Implementing the FairTax: Business Basics

Note: the FairTax is not phased-in and the income tax system phased-out.

For discussion purposes, let's assume that the FairTax legislation (HR25) is enacted and signed into law on July 1st. In fact, the bill will have to pass by then in order to allow retail businesses and state governments to make the administrative changes necessary to be able to put the FairTax into effect on January 1.

The FairTax will be effective on the following January 1. Retailers will charge 23% inclusive (30% exclusive) on the sale of all goods and services to consumers. If they sell items for business purposes to another business and do not charge the FairTax on the transaction; they must retain a copy of that business' registered seller certificate on file for audit purposes.

By the 15th of the February, the first monthly FairTax tax return must be submitted to the state taxing authority. [See the last page for a sample FairTax tax return.]

Regarding income and payroll taxes

Again assuming a July 1 enactment of HR25, all income taxes and payroll taxes will be repealed on the following Dec. 31st. (The day prior to the FairTax going into effect.)

Retailers will stop withholding income and payroll taxes from their employees' paychecks for wages earned on or after January 1st.

All businesses, including retail businesses, will have to file Estimated Taxes (income tax forms) for the last quarter of the current income tax year by January 15th. And personal and corporate income taxes will be due for the final tax year of the income tax on April 15th.

The IRS will remain in place until September 30th, three years after the FairTax is enacted. This is to allow the IRS to carry out all tax processing and enforcement activities relating to income tax returns for the final income tax year, and prior years. The IRS will be processing annual income tax returns for the individual income tax, corporate income tax, estate and gift tax, and the self-employment tax. It will conduct its normal collection and enforcement activities, including audits. The IRS can devote all of its attention to collecting taxes for the final income tax year taxes since there will be no time devoted to getting ready for another income tax year. After Sept. 30th, no appropriations for expenses of the Internal Revenue Service, including processing tax returns for years prior to the repeal of the taxes repealed by HR25, shall be authorized.

Business Responsibilities

Registration

Each person liable to collect the FairTax (including corporations and sole proprietors) who is engaged in a trade or business shall register as a "seller" with the state sales tax administering authority. The state sales tax authority will issue a registered seller certificate to the business. This includes retailers, wholesalers selling to businesses tax exempt, exporters, service providers, mortgage brokers, real estate brokers, insurance agencies, etc. Nonretail businesses have to register in order to qualify to make business purchases tax exempt and export items tax-free.

Businesses are required to designate a contact person for tax matters, and are required to notify the sales tax authority of a change in the identity of the tax matters person within 30 days of said change.

Most businesses are already registered with their state taxing authority. It is expected that the state sales tax authority will consolidate its state sales tax return with the FairTax return; HR25 gives states considerable financial incentives to do so.

Tax Reporting

"Registered sellers" must regularly report gross sales and the FairTax collected on those sales and any FairTax credits the government owes them to their state sales tax authority. They must remit the FairTax collected (minus any credits owed to them) along with the report. Although extensions for the late filing of sales tax reports may be granted, the taxes due must be remitted timely, generally by the 15th of the following month. Example: The FairTax collected on sales in January must be remitted to the state sales tax authority by February 15th. Businesses with small business volume will be able to file quarterly returns.

The sales tax report requires the following information (See the sample sales tax return on the last page.):

1. The gross payments
2. The tax collected
3. The amount and type of any credit claimed
4. Other information reasonably required for the administration, collection, and remittance of the tax (example: Business name, address, type of business, registered seller number).

There are deposit timeliness requirements for medium-sized and large retailers. Medium-sized retailers who collect more than $20,000, but less than $100,000, of FairTax per month must deposit the taxes they collect in a separate bank account each week within three business days of the end of the week. They must report and remit taxes on a monthly basis.

Large sellers are sellers who have collected $100,000 or more of FairTaxes in any of the previous 12 months. They must deposit all taxes collected in a separate bank account and remit the taxes to the state sales tax authority on a weekly basis. Example: Last week's taxes must be remitted on the following Monday. The Secretary of the Treasury may adopt a regulation that requires large sellers to remit collected taxes by electronic funds transfer. (Most large sellers are already set up to do this already since most states require large sellers to remit taxes by electronic funds transfer.)

Large sellers must also post a bond in an amount equal to the greater of $100,000 or 1.5 times their average monthly tax liability during the previous six calendar months. If the seller fails to remit taxes due then the bond or part of the bond may be forfeited to pay overdue taxes plus interest (if any).

Affiliated firms are treated as one person and require only one registration.

Business May Choose Cash or Accrual Accounting

Businesses collecting the FairTax may report and remit the FairTax in the month in which they actually collect the tax or they may elect to report and remit the tax in the month in which they invoice and accrue the sale. (Accrual accounting is a method of accounting that recognizes economic events regardless of when cash transactions happen. It is the opposite of cash accounting, which recognizes transactions only when there is an exchange of cash.) Example: Under accrual accounting, if a business sells a stereo on credit, the business would still recognize the event as a completed transaction in that month and remit the tax, even though full payment had not yet been received.

