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THE DIGITAL VAT (D-VAT)

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The Digital VAT (D-VAT)¹

Richard Thompson Ainsworth

The most sustained U.S. tax policy debate of the past 30 years concerns proposals to replace and/ or supplement the Federal Income Tax with a consumption tax.² Public finance economists and legal tax policy scholars challenged³ and defended⁴ the current income tax system on grounds of fairness,⁵ efficiency,⁶ and simplicity.⁷

¹ Adjunct Professor of Law, Boston University School of Law; Visiting Professor, Ritsumeikan University. B.B.A., Boston College, 1971; J.D., Suffolk Law School, 1982; L.L.M., Boston University Law School, 1990. The author would like to thank the following individuals for helpful comments on earlier drafts of this paper, for comments made in developing the original D-VAT proposal for the President's Advisory Panel on Federal Tax Reform, for discussions on the D-VAT in general, and for assistance in locating historical resources. Hiroki Akioka, Reuven Avi-Yonah, Graeme Cooper, Sandra Hadler, Walter Hellerstein, Oliver Oldman, Carlo Pinto, Carlos Silvani, and Victor Thuronyi. The Digital VAT (D-VAT) was first proposed to the President's Advisory Panel on Federal Tax Reform. The proposal responded to the Panel's second request for comments. Richard T. Ainsworth, *The Digital VAT: A Proposal for the President's Advisory Panel on Federal Tax Reform*, President's Advisory Panel on Federal Tax Reform (Apr. 30, 2005) at <http://comments.taxreformpanel.gov/> (on file with author).

² The role of the U.S. Treasury in initiating this debate has been significant. Many of the central issues gained prominence through the 1977 tax reform study, U.S. DEP'T. OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977). This study called for integration of the corporate and individual income taxes, capital gains taxation at full rates (after adjusting for inflation), and broadening the tax base. In 1984 the Treasury put forward a cash flow or consumption-based income tax in U.S. DEP'T. OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTRH (1984). The 1984 study examined a "pure income tax," one that taxed capitals gains at full, normal rates, had true economic depreciation allowances with inflation adjustments for receipts and inventories, partial integration of corporate and individual income taxes through a deduction for corporate tax of one-half of the dividend paid, a broadened base and lower rates. In 1984 a second, revised edition of the BLUEPRINTS (1977) was published. DAVID F. BRADFORD AND THE U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM (2d ed. 1984).

³ Critics can be classified by their solutions. MICHAEL J. GRAETZ, THE DECLINE (AND FALL ?) OF THE INCOME TAX (1997) (chronicling the failures of the income tax and proposing a VAT); ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2nd ed. 1995) (examining flaws in the current system and proposing a hybrid consumption tax with a subtraction VAT on business income and a wage tax on individuals); EDWARD J. MCCAFFERY, FAIR NOT FLAT: HOW TO MAKE THE TAX SYSTEM BETTER AND SIMPLER (2002) (examining present system and proposing a hybrid national retail sales tax).

⁴ Richard A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44 (1967) (Presenting the classic theoretical defense of a concept of income. The importance of accretion within this definition is defended as a critical facet of tax base measurement. Musgrave's defense directly responds to the *ad hoc* approach to income definition advanced by the comprehensive tax base advocate Boris Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 89 HARV. L. REV. 925 (1967); John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CAL. L. REV. 2095 (2000) (McNulty provides an analytical and comparative defense of the current accretion-based income tax. Comparing the present system to each of the contemporary proposals for change, McNulty finds the present system to be superior on equity, fairness, simplicity and administrability grounds. For McNulty, the case for change has not yet been made); Jerome Kurtz, *Two Cheers for the Income Tax*, 27 OHIO N.U. L. REV. 161, 162 (2001) (A former Commissioner of the IRS, Katz argues "that the income tax is basically the fairest form of taxation, and that change to a new system is extraordinarily risky and administratively unmanageable. Even if some other form of tax, probably some form of consumption tax, might be proven to have economic advantages in the long run, we cannot get there from here.").

