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Choosing the Form of a Federal Value-Added Tax: Implications for State and Local Retail Sales Taxes

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**CHOOSING THE FORM OF A FEDERAL VALUE-ADDED TAX:
IMPLICATIONS FOR STATE AND LOCAL RETAIL SALES
TAXES**

ALAN SCHENK*

INTRODUCTION	292
I. TAXATION OF CONSUMPTION EXPENDITURES	295
II. DESCRIPTION OF VALUE-ADDED TAXES	297
A. <i>Forms of Value-Added Taxes</i>	297
1. <i>European Community-Style and Japanese Credit-Subtractive VAT's</i>	297
a. <i>European Community-Style Invoice- Method VAT</i>	298
b. <i>Japanese Consumption Tax</i>	300
2. <i>Sales-Subtractive VAT (Business Transfer Tax or Uniform Business Tax)</i>	301
B. <i>Zero-Rating and Exemption from Tax</i>	302
1. <i>Zero-rating</i>	302
2. <i>Exemption from tax</i>	303
C. <i>Treatment of International Transactions</i>	306
D. <i>Treatment of Capital Goods</i>	307
III. BASIC DIFFERENCES BETWEEN THE EUROPEAN COMMUNITY INVOICE VAT AND THE BUSINESS TRANSFER TAX	308
IV. THE IMPACT OF VAT FORM ON THE RST BASE AND ON THE ADMINISTRATION OF AND COMPLIANCE WITH STATE RST'S	311
A. <i>In General</i>	311
B. <i>Tax Base</i>	311
C. <i>Administrative Issues</i>	313
D. <i>Compliance Issues</i>	314
V. EFFECT OF COORDINATION	315
VI. STATE RECEPTIVITY TO A FEDERAL VAT	319
CONCLUSION	320

INTRODUCTION

The United States is the only major industrial nation that does not impose some form of broad-based tax on consumption at the national level.¹ Over seventy nations now rely on a value-added tax ("VAT") as a significant source of national revenue.²

Members of Congress and at least two administrations over the past fifty years have introduced bills or considered a federal sales or value-added tax. Except for selective excise taxes, Congress has not enacted any national sales tax or VAT. In 1943, Congress considered a federal sales tax to finance the war effort. In 1970, the Nixon administration reportedly considered a federal value-added tax which would have rebated revenue to the states that had agreed to reduce their tax on real property used to finance education.³ In 1979 and again in 1980, Al Ullman, then Chairman of the House Ways and Means Committee, proposed a federal value-added tax to finance cuts in federal income and payroll taxes.⁴ As part of the United States Treasury's 1984 revenue neutral tax

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1. All members of the European Community were required to adopt VAT as a condition of membership because the European Community funding is based in part on a percentage of VAT revenue raised by each member. Canada and Japan adopted VAT's in recent years. Of the 24 countries that are members of the Organization for Economic Cooperation and Development ("OECD"), only Australia, Iceland, Switzerland, and the United States do not impose a national VAT. See ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, TAXING CONSUMPTION 29 (1988). Since 1987, when the data were compiled for this book, Canada added a VAT, its Goods and Services Tax, and Japan adopted its VAT, the Consumption Tax.

2. See A. TAIT, VALUE ADDED TAX: INTERNATIONAL PRACTICE AND PROBLEMS, INT'L MONETARY FUND 10-14 (1988); GENERAL ACCOUNTING OFFICE, VALUE ADDED TAX: ADMINISTRATIVE COSTS VARY WITH COMPLEXITY AND NUMBER OF BUSINESSES 16 (1993) [hereinafter GAO REPORT ON ADMINISTRATIVE COSTS OF A VAT].

3. Reportedly, one of the reasons former President Nixon's advisors did not recommend this action was that the VAT was not known by accountants and lawyers, and it would require a long period to educate the public and professionals before the tax could become effective.

4. See H.R. 7015, 96th Cong., 2d Sess. (1980) (outlining the VAT portion of the bill). In the fall of 1980, Mr. Ullman was defeated. One reason commonly given for his defeat was his proposal for a VAT. His home state of Oregon is one of the only five states that does not have a state level retail sales tax. There were,
(continued)

reform proposal, the Treasury considered but rejected a federal VAT.⁵ The Treasury report concluded that the administrative cost of implementing a broad-based VAT was too great unless Congress wanted to raise substantial additional federal revenue.

The renewed interest in a federal value-added tax in the early 1990's came from Congress' concern about the growing national debt, the United States' competitive position in the international marketplace as evidenced by chronic imbalance of trade deficits, and the demand for additional federal programs such as universal health care.

In recent years, however, Congress, scholars, and various commentators have once again begun to consider some form of a broad based tax on consumption. There have been four VAT bills introduced in Congress since 1985. Senator Ernest F. Hollings proposed a federal VAT, suggesting that the revenue be earmarked to pay down the national debt.⁶ Congressman John Dingell proposed a VAT to finance a national health care system.⁷ Congressman Richard T. Schulze (and earlier Senator William V. Roth) proposed a different form of VAT, the Uniform Business Tax ("UBT") or the Business Transfer Tax ("BTT"), to replace the corporate income tax and possibly to reduce or eliminate the employer's share of the social security tax.⁸ The UBT and BTT proposals were designed in part to improve our international competitive position.

In 1992, a national commission and a working group began to study the possibility of a federal VAT. In September 1992, the Center for Strategic and International Studies' Strengthening of America Commission,⁹ co-chaired by Senators Sam Nunn and Pete Dominici, recommended the replacement of the current federal individual income tax with a progressive consumption-based income tax and the replacement of the federal corporate income tax with a tax on business activity. The tax on business activity likely would resemble the BTT or the UBT method of calculating tax on value added. Senators John Danforth and David Boren sponsored a working group to consider what form of federal consumption

however, several other significant reasons unrelated to his VAT proposal for Mr. Ullman's defeat.

5. U.S. DEPT. OF THE TREASURY, *TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT, VALUE-ADDED TAX 1984* [hereinafter *TREASURY TAX REFORM REPORT, VOL. 3*]

6. S. 169, 102d Cong., 1st Sess. (1991).

7. H.R. 16, 103d Cong., 1st Sess. (1993).

8. S. 1102, 99th Cong., 1st Sess. (1985) (the Roth Bill); H.R. 3170, 102d Cong., 1st Sess. (1991) (the Schulze Bill).

9. THE CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, *THE CSIS STRENGTHENING OF AMERICA COMMISSION FIRST REPORT 91-92* (1992).

tax would be appropriate for the United States.¹⁰ To date, that working group has not released its findings.

There has been a more recent proposal by a Congressman for a VAT. In June of 1993, Congressman Sam Gibbons proposed a sales-subtractive form of VAT (like a BTT) to replace the federal corporate income tax and the payroll tax, as well as most of the federal individual income tax.¹¹

Not all of the proposals for a value-added tax have focused on the federal government. A number of studies and commentaries suggest that the states either move from the existing form of consumption tax (the state retail sales tax ("RST")) to a broader-based consumption tax (the value-added tax)¹² or shift from a state income tax and other taxes on business activity to a state VAT. States could follow Michigan's lead and replace income and other taxes on business activity with an apportioned tax like the Michigan Single Business Tax, a modified addition form of value-added tax.¹³

Some commentators favor a shift from the state retail sales tax to a state level VAT in order to expand the sales tax base, especially to tax services. A European-style VAT at the state level also would avoid the cascade tax effect that results under the RST's when business purchases are included in the RST base and are taxed a second time when the tax-

10. See VAT, Danforth, Boren, Sponsor Consumption Tax Working Group to Study Tax Reform Options, Daily Report for Executives (BNA) No. 155, at 66 (Aug. 11, 1992). The Danforth-Boren tax reform package, described as a Business Activities Tax, is a subtractive form of VAT. See BNA Daily Tax Report, Nov. 4, 1993, at G1.

