to eliminate these incentives. Furthermore, a significant purpose of the current rules is to discourage employers from offering retirement and health plans that benefit certain groups of employers more than others. These nondiscrimination rules would be eliminated.

Exemptions. It is unclear whether there would be exemptions under the proposal for specified transactions, individuals, or goods and services. It appears that the only contemplated exemption would be for the receipt of wages. Currently, state sales taxes exempt many goods and services, including food items. Generally, the policy reason behind the exemptions is to reduce the regressiveness of the sales tax.

Federal trust funds. Certain existing excise taxes are collected for specific purposes and deposited into special trust funds. For example, the federal gasoline tax is deposited into the highway trust fund to be spent on infrastructure programs. While the transactions that give rise to the existing excise taxes would likely be subject to the proposed fee, it is unclear what would happen to the existing trust funds structure (i.e., whether funds would be segregated and placed into the special accounts).

Trust funds also exist for Social Security and Medicare. Unlike the excise taxes mentioned above, the transactions that give rise to the Social Security and Medicare taxes (i.e., wage payment) would not be taxed under the proposal. It is unclear whether the proposal would segregate monies to be distributed into the Social Security and Medicare trust funds. This may not have a practical effect since the money in the trust funds is currently used for general government spending. However, there is a continuing debate about the proper treatment of these funds for accounting and spending purposes. If the proposal would not segregate monies for placement in the trust funds, then it would effectively end this debate.

Foreign treaties. The proposal would impact existing U.S. tax treaties. The United States has entered into numerous income tax treaties that are generally aimed at preventing the double taxation of residents who work abroad and providing certain income tax benefits to individuals and entities with foreign-produced income. Furthermore, the United States has entered into totalization agreements with several countries, which are basically treaties that exempt U.S. citizens and residents from paying social security taxes to another country. These treaties and agreements, and the benefits provided thereunder, only apply to income and social security taxes, both of which would be eliminated under the proposal.

Outstanding tax attributes. It is unclear how the proposal would treat existing tax attributes, such as unused net operating losses and credits that may be carried over to future tax years. The elimination of the income tax would make these attributes worthless, which

could create an inequality between taxpayers who were able to take full advantage of the benefits and those who could not. For example, a business that was able to completely depreciate a piece of property before the elimination of the income tax would theoretically be in a better position than a company that had undepreciated basis remaining at that time.

Public funding of presidential campaigns. Under current law, public funding of presidential election campaigns is accomplished through taxpayers electing to contribute money by checking a box on their income tax forms. When a taxpayer agrees to contribute, his or her tax liability is not increased; rather, the money is diverted from the general tax collection into a special account. The proposal would appear to abolish the method by which the money is raised and it is unclear whether or how the funding would be continued.

Tax Court. The proposal would appear to eliminate all of the areas over which the Tax Court has jurisdiction.

Tax-exempt organizations. It is unclear how the proposal intends to treat tax-exempt organizations. In so far as charitable donations are made in order to receive the benefit of the charitable deduction, the proposal would eliminate that incentive. It would appear that receiving a charitable donation could be a taxable transaction. Furthermore, the exemption of these organizations from the income tax reflects an approval of their public service purposes. It is unclear whether the proposal would extend their tax-exempt status to the fees.

Tax expenditures. The government's current allowance of tax deductions and credits is a form of federal spending that provides monetary benefits to taxpayers. Many of these deductions and credits are intended to influence behavior. For example, deductions and credits exist to encourage efficient energy production, land conservation, and historic building preservation. Another example is the deduction provided for contributions to a medical savings account. It is unclear whether the proposal would include an attempt to maintain these incentives (e.g., through direct subsidies).

The proposal would also seem to eliminate the Earned Income Tax Credit and the refundable portion of the child-tax credit. It is unclear whether the proposal would continue to provide these subsidies.

Transactions between related parties. It is unclear how the value of transactions between related parties (e.g., parent and subsidiary companies or familial relationships) would be determined. The fee would be based on the transaction's value. When the parties are not related, the participants would be bargaining at arms-length so that the taxable value would generally reflect the transaction's fair market value. However, transactions between related parties would not be bargained at arms-length and the taxable value would likely be less than fair market value. The current tax code addresses this issue through such things as the transfer-pricing rules.