⁵ In essence the fairness argument favoring a consumption tax is that an accretion model taxes too broadly. It burdens productive activities, specifically the receipt and realization of income or gain. Investments are

This debate over revamping the national taxing scheme has not been argued purely in the academic forum. Concrete legislative proposals have been advanced for a

overtaxed. A cash-flow or consumed income tax on the other hand, does not tax saved income. Thus, it encourages saving, investment and productivity. A consumption tax treats people equally (fairly) when viewed from a lifetime perspective. BLUEPRINTS (1984), *supra* note 2, at 39-45, 48 (“The argument has been made that the choice is *not* between a tax favoring the rich (who save) and the poor (who do not), as some misconceive the consumption tax, and a tax favoring the poor over the rich by the use of progressive rates, as some view the income tax. The choice is between an income tax that, *at each level of endowment*, favors early consumers and late earners over late consumers and early earners and a consumption tax that is *neutral* between these two types of individuals.”); William D. Andrews, *A Consumption or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1167 (1974) (“The most sophisticated argument in favor of a consumption-type tax is that the lesser burden of a deferred tax is more appropriate because it ultimately imposes more uniform burden on consumption, wherever it may occur, than does an accretion-type tax.”); *Contra* Alvin C. Warren, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 947 (1975) (Targeting Andrews’ fairness argument alone, Warren assesses the neutrality of the cash-flow tax. His chief concern is that unlike an accretion-type income tax, a cash-flow tax allows income from the wealthy to escape taxation.); Alvin C. Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?* 89 YALE L. J. 1081 (1980) (reaffirming and elaborating on the position taken in opposition to Andrews earlier); Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961, 967 (1992). (Also targeting the fairness argument alone, Fried considers both cash-flow and yield-exemption types of consumption taxes. Fried isolates what she considers to be the three main fairness argument favoring consumption taxes, and concludes”... the fairness arguments for a consumption tax that have dominated the tax literature do not withstand scrutiny.”).

⁶ Laurence J. Kotlikoff, *The Case for the Value-Added Tax*, 39 TAX NOTES 239, 241 (April 11, 1988) (“A variety of studies, including *Dynamic Fiscal Policy* written by myself and Alan Auerbach, have shown that taxing consumption is more efficient than taxing wage income by itself, capital income by itself, or both capital and wage income through an income tax ... taxing consumption through a VAT is equivalent to taxing current and future labor income plus taxing initial wealth.”); *See* Alan J. Auerbach, *Measuring the Impact of Tax Reform*, 49 NAT’L TAX J. 665, 669 (December 1996) (Auerbach notes that these kinds of efficiency measurements are difficult. “To determine the impact of a tax reform, it is necessary not only to develop theories of that tax reform’s impact, but to test the theories. The lack of controlled experiments and of the ability to measure economic changes limits the scope for performing such evaluations.”); Alan J. Auerbach & Joel Slemrod, *The Economic Effects of the Tax Reform Act of 1986*, 35 J. ECON. LIT. 589, 620 (March, 1997) (Auerbach undertook to measure efficiency improvements due to the TRA86’s reform that moved the US closer to a consumption base. He found efficiency gains, and found that “... most analyses concluded that TRA86 improved the efficiency of the tax system, although the magnitude of the improvement was disputed.”); Andrews, *Consumption or Cash Flow*, *supra* note 5, at 1165-1177.

⁷ HALL & RABUSHKA, *THE FLAT TAX*, *supra* note 3, at 52-82 (Among the tax reform proposals that would still require a large number of individual returns Hall and Rabushka make the most popularly appealing “simplification” argument. They suggest that a single, flat rate consumption-type tax can be imposed with returns not much bigger than post cards.); Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the US Tax System*, 112 YALE L.J. 261, 299 (November, 2002) (Professor Graetz would simplify income tax filing by financing a standard deduction of \$100,000 through the adoption of a credit-invoice VAT. The “... principal advantage [of his proposal] would be its major simplification of the tax lives of the American people. My plan would eliminate more than 80% of the income tax returns that currently are filed each year and would allow substantial simplification of the limited income tax that would remain.”); Andrews, *Consumption or Cash Flow*, *supra* note 5, at 1149 (“A consumption-type tax requires deductions and additions to eliminate savings and dissavings. But these, being based solely on money transactions, are incomparably simpler than either making adjustments to include unrealized appreciation under a true accretion-type tax or living with the complexity and distortion that results from the existing hybrid treatment of accumulation. ... capital transactions are treated on a simple cash flow basis. Investments are simply deducted when made ... All that is required is to separate business and investment activities on the one hand from personal consumption on the other, as under present law, ...”).