11. See Sam M. Gibbons, Proposal for a New Revenue System for the United States Incorporating a Value-Added Tax, Address Before the Loyens-Lefebvre-Radler European Tax Network Conference (June 29, 1993), in TAX NOTES INT'L, Sept. 3, 1993, at 171-74.

12. See Robert D. Ebel, *State Value Added Taxes*, 1 STATE TAX NOTES 269 (1991) (suggesting a possible origin-based state VAT). References in this article to state RST's include local RST's in those states that impose retail sales taxes both at the state and local levels of government.

13. See James Francis, *A Closer Look at a State Invoice Credit VAT*, 3 STATE TAX NOTES 804 (1992). In his article, Mr. Francis, director of tax research at the Florida Department of Revenue, argues that an apportioned state level addition method VAT is inferior to the European Community-style invoice VAT. He suggests that a European Community-style VAT at the state level will tax consumption and not production, while an apportioned VAT, like the Michigan SBT, taxes only the portion of final consumption produced within the taxing jurisdiction. Mr. Francis notes that an addition method VAT could be structured to tax consumption (by using a sales only allocation formula), but that the Michigan SBT does not do so. Michigan, from 1953 to 1967, imposed a state level subtraction form of VAT, the Business Activities Tax. 1953 Mich. Pub. Acts 150.

inclusive cost of these purchases is included in the sales price of goods or services sold at retail.¹⁴ Alice Rivlin, a noted commentator in the field, suggested that state level revenue could be increased if a uniform value-added tax were adopted, with the revenue allocated among states by a formula driven by population.¹⁵

With these principles in mind, this article will have a limited scope. The focus of the article will be to propose solutions to the following three recurring questions:

1. Will the form of a federal VAT that operates along with state RST's affect the administration and compliance costs of both taxes?
2. Is coordination of federal and state sales taxes likely, and will such coordination depend upon the form of federal VAT?
3. Will state support of or opposition to a federal VAT be affected by the form of that federal VAT?

When a federal VAT is discussed in this article, it is assumed that the federal VAT will operate side-by-side with the existing state and local RST's. Part V of this article will consider the benefits and problems associated with full or partial coordination of state and local sales taxes with the new federal VAT. The article does not consider the possibility that Congress could adopt a federal retail sales tax, a tax which would operate independent of, or in coordination with, the state and local RST's.

To highlight the differences among forms of federal VAT on state and local governments, this article will focus primarily on two forms of subtractive-method VAT's, namely, the European-style credit subtractive (or invoice) VAT and the sales-subtractive VAT (or Business Transfer Tax). Parts I and II discuss the taxation of consumption and describe a broad array of possible methods of collecting taxes on consumer expenditures.

I. TAXATION OF CONSUMPTION EXPENDITURES

Since World War II, Congress has relied on taxes imposed at the source of earning income (income and payroll taxes) for the bulk of federal revenue. By contrast, our major trading partners rely both on taxes

14. This effect is described in more detail in part I of this article. *See infra* part I.

15. *See* ALICE M. RIVLIN, *REVIVING THE AMERICAN DREAM: THE ECONOMY, THE STATES, AND THE FEDERAL GOVERNMENT* (1992). Ms. Rivlin also has supported a federal tax that would be shared with the states. *See* Peter Jakubowicz, *Rivlin Supports Federal Tax "Shared" With States*, 4 *STATE TAX NOTES* 10 (1993); *see also* John A. Miller, *State Adoption of a Value Added Tax: A Desperate Act in Search of the Proper Occasion*, 71 *NEB. L. REV.* 192 (1992).

imposed at the source of funds and on taxes imposed at the point the funds are used (value-added tax on consumption). Some nations that experience high levels of income and payroll tax evasion feel that their tax collections are more successful if taxes are collected both at the source and at the point of fund's use. These nations also assume evasion of a particular tax increases as its rate increases. If this assumption is correct, then compliance will be greater if a nation relies on multiple taxes, such as income and VAT combined, imposed at moderate rates, instead of one tax imposed at a high rate, such as the income tax or VAT alone.

Support for taxes on consumption finds its roots in the seventeenth century writings of Thomas Hobbes. According to Hobbes, the state should impose a consumption tax on an individual's withdrawal of community resources for his or her personal use rather than imposing a tax like an income tax on his or her contribution to the community resources by performing services or providing capital.¹⁶

Some commentators suggest that our federal tax system discourages individuals from saving money by taxing their income from savings under the income tax and by not taxing general consumption under any broad-based federal sales tax. If Congress decides to reform the federal tax system in order to tax consumption more and income less, Congress could do so in a number of ways. First, Congress could impose an annual tax on individual or household consumption with an individualized cash flow income tax. With a cash flow income tax tailored to individual circumstances, each taxpayer (individual or family unit) reports receipts from services, gifts and other sources for the tax period and deducts increases in his or her investments or net savings for that period. Second, Congress could impose a period tax on consumer expenditures and have businesses collect that tax at each stage of production and distribution. Under this plan, the federal government could rely on a Business Transfer Tax or similar tax measured by business activity for each reporting period, with the data taken largely from records maintained for income tax purposes. Third, Congress could impose a transaction tax on taxable sales of consumer goods and services with a European-style invoice VAT that is measured by value added at each stage of production and distribution and collected and remitted by the selling businesses.¹⁷ Fourth, Congress could impose a federal retail sales tax and impose an obligation on retailers collect and remit the tax.

16. See THOMAS HOBBS, *LEVIATHAN* 184 (1914).

17. In this paper, I will not consider the individualized cash flow income tax.

II. DESCRIPTION OF VALUE-ADDED TAXES

A. *Forms of Value-Added Tax*

A tax on consumption can be imposed only on personal consumption expenditures, or alternatively, the tax can be imposed on taxable goods and services acquired for any purpose. Although technically, a tax on consumption should not apply to investments or purchases associated with investments, a goods and services tax may tax some items that can be considered investment or investment-related expenditures. Whether a tax is labeled as a tax on personal consumption or a tax on goods and services, the national value-added taxes in use today typically tax some items that may be classified as investments or as investment-related expenditures. For example, collectible stamps or coins may be held as investments, but these items may also be taxed. Included in the group of taxes on consumption are the familiar state retail sales tax or one of a variety of value-added taxes imposed either on sales transactions (such as the European form of invoice-method VAT) or on business activity for a reporting period (such as the Business Transfer Tax). Whether a sales tax is legally imposed on a seller or purchaser, the seller ordinarily is required to collect the tax from the purchaser and remit it to the government.¹⁸

1. *European Community-Style and Japanese Credit-Subtractive VAT's*

Most countries that impose national value-added taxes use the European-style credit-subtractive VAT, which relies on invoices. These are transaction-based taxes. Under a credit-subtractive invoice VAT, the business seller applies the tax rate to his or her taxable sales in order to arrive at a preliminary tax liability ("output tax"). From this tax, the taxpayer can claim credit for the tax stated on each invoice covering taxable purchases from other firms ("input tax credit") to the extent that these purchases are used in taxable sales activity.

Japan's Consumption Tax, however, is a credit-subtractive VAT that does not rely on invoices. It has features of both a transaction tax and a tax on business activity for each reporting period. The business seller applies the tax rate to his taxable sales and is entitled to claim credit

18. The tax occasionally must be remitted by the purchaser. *See, e.g.*, Canadian Goods & Services Tax, R.S.C. ch. 45, § 228(4) (1990) (Can.) (requiring certain purchasers of real property who are not VAT registered to remit tax on those purchases).

against this tax liability for tax paid on purchases. The credit, however, is calculated from the tax-inclusive cost of purchases taken from purchase records rather than from the separately stated tax on tax invoices.