Those that use the accrual method of accounting internally may find it easier to pay taxes using the accrual method. There is a bad debt credit for registered sellers using the accrual method whereby they can get a refund of taxes paid on gross payments that were not received (i.e., paid for with a check with insufficient funds).

Most businesses will probably prefer the cash method since it means that they do not need to pay tax on a transaction until they have been paid. If someone pays only part of a bill, then the tax is remitted for only the portion that has been paid. Example: A lawyer bills a client $500. Taxes due on this sale are $150 for a total of $650. If his/her client only pays $350, then the lawyer would only remit 23 percent of the gross payment as tax ($80.50) with the monthly sales tax report. The next month, his client pays the balance of $300. The lawyer would remit 0.23 times $300 or $69.50 on that month's sales tax report. The total tax remitted is the same.

Recordkeeping

The state tax administering authority may conduct reasonable audits and examine the books, papers, records, or other relevant data to ensure that the FairTax is administered properly.
For audit purposes, businesses collecting the FairTax are required to keep the following records:

1. A record of all sales tax receipts provided to customers
2. Complete records of intermediate and export sales
3. Purchaser's intermediate and export sales certificates and tax numbers
4. The net of tax amount of purchase

These records must be sufficient to determine the amounts reported, collected, and remitted for a period of six years after the report was filed.

Any business including not-for-profit organizations and government enterprises that purchased taxable property or services but did not pay tax because they asserted an intermediate or export sales exemption are required to keep records sufficient to determine whether said exemption was valid for a period of seven years.

The purpose of such record retention is to allow an auditor to review reported taxable and exempt sales after the fact. It enables the auditor to determine if sales were properly tax exempt or if the FairTax should have been collected on the sale.

Statement of FairTax on Sales Receipt

A business collecting the FairTax must provide to the purchaser a receipt for each transaction that sets forth at least the following information:

1. The property or services price exclusive of tax
2. The amount of tax paid
3. The property or service price inclusive of tax
4. The tax rate (the amount of tax paid divided by the price inclusive of tax)
5. The date that the good or service was sold
6. The name of the registered seller

7. The seller registration number

There are two exceptions: (1) the above does not apply to sales by certain vending machines, and (2) receipts with respect to financial intermediation services. These receipts are issued when the FairTax is imposed, which is generally when monthly or quarterly financial statements are rendered.

Penalties for late payment or other noncompliance

Civil penalties for noncompliance are graduated so that more severe violations are punished more severely and generally escalate over time (subject to caps) so that there is a continuing incentive to comply. These penalties are much simpler than the current system which has about 150 different penalties. They are:

- Failure to register – penalty of $500
- Reckless or willful failure to collect tax, reckless or willful failure to pay tax, and willful assertion of invalid exemption – civil penalty, the greater of $500 or 20 percent of tax not collected; criminal penalty, imprisonment for up to one year
- Late filing – the greater of $50 for each month the report is late, or 0.5 percent of gross payments required to be shown on reports
- Bad checks – the greater of $25 per check or 2 percent of check amount
- Accepting false intermediate or export sales certificate – 20 percent of the tax not collected
- Failure to maintain a segregated account – $1,000 penalty
- Late payment interest – Interest penalty shall be charged on late tax payments equal to 1.0 percent per month from the due date. Caps this penalty at 24 percent.
- Violation of confidentiality of tax information – fined up to $10,000 or imprisoned for up to one year, or both
- False rebate claim – civil penalty, the greater of $500 or 50 percent of the claimed annual rebate amount not actually due, must repay any falsely due rebates; criminal penalty, imprisonment for up to one year

Summary of Timeline

July 1, 2016 – The FairTax is enacted.
Dec. 31, 2016 – taxes on income for all tax years beyond December 31, 2016 are repealed. All income tax withholding and payroll tax deduction for federal taxes ends.
Jan. 1, 2017 – the national sales tax is imposed on final consumption of all goods and services.
Jan. 15, 2017– estimated tax payments (form ES) for the final quarter of tax year 2016 are due.
Apr. 15, 2017 – income tax returns for the 2016 tax year will be due.
Jan. 1, 2017 to Sept. 30, 2019 – the IRS will be processing 2016 annual tax returns for the individual income tax, corporate income tax, estate and gift tax, and the self-employment tax. It will conduct its normal collection and enforcement activities, including audits.
Sept. 30, 2019 – No funding of the IRS beyond this date is authorized.

Authored by Karen Walby, Ph.D., Research Consultant, www.FairTax.org., Dec. 21, 2010. Summary of Timeline updated Jan. 27, 2016 by CPB.