national retail sales tax,⁸ a European-style Value Added Tax,⁹ as well as a whole host of what David Bradford calls “the two-tiered consumption taxes.” These “two-tiered” taxes commonly join a business level subtraction VAT with either a “yield-exemption” (pre-paid) or a “consumed income” (cash flow/ post-paid) tax at the individual level.¹⁰

From early on, a characteristic of this debate has been the marginalization of practical questions about the “fit” of these proposals both internationally¹¹ and sub-

⁸ Each of the following proposes a national retail sales tax: National Retail Sales Tax, H.R. 3039, 104th Cong. (1996) (proposed by Congressman Dan Schaefer, CO); H.R. 2001, 105th Cong. (1998) (proposed by Congressman Dan Schaefer, CO); H.R. 1467, 106th Cong. (1999) (proposed by Congressman W.J. “Billy” Tauzin, LA); The Fair Tax Act, H.R. 25, 108th Cong. (2003) (proposed by Congressman John Linder, GA); S. 1493, 108th Cong. (2003) (proposed by Senator Saxby Chambliss, GA).

⁹ Each of the following proposes a European-style credit-invoice VAT: The Tax Restructuring Act of 1979 and 1980, H.R. 5665, 96th Cong. (1979) and H.R. 7015, 96th Cong. (1980) (proposed by Congressman Al Ullman); The Revenue Restructuring Act of 1996, H.R. 4050, 104th Cong. (1996) (proposed by Congressman Sam Gibbons, FL); The National Health Insurance Act, H.R. 16, 106th Cong. (1993) and S. 237, 104th Cong. (1993) (proposed by Congressman John D. Dingle, MI and Senator Ernest F. Hollings, SC to finance this health plan); The War Financing Act of 2003, S. 112, 108th Cong. (2003) (proposed by Senator Ernest F. Hollings, SC to finance the Iraq war).

¹⁰ Each of the following proposes a business level subtraction VAT with a yield-exemption (pre-paid) type consumption tax at the individual level: Freedom and Fairness Restoration Act of 1994, H.R. 4585, 103rd Cong. (1994) (proposed by Congressman Richard K. Arme, TX); The Flat Tax, S. 488, 104th Cong. (1995) (proposed by Senator Arlen Specter, PA); The Tax Simplification Act of 2003, H.R. 3060, 108th Cong. (2003) and S. 1040, 108th Cong. (2003) (proposed by Congressman Nick Smith, MI and Senator Richard C. Shelby, AL); The Flat Tax Act of 2003, S. 907, 108th Cong. (2003) (proposed by Senator Arlen Specter, PA).

Each of the following proposals advocates a business level subtraction VAT with a consumed income type (“cash-flow,” or post-paid) consumption tax at the individual level: The USA Tax of 1995, S. 722, 104th Cong. (1995) (proposed by Senators Sam Nunn, GA and Pete V. Domenici, NM); the Simplified USA Tax of 2003, H.R. 269, 108th Cong. (2003) (proposed by Congressman Phil English, PA).

¹¹ “Hybrid” consumption tax advocates, those following Hall-Rabushka’s “flat tax” design, are caught in a tax dilemma; GATT/WTO conformity or a doubling of transfer pricing enforcement problems. Stephen E. Shay and Victoria P. Summers, *Selected International Aspects of Fundamental Tax Reform Proposals*, 51 U. MIAMI L. Rev. 1029 (July 1997) (pointing out the first horn of the dilemma, that conformity with GATT/WTO requires adoption of an origin-based hybrid tax); Reuven, S. Avi-Yonah, *Risk, Rents, and Regressivity: Why the United States Needs Both an Income Tax and a VAT*, 37 TAX NOTES INT’L 1651, 1661-62 (Jan. 10, 2005) (identifying the second horn of the dilemma, that it is only a destination-based hybrid tax that will avoid having transfer pricing problems both on inbound and outbound transactions); Reuven S. Avi-Yonah, *From Income to Consumption Tax: Some International Implications*, 33 SAN DIEGO L. REV. 1329, 1339-43 (1996) (initial and most detailed presentation of the double transfer pricing problem).