These two forms of credit-subtractive VAT's can be illustrated with the following example.¹⁹ In a tax period, a jeweler purchases supplies, utilities and tools for \$4400, including a ten percent (\$400) tax. She produces bracelets and sells them to a local craft shop for \$10,000 plus \$1000 tax. The craft shop resells for \$15,000 all of the bracelets purchased from this jeweler and adds a tax of \$1500. With the European Community-Style invoice-method VAT and with the Japanese Consumption Tax, the final consumers pay \$16,500 for the bracelets, including \$1500 in tax, and the government collects \$1500 total tax.

a. European Community-Style Invoice-Method VAT
(a credit-subtractive VAT with invoices)

Sales by jeweler:

Output tax on taxable sales (\$10,000 x 10%) ²⁰	\$ 1,000
Input credit on taxable purchases (\$4000 x 10%) ²¹	<u>(400)</u>
Net tax payable to government ²²	\$ 600

19. In the example, it is assumed that the seller will shift the VAT to the buyer in the form of higher tax-inclusive prices.

20. The individual amounts that make up this total are taken from sales invoices that list the VAT charged on the sales.

21. This total consists of tax on purchase invoices (the supplier's sales invoices) that separately list the VAT charged on the individual purchases.

22. The addition method of computing VAT illustrates the fact that only value added by the business is being taxed. For example, assume for these sales the jeweler paid wages of \$2500, a rent and interest expense of \$1000, and earned a profit for VAT purposes of \$2500. The jeweler's sales price of \$10,000 (exclusive of VAT) consisted of the following:

Purchases (excluding VAT)	\$ 4,000
Wages	2,500
Rent and interest expense	1,000
Profit for VAT purposes	<u>2,500</u>
Sales price	\$ 10,000

The jeweler's value added base is the same \$6000, the total of the wages, rent and interest expense, and profit.

Sales by craft shop:

Output tax on taxable sales (\$15,000 x 10%) ²³	\$ 1,500
Input credit on taxable purchases (\$10,000 x 10%) ²⁴	<u>(1,000)</u>
Net tax payable to government	<u>500</u>
Cost to consumers (\$15,000 + \$1500 tax)	<u><u>\$16,500</u></u>

Tax collected by government:

From suppliers on taxable sales to the jeweler ²⁵	\$ 400
From jeweler on taxable sales to craft shop	600
From craft shop on taxable sales to consumers	<u>500</u>
Total tax collected by government	\$ 1,500

It is apparent from the above example that the business purchaser receives credit against his output tax liability for any VAT paid on his purchases. If the business purchaser, on average, receives the benefit from the credit for tax on purchases before he must pay this tax to his suppliers, the VAT on purchases should not become a cost (even an interest cost) of doing business and therefore should not enter the pricing structure for that business' sales.

Under the Japanese Consumption Tax, the seller calculates output tax by applying the tax rate to the tax-exclusive price of her taxable sales. She then calculates her input credit by identifying the tax component in the tax-inclusive price of his purchases.²⁶

23. See *supra* note 20.

24. See *supra* note 21.

25. This \$400 is collected from the supplier and those businesses which provided goods and services to that supplier.

26. Under the Japanese Consumption Tax, a business purchasing goods from an exempt small supplier can claim an imputed credit for the presumed tax element in this purchase, whether or not the business actually paid any tax on such purchase. Credit is denied only for the consumption tax element in the cost of particular purchases (such as postage stamps) that are exempt from tax. Japanese Consumption Tax, Law No. 108, part IV, § 7(1)(a) (1988). Japan's Consumption Tax has some unique features that will not be explored in depth in this paper. For a more thorough discussion of the topic, see Alan Schenk, *Japanese Consumption Tax: The Japanese Brand VAT*, 42 TAX NOTES 1625 (1989).

b. Japanese Consumption Tax
(a credit-subtractive VAT without invoices)

Sales by jeweler:

Output tax on sales (\$10,000 × 10%) ²⁷	\$ 1,000
Input credit on \$4400 tax-inclusive purchases taken from purchase records × 10/110 ²⁸	<u>(400)</u>
Net tax payable to government	\$ 600

Sales by craft shop:

Output tax on sales (\$15,000 × 10%) ²⁹	\$ 1,500
Input credit on \$11,000 tax-inclusive purchases taken from purchase records × 10/110 ³⁰	<u>(1,000)</u>
Net tax payable to government	<u>500</u>
Cost to consumers (\$15,000 + \$1500 tax)	<u><u>\$16,500</u></u>

Tax collected by government:

From suppliers on taxable sales to the jeweler ³¹	\$ 400
From jeweler on taxable sales to craft shop	600
From craft shop on taxable sales to consumers	<u>500</u>
Total tax collected by government	\$ 1,500

27. This total consists of the tax from sales invoices that list VAT charged on sales, or from sales records that list the tax-exclusive prices of sales and list VAT separately. Some taxpayers can use tax-inclusive prices taken from sales records to calculate the VAT-exclusive prices. Based on the example in the text, the seller would multiply the \$11,000 tax-inclusive prices by 100/110 to obtain the \$10,000 tax-exclusive price to which the ten percent tax rate would be applied.

28. Under the Japanese Consumption Tax, in calculating input credits, businesses are not limited to VAT charged on purchase invoices. Indeed, sellers of taxable goods and services can claim credit for the presumed VAT component in the cost of items purchased from exempt small businesses. These sellers, however, are denied credits for the cost of goods or services exempt from tax.

29. See *supra* note 20. If the craft shop can take tax-inclusive prices from its sales records, it would multiply the \$16,500 tax-inclusive prices by 100/110 to obtain the \$15,000 tax-exclusive prices.

30. See *supra* note 21.

31. See *supra* note 25.

2. *Sales-Subtractive VAT (Business Transfer Tax or Uniform Business Tax)*

The tax liability under a VAT may be imposed on total business activity for each tax period rather than on each taxable transaction. The data necessary to calculate the tax on business activity may be taken in large part from sales and purchase records maintained for income tax purposes. The tax is not separately stated on sales invoices. Two such VAT's have been discussed by members of the United States Congress—one is Senator William V. Roth's proposed Business Transfer Tax and the other is former Representative Richard T. Schulze's proposed Uniform Business Tax. While there are some differences in detail, the BTT and UBT require similar calculations of tax base and tax liability. The tax base is calculated by using tax-inclusive prices for sales and purchases. To collect the same revenue as a ten percent tax imposed on tax-exclusive prices, the BTT or UBT rate must be 9.0909 percent. Using the data in the above example, the final consumers pay the same \$16,500 and the government collects the same \$1500 total tax.

Sales by jeweler:

Taxable sales (inclusive of tax)	\$11,000
Deductible purchases (inclusive of tax)	<u>(4,400)</u>
Net tax base	6,600
Tax rate applied to tax-inclusive base	<u>9.0909%</u>
Net tax payable to government	\$ 600

Sales by craft shop:

Taxable sales (inclusive of tax)	\$16,500
Deductible purchases (inclusive of tax)	<u>(11,000)</u>
Net tax base	5,500
Tax rate applied to tax-inclusive base	<u>9.0909%</u>
Net tax payable to government	<u>500</u>
Tax-inclusive cost to consumers	<u><u>\$16,500</u></u>

Tax collected by government:

From suppliers on taxable sales to the jeweler ³²	\$ 400
From jeweler on taxable sales to craft shop	600
From craft shop on taxable sales to consumers	<u>500</u>
Total tax collected by government	\$1,500

B. Zero-Rating and Exemption from Tax

The above description of the various forms of VAT's assumes sales of goods and services are all taxable at a standard ten percent rate. Countries employing VAT's typically zero rate some sales, such as exports, and exempt from tax other sales, such as financial services.³³

1. Zero-rating

In the above example, assume under a European Community-style VAT the craft shop sold all of the bracelets for export and exports are zero-rated.³⁴ The craft shop will not charge tax on the export sales but may still claim credit for the \$1000 input tax on its purchases. The craft shop will charge \$15,000 for the exported bracelets and will receive a \$1000 refund of the tax paid on its purchases. The government will not collect any net tax on the value of the exported bracelets.

Sales by craft shop:

Output tax on taxable sales (\$15,000 × 0%)	\$ 0
Input tax on purchases (\$10,000 × 10%)	1,000
Net refund available from government	<u>1,000</u>
Cost to export customer (\$15,000 + \$0 tax)	<u>\$15,000</u>

32. See *supra* note 25.

33. Some countries employ lower rather than zero rates for various necessities or higher rates for luxuries. Multiple positive rates are not discussed in this article.

34. As discussed later in the text, under a destination principle tax like the European Community-style VAT, exports are zero-rated and imports are taxed. See *infra* part II.C.

Tax collected by government:

From suppliers on sales to the jeweler	\$ 400
From jeweler on sales to craft shop	600
Refund to craft shop	<u>(1,000)</u>
Total net tax collected by government	\$ 0

Under the BTT, if the same bracelets are exported by the craft shop, the shop will charge the foreign customer \$15,000³⁵ and will receive a refund of the \$1000 tax component in its purchases from the jeweler. As in the example of the European Community-style VAT, the government will not collect any BTT on the value of the exported bracelets.

Sales by craft shop:

Export sales are not included in tax base	\$ 0
Deductible purchases (inclusive of tax)	<u>(11,000)</u>
Net tax base	(11,000)
Tax rate applied to tax base	<u>9.0909%</u>
Net refund available from government	1,000
Cost to export customer (\$15,000 tax-inclusive price)	<u>\$15,000</u>

If sales at an intermediate stage are zero-rated but sales to final consumers are taxed, the revenue lost on the zero-rated intermediate sale is recouped on the final taxable sale. For example, if food sales by farmers are zero-rated and food sales by restaurants are taxed, revenue lost on the sale of zero-rated food by a farmer to a restaurant is recouped when the restaurant serves that food to a customer as part of a taxable meal.

2. Exemption from tax

If sales are exempt from tax only at the retail stage,³⁶ the government loses revenue only on the value added by the retailer and the consumer saves only the tax attributable to the retailer's value added. This effect should occur whether Congress imposes a European Community-style

35. The BTT is not separately stated at any stage of production or distribution. It may be less likely that the precise VAT component in the price of exports can be removed and that the export price will be the same as under a European Community-style VAT, especially if business purchases that are exempt from VAT are treated differently under these two forms of VAT.

36. The exemption may be granted for all sales by a seller (such as a small business) or for particular kinds of sales by a seller (such as educational services rendered by a university but not all sales and services by that institution).

VAT or a BTT. In the above example, if sales by the craft shop were exempt under a European Community-style VAT (such as if the shop were exempt from tax under a small business exemption), the shop could not recover tax paid on its purchases. Thus, the shop is likely to charge its customers \$16,000 for the bracelets, a price representing \$15,000 plus the \$1000 input tax that it must bear. The government will collect total tax of only \$1000 on the value added before this exempt stage.

Sales by craft shop:

Output tax on sales exempt from tax	\$ 0
Input tax on purchases attributable to exempt sales not creditable	<u>0</u>
Net tax payable to government	<u>\$ 0</u>
Cost to consumers (\$15,000 plus \$1000 tax paid on purchases by craft shop)	<u>\$16,000</u>

Tax collected by government:

From suppliers on taxable sales to the jeweler	\$ 400
From jeweler on taxable sales to craft shop	600
From craft shop on exempt sales to consumers	<u>0</u>
Total tax collected by government	\$ 1,000

If, on the other hand, an exemption is granted at an intermediate stage of production or distribution under a European Community-style VAT, the government may actually collect more revenue and the consumer may pay a higher price than if that intermediate stage were taxable.

Under a European Community-style VAT, if sales by the jeweler are exempt from tax but sales by the craft shop are taxable, then assuming that the tax paid on the jeweler's purchases is included in the price she charges for the bracelets, the jeweler will charge the craft shop \$10,400. The sales invoice will not list any VAT because the sale is exempt from VAT. The jeweler cannot claim input credits for VAT paid on her supplies because tax on purchases attributable to exempt sales is not creditable. The craft shop likely will sell the bracelets for \$15,400 exclusive of tax (\$15,000 plus the \$400 non-creditable VAT included in the cost of the bracelets) and will add a tax of \$1540 (10% of \$15,400) for a total of \$16,940. The craft shop cannot claim any credit for tax on purchases of the bracelets because VAT was not charged or listed on its purchase invoice. The consumers will pay \$16,940, \$440 more than if the jeweler's sales were taxable. The government will receive \$1940 in total revenue, \$440 more than if the jeweler's sales were taxable. The \$440 difference in both cases is the \$400 VAT included in the price of the jeweler's exempt sale of the bracelets to the craft shop plus 10% VAT on that \$400 part of the craft shop's \$15,400 selling price.

Sales by jeweler:

Output tax on sales of \$10,400 (exempt)	\$ 0
Input tax on purchases not creditable	<u>0</u>
Net tax payable to government	\$ 0

Sales by craft shop:

Output tax on taxable sales	
\$15,400 x 10%	\$ 1,540
Input tax on exempt purchases of \$10,400	<u>0</u>
Net tax payable to government	<u>1,540</u>
Cost to consumers \$15,400 + \$1540	<u><u>\$ 16,940</u></u>

Tax collected by government:

From suppliers on taxable sales to the jeweler	\$ 400
From jeweler on exempt sales to craft shop	0
From craft shop on taxable sales to consumers	<u>1,540</u>
Total tax collected by government	\$ 1,940

Under the BTT, if the jeweler is exempt from tax and the craft shop is taxable, the jeweler will charge the craft shop \$10,400. The craft shop likely will include the \$400 VAT component in the cost of its purchases as part of its sales prices and therefore will charge its customers \$16,940 (\$15,400 pre-tax selling price plus 10% of \$15,400). If the BTT operates as it should and a purchaser cannot deduct the cost of purchases that are exempt from tax, the craft shop will not receive any deduction for the purchases from the exempt jeweler and therefore will remit the entire \$16,940 x 9.0909% rate, or \$1540 tax to the government.³⁷ The government will receive total revenue of \$1940, that is \$400 from the jeweler's suppliers and \$1540 from the craft shop. As with a European Community-style VAT, the revenue under the BTT will be \$1940, \$440 more than if the jeweler were taxable.³⁸

Sales by jeweler:

37. If businesses are required to separate taxable purchases from exempt purchases, the administrative and compliance costs will increase. This approach, however, is consistent with value-added tax theory.

38. If, similar to the Japanese Consumption Tax, the craft shop were allowed to deduct the cost of purchases from exempt small businesses and the jeweler were an exempt small business, then the craft shop could deduct the entire \$10,400 cost of purchases from the jeweler and thereby reduce its tax liability by the presumed \$945.45 tax component in its purchases ($100/110 \times \$10,400$). This benefit would exceed the actual \$400 tax component in the \$10,400 purchase price.

Exempt sale of \$10,400	\$ 0
Deductible purchases (inclusive of tax)	<u>0</u>
Net tax base	\$ 0

Sales by craft shop:

Taxable sales (includes \$15,400 and the \$1540 tax)	\$16,940
Deductible purchases (inclusive of tax)	<u>0</u>
Net tax base	16,940
Tax rate applied to tax-inclusive base	<u>9.0909%</u>
Net tax payable to government	<u>1,540</u>
Tax-inclusive cost to consumers	<u>\$16,940</u>

Tax collected by government:

From suppliers on taxable sales to jeweler	\$ 400
From jeweler on exempt sale	0
From craft shop on taxable sales to consumers	<u>1,540</u>
Total tax collected by the government	\$ 1,940

C. *Treatment of International Transactions*

One feature of a credit-subtractive or sales-subtractive VAT relates to the tax treatment of international transactions. Comparable treatment can be provided under both of these subtraction method VAT's. A VAT can be imposed on an origin or destination principle. Under the origin principle, the tax is imposed in the jurisdiction where goods are produced or where services are rendered, regardless of where they are consumed. Thus, sales for export and sales in the domestic market both are taxed, while imports of goods or services are not taxed. The European Community hopes ultimately to impose taxes within the Community on the origin principle, but retain the destination principle for transactions with parties outside the Community.³⁹

Under the destination principle, tax is imposed in the jurisdiction where goods and services are consumed, regardless of where they are produced or rendered. Exports are free of tax (zero-rated) and imports are taxed. All countries currently imposing VAT's rely on the destination principle for international transactions. Thus, it is reasonable to assume

39. See Council Directive of 16 Dec. 1991 supplementing the common system of value added taxation and amending Directive 77/388/EEC with a view to the abolition of fiscal frontiers, 91/680/EEC, discussed in Ben J.M. Terra & Julie Kajus, *Removal of Fiscal Frontiers: The New Directive Amending and Supplementing the Sixth Directive*, INT'L VAT MONITOR, Feb.-Mar. 1992, at 2.

that any United States VAT, whether a European Community-style VAT or the BTT, would rely on the destination principle.

D. Treatment of Capital Goods

A VAT can be described as a gross national product-style ("GNP") VAT, a national income-style ("NI") VAT, or a consumption-style ("C") VAT. The differences depend upon how purchases of capital goods are treated. Under the GNP-style VAT, capital goods are included in the tax base of the business that consumes these goods in the process of producing or distributing goods or rendering services. Thus, for example, if a European Community invoice VAT were a GNP-style VAT, a business purchasing equipment for \$10,000 plus \$1000 VAT for use in its business would not receive any input credit for the \$1000 VAT paid on the equipment. Under a BTT, the business would not receive a deduction for the VAT-inclusive \$11,000 price of its equipment purchase. Because under either form of VAT the business would bear the \$1000 VAT, the business likely would shift this tax to its buyers by increasing the prices of its goods or services by \$1000. The \$1000 tax on the equipment thus would be taxed again when the business sells those goods or services. In this example, the \$1000 VAT included in the pre-tax prices of the business' goods or services would be subject to another \$100 VAT (10% of \$1000) when those goods or services are sold.

Under the NI-style VAT, a business can recover the VAT component in the price of its capital purchases through a depreciation-like credit or deduction. Under a European Community invoice VAT, the business will claim input credits for the \$1000 VAT paid on the purchase of the equipment over the life of the equipment. Under the BTT, the business can deduct a portion of the \$11,000 tax-inclusive price of the equipment each year over the life of the equipment. In either case, a portion of the \$1000 VAT will be included in the pre-tax price of the business' sales of goods or services and therefore will be taxed again. Unless the VAT adopts the income tax rules for capitalizing and depreciating capital goods, the administrative and compliance costs of a NI-style VAT would be significantly higher than the other two methods of treating capital goods.

Under the C-style VAT, a business can recover the \$1000 tax paid on equipment purchases in the tax period in which the equipment is acquired. Under the European Community invoice VAT, the business can claim an input credit for this \$1000 tax. Under a BTT, the business can deduct the \$11,000 tax-inclusive cost of the capital purchase. With a C-style VAT, the business purchasers do not account for purchases of capital goods any differently than they account for purchases of inventory, supplies or other items. The tax component in purchases of capital goods is removed from the VAT base and therefore is not included in the pre-tax

price of business output. The cost of the capital goods, like the cost of labor, will be factored into the sales price of a business' goods and services and therefore will be taxed only once, when those items are sold. Almost every country with a VAT employs a C-style VAT.⁴⁰

III. BASIC DIFFERENCES BETWEEN THE EUROPEAN COMMUNITY INVOICE VAT AND THE BUSINESS TRANSFER TAX

There are a number of differences among the European Community invoice VAT, the Japanese Consumption Tax and the Business Transfer Tax that may affect the political, administrative and revenue implications of adopting a particular kind of federal VAT alongside the varying state retail sales taxes.⁴¹ The European Community-style VAT and the Japanese Consumption Tax both are credit-subtractive taxes. In the remainder of the article, for purposes of simplifying the analysis, the comparison will be limited to the European Community invoice VAT and the BTT. The Japanese Consumption Tax has attributes of the European Community-style VAT as well as the BTT, and has some advantages over the others.⁴² This article, however, focuses on the implications of form on state and local sales taxes. Because these taxes represent the two most widely discussed forms of subtraction VAT's, it is adequate to contrast the invoice VAT and BTT.

The European Community invoice VAT is imposed on taxable sales, is separately stated on invoices issued by sellers above the retail stage and at the retail stage, and may either be included in the price marked, separately stated, or added at the cash register. Even if retailers are not

40. Finland previously relied on a sales-subtractive kind of VAT that provided a depreciation-like deduction for the cost of many capital goods. As Finland transformed its VAT to a European Community credit-subtractive VAT, it liberalized the treatment of purchases of capital goods. See PRICE WATERHOUSE INFORMATION GUIDE, *DOING BUSINESS IN FINLAND* 38 (Supp. 1989).

41. It is possible to have a simple federal-state system or a coordinated system. For a discussion of various coordination options, see Charles E. McClure, Jr., *State and Local Implications of a Federal Value-Added Tax*, 38 *TAX NOTES* 1517, 1527-29 (1988). Coordination is discussed later in this article. See *infra* part V.

42. For example, most countries with European-style invoice method VAT's do not cross-match invoices. The cost of taxpayer compliance may be reduced if the requirement to issue tax invoices is dropped. That is what the Consumption Tax has done. Even without the requirement to issue tax invoices separately stating tax on the sale, the enforcement agency (the I.R.S. in the United States) will rely on purchase documents to verify the deduction or credit claimed on purchases.

required to separately state the VAT on sales invoices, in many countries the retailer must post a sign notifying customers that the prices include VAT. The BTT, by contrast, is a period tax included in the sales prices of taxable goods and services, and is not added at the cash register or separately stated on sales invoices.

If Congress adopts a federal VAT that operates alongside state RST's, the state RST's can be imposed on taxable retail sales prices that include or exclude a European Community invoice VAT. Legislative action may be required in order to include or exclude the VAT from the RST base. Because the BTT is not separately stated, without state legislative action, an RST will be imposed on BTT-inclusive prices.

The public perception of the differences between the European-style VAT and the BTT may affect the attitude of state and local government toward a VAT and, even more broadly, the political viability of a federal VAT. If Congress enacts a European Community invoice VAT, the states' political opposition to a federal VAT may intensify because state governments may view it as an intrusion into the field of sales tax previously reserved exclusively for them. This VAT imposed on transactions looks like a sales tax and generally will be added to business invoices and to prices at the cash register. In contrast, states may not raise a serious objection to a federal BTT that is buried in the sales prices of taxable goods and services because buyers do not see the tax on every taxable purchase.

If Congress adopts a federal VAT and states continue to rely on RST's, it is more feasible to operate these uncoordinated taxes if the VAT is imposed at a single rather than multiple rates. The European Community invoice VAT can be imposed at multiple rate. By contrast, the imposition of a BTT at multiple rates would be extraordinarily complex, if not altogether impossible.⁴³

A multiple rate federal VAT will increase the compliance burden on businesses subject to one or more state RST's. Businesses, particularly small businesses that do not have computerized accounting or computerized cash registers, may incur higher clerical expenses to separate sales by multiple federal VAT rates and the RST rate. Administrative costs to state departments of revenue also may increase if a VAT is imposed at multiple rates. To the extent a BTT prevents

43. With a BTT, intermediate-stage sales are made inclusive of the VAT. If the BTT were imposed at multiple rates, some sales would be taxed at one rate and others at another rate. Business purchasers could not identify the tax component in each purchase, and thus, there would not be any feasible way to assure the entire retail value of a product or service will be taxed to the consumer at the appropriate rate.

multiple rates, it may be better than an invoice VAT. If Congress refused to impose multiple rates under a VAT, however, the BTT would not have this advantage.

The introduction of a federal VAT or a change in an existing VAT rate (up or down) will create greater transition problems under a BTT than under a European Community-style VAT. A VAT is a tax levied on consumer expenditures. If Congress enacts a new ten percent VAT, the consumer who purchases after the effective date should bear a ten percent tax on the entire value of the goods or services consumed. This result is difficult to achieve under a BTT for goods in production or distribution on the date the tax becomes effective unless businesses are denied deductions for purchases that were not subject to the BTT. A more difficult problem exists if the rate of an existing BTT is changed. For example, if the BTT rate is increased from five to ten percent, value added up to the effective date of the change will be taxed at five percent and only the value added on and after the effective date will be taxed at the new ten percent rate. Since the BTT is buried in the price of purchased goods and services, the business purchaser cannot identify purchases with the five or ten percent BTT component. This feature is a negative aspect of the BTT.

There is no such problem with a rate change under a European Community invoice VAT because sellers, after the effective date, charge tax on sales at the new rate and claim input credits only for the actual tax separately stated and paid on purchases. As a result, consumers will pay and the government will receive tax at the new rate on the full value of the retail sales. For example, if a retailer purchased some inventory that was taxed at the old five percent rate and some at the new ten percent rate, the retailer will claim an input credit for the actual tax paid on these purchases. At this point, the inventory is completely free of tax. When this inventory is sold to consumers, the retailer will charge and the consumer will pay tax calculated on the retail price at the new ten percent rate.

With the European Community invoice VAT, businesses may pressure states to harmonize existing RST bases and reporting rules in order to reduce compliance costs. With a federal Business Transfer Tax, businesses may view the BTT (a period tax) and the RST (a transaction tax) as entirely separate taxes and therefore not pressure states to coordinate the RST with the BTT base.

IV. THE IMPACT OF VAT FORM ON THE RST BASE AND ON THE ADMINISTRATION OF AND COMPLIANCE WITH STATE RST'S

A. *In General*

Retail sales taxes, with varying bases and rates, are imposed at the state level in forty-five states. If Congress adopts a federal VAT, will the kind of VAT chosen affect (1) the tax base of the RST's in the long term, and (2) the costs for government to administer and for business to comply with co-existing state and local retail sales taxes?

If the states do not coordinate their RST bases with a federal sales tax, the costs to administer and comply with both federal and state sales taxes still may be reduced if one level of government administers both taxes.⁴⁴ While this combined administration is more feasible if both taxes are retail sales taxes, some economy of operation may be achieved even if a federal VAT and state level RST's are imposed simultaneously.⁴⁵ It is unlikely, however, that either level of government will relinquish its power to hire its tax staff and administer its own sales tax unless there is some economic incentive to do so.

The costs for businesses that must comply both with the federal VAT and one or more state RST's will increase measurably if there are differences in the two (or three)⁴⁶ tax bases, differences in reporting periods, and multiple tax returns required for each reporting period.⁴⁷

B. *Tax Base*

If, upon enactment of a federal VAT, a state retains its RST, the state revenue will increase if the RST is imposed on VAT-inclusive prices.⁴⁸ Some state legislatures may find it politically difficult to increase revenue by imposing the RST on tax-inclusive prices. On the other hand, if Congress adopts a Business Transfer Tax, the retail sales prices will include the BTT. Absent action by the state legislatures, most states will

44. See John A. Miller, *State Administration of a National Sales Tax: A New Opportunity for Cooperative Federalism*, 9 VA. TAX REV. 243, 245-47 (1989). The issues related to the coordination of federal and state sales tax bases are discussed in a subsequent section of this article. See *infra* part V.

45. See *id.* at 251-52 (raising some significant questions about this kind of combined administration).

46. There may be three different taxes on consumers in states that impose sales tax at the state and local levels.

47. The costs will rise still further if the tax reporting periods are different for federal VAT and state RST purposes.

48. See *supra* part IV.A.

raise more RST revenue if Congress imposes a BTT rather than a European-style VAT.

The VAT's in use today tend to be broadly-based taxes imposed on services as well as goods. If a separately-stated European Community-style invoice VAT is broadly based, the states may find it easier politically to expand the RST bases to tax items subject to that federal VAT. Any base broadening of the state RST will increase revenue, making it available for additional state services or for a state tax cut. If base broadening results in a state RST base that matches the federal VAT base, the administrative costs to federal and state government and the compliance costs to business in that state should decline.⁴⁹

As discussed earlier, the BTT is a period tax that is neither separately stated on sales invoices nor added at the cash register. It is therefore not apparent to consumers which goods and services are taxed and which are not. The BTT therefore may not provide any political coverage for states to expand their RST bases. Thus, only the European invoice VAT may facilitate a state's desire to broaden its RST base. Offsetting this possible advantage of a European invoice VAT is the fact that the visibility of this federal VAT may make it more difficult for states to increase their RST rates. Such action will increase the total tax rate listed on sales invoices or cash register tapes.

On balance, it is unlikely that the form of a federal VAT will significantly affect existing state RST bases. The RST revenue will increase if the RST is imposed on the VAT-inclusive rather than VAT-exclusive prices of taxable goods and services. A BTT buried in the price of taxable goods and services automatically will be included in the RST base.⁵⁰ It is less clear if states would decide to include or exclude a separately stated European Community-style invoice VAT in their RST bases. The visibility of the European Community-style invoice VAT makes differences in the RST and VAT bases a source of complexity. To the extent that states harmonize their RST's with the broader-based VAT, the RST base will expand. However, the visibility of the combined VAT and RST rate on taxable goods and services may inhibit increases in RST rates.

49. See *infra* part IV.C.

50. A state legislature could reduce its RST rate to accommodate the inclusion of the BTT in the RST base, but this action is not very likely to occur.

C. Administrative Issues

If Congress imposes a new broad-based tax on consumption, the VAT may result in significant administrative cost at the federal level⁵¹ and an increase in administrative cost for states with RST's, particularly if the VAT is a transaction form of consumption tax like a European Community-style invoice VAT. If a federal VAT is imposed along with existing state RST's and each tax is administered by a different unit of government, the administrative costs will be higher if the taxes are not coordinated.⁵²

One advantage of adding a federal consumption tax is that federal and state governments can share taxpayer information to increase the level of compliance with both taxes. The Canadian Goods and Services Tax, a European Community-style invoice VAT, provides for extensive information sharing between the federal government and the provinces.⁵³ Indeed, the federal government can respond to a province's request for information about the federal Goods and Services Tax as if the request came from within the federal government.

Congress can require businesses to report by state a variety of data under a federal VAT, such as information regarding sales. This information can be quite useful for state tax administration. For example, states may be able to gain access to information on interstate sales, including mail order sales, and in this fashion increase compliance with state use tax laws on purchases from other states.

If the federal VAT and the state RST's have different rules governing the administration, audit, collection and assessment of taxes, these differences can increase the cost for each level of government to administer and for businesses to comply with both taxes. On the other hand, even if the tax bases are not coordinated, Congress and the state legislatures could opt to harmonize their rules on tax administration,

51. According to a U.S. General Accounting Office report, it would cost between \$1.22 and \$1.83 billion for the federal government to administer a European-style invoice VAT, depending on the number of organizations that would be exempt under a small business exemption. See GAO REPORT ON ADMINISTRATIVE COSTS OF A VAT, *supra* note 2, at 3. These estimates do not include some expenses, such as the Justice Department and Internal Revenue Services' costs to litigate VAT cases. *Id.* at 36.

52. For the following discussion, it is assumed that the taxes are not fully coordinated or harmonized. The implications of coordination are discussed in the next section. See *infra* part V.

53. There is protection against unauthorized disclosure of taxpayer information and severe limits on what kind of information can be disclosed to anyone, including a unit of government. Canadian Goods & Services Tax, R.S.C. ch. 45, § 295, as amended (1993) (Can.).

assessment, collection, and audit standards, thereby reducing the cost to administer and comply with both taxes.

Economies from harmonization of these rules can be achieved with either a European Community-style VAT or a BTT. Since the BTT is a period tax and the European Community-style invoice VAT is a transaction tax like the RST, states will more likely shift from an RST to a European Community-style VAT rather than to a BTT. On the other hand, if the federal VAT is a BTT, the states' costs to administer their RST's may not change.⁵⁴

If the Internal Revenue Service and state departments of revenue cooperate in developing litigation strategy, the costs of adding a federal VAT could be reduced further. These cost reductions can be achieved even if the federal VAT and the state RST bases are not harmonized.

D. Compliance Issues

If Congress imposes a new broad-based tax on consumption, the VAT may result in increased compliance costs to businesses subject to both the VAT and existing state RST's. This is especially true if the VAT is a European Community-style transaction form of consumption tax and the tax bases and reporting rules are different at the federal and state levels. The complexity at the check-out counter may be significant, particularly for retail businesses without automated cash registers. A business in this position may have to hire additional personnel, train existing employees, and purchase new equipment to handle the European Community-style VAT.

Coordination of tax bases, reporting requirements, collection procedures and assessment rules may significantly reduce the total cost of compliance with the two levels of tax on consumption. Adoption of a BTT rather than a European Community-style VAT may substantially reduce the costs of complying with the federal and state taxes, especially if the data for the BTT return can be taken from records maintained for income tax purposes.

Businesses may find it easier and cheaper to comply with a VAT that imposes a tax based on the nature of the goods or services sold, rather than on the status of the buyer (as a taxable or exempt person) or on the buyer's use of the goods or services (such as use in farming). The "status" distinctions, common under RST's, require sellers subject to RST's to obtain resale exemption certificates to substantiate their treatment of the sale as an exempt sale. This advantage of a VAT will disappear, however, if

54. See *infra* part IV.D. (discussing states' administrative costs associated with RST's if Congress enacts a federal BTT).

Congress grants VAT exemptions that depend on the status of the buyer or the buyer's intended use of the purchased item. To reduce compliance costs for a VAT, it is preferable for Congress to tax the sales and provide relief to eligible purchasers with tax rebates or refunds of excess input tax credits.⁵⁵

V. EFFECT OF COORDINATION

In a state with both state and local RST's, the state department of revenue and businesses subject to the RST already have experience with a coordinated sales tax regime. In some cases, the state and local tax bases are the same; in other cases the tax bases are different.

If Congress enacts a BTT, it is unlikely that states will replace their RST's with a broader-based state level BTT. States have relied on RST's for decades. Politically, it may be difficult for the states to make a radical change from such a transaction tax to this kind of consumption tax.⁵⁶ On the other hand, states may not feel politically threatened with the federal BTT operating side-by-side with the RST's because the BTT is imposed on business activity for each reporting period, not on individual transactions. Businesses will file returns for the federal BTT periodically, with the required data for the return taken largely from accounting records. Since the BTT is not separately stated on invoices, especially on a retailer's cash register receipts issued on sales to consumers, the public may not consider the BTT to be a sales tax. The BTT thus may not affect a state's ability to increase its RST rate.

If Congress enacts a European Community-style invoice VAT and the state RST's are not harmonized with the VAT, businesses subject to the federal VAT and one or more state RST's are likely to experience increases in compliance costs during the introductory period, principally from hiring additional personnel, training existing personnel, and purchasing new equipment to handle the new tax. States also may find that administrative costs will remain static or even increase if they rely on RST's that are not coordinated with a federal European Community-style invoice VAT. Audit costs may also increase if states must verify that businesses are accounting for sales in conformity with the state RST as opposed to federal VAT rules, especially if the states tax items that are exempted or zero-rated under the federal tax. These increased costs

55. This alternative also reduces the costs for government to administer the tax and audit returns.

56. It is more likely that a state may replace its income and other taxes on business with a state-level VAT similar to a BTT or a Michigan-style Single Business Tax in order to attract or retain businesses.

may be palatable if state RST revenue increases as a result of increased compliance flowing from the exchange of taxpayer information between the Internal Revenue Service and state revenue departments. Otherwise, states may resist the adoption of a federal European Community-style invoice VAT. It is generally assumed, however, that to make federal-state coordination of a VAT realistic, the federal government must impose a credit-subtractive VAT, such as a European Community-style invoice VAT.⁵⁷

If Congress enacts a European Community-style invoice VAT, a state that decides to coordinate its sales tax with the federal VAT can expand only its retail state tax base to coincide with the federal base. Alternatively, the state can replace its RST with a state multistage VAT imposed on the federal base.⁵⁸

If a state partially or fully coordinates its sales tax base with a federal VAT, it is not clear that the state's sales tax revenue would increase. Some commentators estimate that at least fifteen to twenty-five percent of state sales tax revenue is derived from RST's paid on business inputs.⁵⁹ If a state converts to a multistage invoice VAT and grants input credits for all tax paid on business purchases, the state sales tax base must increase substantially in order to maintain the prior level of revenue.

If states do not completely coordinate their RST's with a federal European Community-style invoice VAT, the costs for businesses to comply with a partially coordinated system may be approximately the same as complying with completely independent federal VAT and state sales tax systems. In particular, partial coordination will not reduce compliance costs if there are different federal and state tax bases, tax period rules, and tax reporting rules.

57. See MICHAEL H. WILSON, *TAX REFORM 1987: SALES TAX REFORM 47* (1987). For a discussion of various methods of coordinating a federal sales tax or VAT with state and local sales tax regimes, see McLure, Jr., *supra* note 41, at 1517.

58. There are other options not covered in this article. For example, Congress could impose a federal RST and encourage states to adopt the federal base for state and local RST's. Alternatively, states could adopt a uniform RST base and Congress could adopt the same base for a federal RST. In either case, the harmonized RST could be administered by the federal government alone, by the states only, or by both levels of government. See McLure, Jr., *supra* note 41, at 1527-29.

59. See JOHN F. DUE & JOHN L. MIKESSELL, *SALES TAXATION: SALES AND LOCAL STRUCTURE AND ADMINISTRATION 321 & n.2* (1983); *TREASURY TAX REFORM REPORT, VOL. 3* (1984). In Canada, estimates indicate that about one-third of provincial sales tax revenue is derived from the tax on business inputs. WILSON, *supra* note 57, at 51.

Congress and the states can reduce administrative and compliance costs of a federal and state tax on consumption if the two levels of government can agree that a single agency, federal or state,⁶⁰ will audit both returns and if they can agree upon a uniform litigation strategy. This kind of cooperation between the federal and state government may not be very realistic unless there is some understanding that both levels of government will receive funding for administration and both will have the authority and resources to hire personnel. States will not likely be willing to eliminate their audit staff and transfer these audit positions to the federal government unless they receive some benefits in return.

If a single agency collects both the federal VAT as well as a state RST or state VAT, a formula must be devised to allocate the revenue between the federal government and the states in the coordinated system.⁶¹ The allocations to the various states would differ dramatically depending upon whether the states are to receive revenue on the basis of the value added in the state (origin principle) or on the level of consumption in the state (destination principle).

If not all of the states with RST's adopt a coordinated state VAT, the states that chose not to harmonize may be pressured to do so in order to become more attractive to businesses. Businesses also may press for credits against state sales tax liability for state sales tax paid on their purchases. Even if a state replaces its RST with a European Community-style invoice VAT, however, there is no assurance that this system will give local businesses full input credit for state VAT paid on their purchases. Quebec, for example, harmonized its provincial sales tax, the Quebec Sales Tax, with the federal Goods and Services Tax but, for revenue reasons, the province restricted the allowance of input credits against the Quebec Sales Tax for the tax paid on purchases by businesses.

60. The state departments of revenue have decades of experience administering state and local sales taxes. If a single level of government administered the coordinated VAT, the states seem to be the natural choice. See Catherine Hubbard, *VAT Should Be State-Administered, Says Duncan*, 2 STATE TAX NOTES 472 (1992); see also Miller, *supra* note 44. The German experience with a VAT should be thoroughly investigated before the United States adopts a state administration of a federal VAT regime. In Germany, a national VAT is administered by subordinate units of government. It has been suggested that states may attempt to attract business by implementing a policy under which local businesses are treated more leniently on audits. In Canada, the Quebec province administers a largely harmonized federal-provincial VAT. Quebec's experience also should be pursued further.

61. For states with both state and local sales taxes, the allocation will be more complicated.

The Quebec experience with a coordinated federal-provincial sales tax base highlights a potential problem area if some but not all states coordinate. Quebec acceded to pressure and provided more favorable Quebec Sales Tax treatment to service providers that could shift operations to provinces that did not have an expanded provincial VAT and did not tax these services. For example, Quebec zero-rated financial services that were not taxed under sales taxes in other provinces.⁶² To recoup some of the lost revenue, Quebec imposed a separate tax, but at reduced rates, on paid-up capital of financial institutions, insurance premiums, and wages of financial institutions.⁶³

In states that do not impose RST's, revenue departments and businesses would not face dual sales tax administrative and compliance problems. Interestingly, during the debate in Canada over the enactment of the Goods and Services Tax, Alberta, the only province without a provincial sales tax, was the most outspoken opponent of the federal tax. The provincial aversion to a sales tax carried over to the national sales tax debate.

As an alternative coordination option, Congress could enact a federal VAT and require the federal government to serve as the collection agency for the states that adopt identical VAT's. The federal government would remit to the states their share of VAT revenue.⁶⁴ Again, a number of methods can be used to allocate this revenue. The federal government can allocate revenue to the states on the basis of the value added in each state (an origin principle). To make this option viable, businesses must identify the value added within each state. The federal government can allocate VAT revenue to the states on the basis of final consumption in their states.⁶⁵ Using this destination principle, businesses must identify the destination of sales.

Canada is relying on a "carrot and stick" approach to encourage provinces to coordinate their sales taxes with the federal Goods and Services Tax. The federal government has offered to collect provincial sales tax on imports for the provinces that harmonize their tax on goods with the Goods and Services Tax.⁶⁶ Without federal assistance at the border, the provinces find it is too costly to pursue numerous individual importers in order to collect this tax. The federal government also may

62. See R.S.Q. ch. 67, § 198(1) (1991) (Quebec).

63. See Quebec Budget Speech, Appendix A (May 14, 1992).

64. The VAT rate could be increased for local governments that piggybacked on the state VAT. This revenue could be remitted to the state for redistribution to the local government or it could be remitted directly to the local government.

65. See McLure, Jr., *supra* note 41, at 1529.

66. See Govt. of Canada, News Release No. 92-012 (Feb. 12, 1992).

provide technical assistance in order to encourage provinces to harmonize their Provincial Sales Tax with the Goods and Services Tax. In the area of technical assistance, the federal government may help the provinces draft the statutory revisions necessary to coordinate Provisional Sales Tax and Goods and Services Tax bases. Even though provinces will benefit from revenue increases resulting from an expansion of the tax base, as mentioned earlier, the provinces will suffer revenue reductions if they grant credits against provincial-level goods and services taxes for input tax on business purchases.⁶⁷ It has been estimated that approximately one-third of the Provincial Sales Tax revenue is raised from tax on business inputs. To assure provinces that they will not sustain revenue loss from the switch, the federal government may have to provide revenue guarantees.

Michigan imposes both an RST and the Single Business Tax, a VAT calculated under the addition method. The experience of the Michigan Department of Revenue and businesses subject to both the Michigan Retail Sales Tax and the Single Business Tax indicates that businesses can and do comply with a side-by-side transaction form of an RST and a VAT on business activity calculated in part from business records maintained for income tax purposes. Michigan's experience may indicate that a federal BTT and state RST's can realistically operate in tandem.

VI. STATE RECEPTIVITY TO A FEDERAL VAT

A state may favor or oppose a federal VAT depending upon the nature of the federal VAT, the degree to which the state relies on RST's for its revenue, and the federal government's proposed use of the revenue from the VAT. A state, for example, may be more inclined to support the enactment of a federal VAT if the revenue is used to finance programs currently funded in part by the state, such as Medicaid, thus freeing up scarce state resources for other needs or paving the way for tax cuts. A state may more strongly oppose a transaction tax, such as the federal European Community-style invoice VAT that clashes with its RST than a period tax, such as the federal BTT because it is not separately stated on sales invoices. A state with a high-rate RST may feel that its tax base will be threatened more by a federal European Community-style invoice VAT than a BTT because consumers may resist an increase in the combined rate of the separately stated RST and European Community-style invoice VAT more than the adoption of a federal BTT that is buried in the prices of goods and services.

67. See WILSON, *supra* note 57, at 51.

CONCLUSION

Whether Congress increases federal reliance on consumption taxes with increased excises like the energy tax or taxes on alcohol and tobacco, it seems inevitable that the federal government will be moving toward a broad-based federal tax on consumption. It is not too early for state and local government advisors and lobbyists, and for businesses that will be affected by a federal VAT operating side-by-side with state RST's to begin preparing for a national debate on a federal tax on consumption.

The form of a federal VAT operating along with diverse state RST's will affect government administration and business compliance costs. A BTT will cost less, but it does not easily accommodate exemptions (an advantage), would not permit multiple rates (another advantage), and may not permit precise border tax adjustments. The BTT also will create transition problems if Congress adjusts the rate.

If the states were inclined to harmonize their RST's with a federal VAT, it may be more likely to occur with a European Community-style invoice VAT than a BTT because the invoice VAT looks more like a sales tax. It may not be very realistic, however, to assume that states will harmonize their RST's with any form of federal VAT, especially if harmonization will produce a loss of jobs for state tax personnel, unless the states receive a significant economic incentive to do so.

State and local governments' support or opposition to a federal VAT ultimately will depend not only on the proposed form of VAT, but on such factors as the state's RST rate and the kind of federal programs that will be financed with the VAT revenue. Public perceptions of the VAT also may influence the attitude of state and local governments toward a federal VAT. For example, if the VAT is a hidden BTT that is not added to the consumer's cost at the check-out counter, the BTT may not affect the state and local governments' ability to raise revenue from its RST.

Finally, assuming state and local RST's continue to operate basically in their existing form, a BTT would be more compatible and less costly to administer and compliance costs would be lower than a European Community-style invoice VAT. The reason is that a BTT is hidden and therefore does not clash with the separately stated RST's. Is it, however, good public policy to choose a particular form of VAT because it does the best job of masking its identity as a tax on consumption?