Aside from the impossibility of making required border adjustments for GATT/WTO conformity in a destination-based hybrid system, there are problems with the taxability of cross-border services, issues with the financial services industry generally, as well as direct investment in the US and overseas investment decisions of US multinationals. Further complications arise from the likelihood that the current tax treaty network may not survive the abolition of the income tax, something that is a problem for many proposals. *Id.* at 1343-53. Michael J. Graetz, *International Aspects of Fundamental Tax Restructuring: Practice or Principles*, 51 U. MIAMI L. Rev. 1093, 1107 (July, 1997) (discussing “American exceptionalism,” the Shay-Summers analysis generally and questioning the wisdom of “...adopt[ing] a form of consumption tax untried elsewhere in the world instead of moving toward a standard form of value added tax or retail sales tax. The practical and political international advantages of the standard form should by now be obvious.”).

nationally.¹² The advocates of change tend to narrow their focus.¹³ Although great efforts are devoted to gathering intellectual support from economic theorists and political

¹² Although the proposals themselves have tended to ignore the issue of how a federal change will “fit” with the currently operating state and local tax systems, this oversight is not a characteristic of the commentary. However, a further characteristic of this commentary is that it is reactive, not proactive in nature. Almost all studies emphasize: (1) the natural dependency of the state and local tax systems on the federal, (2) the complexity that federal change will bring to the state and local systems, and (3) the scope of the adjustments that will be required (at the state and local levels) to make tax systems even appear to work harmoniously. No state and local commentary develops new recommendations for federal reform from within the context of their expertise. The commentary is linear. It takes one or more federal reforms, delves into the difficulties and complexities that will be encountered if a reform is adopted, and then concludes that the *status quo* is preferable. What the commentary never does is circle back on a federal proposal, applying the knowledge and insights derived from the state and local systems to point out a better way. Consequently the application of modern technology to the complexities of adding a federal level consumption tax to the current tax landscape is never considered.

Ronald Alt, Sr. & Harley T. Duncan, *The Impact of Federal Changes on State Tax Systems*, 2 STATE TAX NOTES 308 (March 2, 1992) (strongly underscoring the state-federal piggyback relationship, explaining how a state desire for “simplicity and compliance” makes it difficult for states to “go-it-alone” even when federal changes are minor); Douglas Holtz-Eakin, *Fundamental Tax Reform and State and Local Governments*, 49 NAT’L TAX J. 475 (1996) (considering the four major threads in federal reform -- RST, VAT, hybrid subtraction VATs with either consumed income or yield exemption taxes – and pointing to the negative impact that each of these would have on state revenues and on the quality and extent of state services); Douglas Holtz-Eakin, *Consumption-Based Tax Reform and the State-Local Sector: A Study for the American Tax Policy Institute*, 13 AM. J. TAX POL’Y 115, 132 (1996) (presenting an impact assessment of federal consumption tax proposals on state services, concluding that “[f]undamental tax reform at the federal level is simultaneously fundamental tax reform for all state and local governments.”); Matthew N. Murray, *Would Tax Evasion and Tax Avoidance Undermine a National Retail Sales Tax?* 50 NAT’L TAX J. 167, 177 (March 1997) (looking at only the national retail sales tax proposals, and concluding that the necessarily high tax rates of a federal RST would increase avoidance and evasion incentives and promote an underground economy. No suggestions for facilitating this transition are developed, no preferences among existing proposals is offered, and no firm conclusions are expressed because, “... the lack of experience in administering a high-rate, broad-based indirect tax means that it is impossible to say whether evasion and avoidance would be more or less pronounced under an NRST than under and income tax (or VAT) regime.”); John L. Mikesell, *The American Retail Sales Tax: Considerations on their Structure, Operations, and Potential as a Foundation for a Federal Sales Tax*, 50 NAT’L TAX J. 149, 163 (March 1997) (considering in detail the proposals for national retail sales taxes, rejecting a federal RST in favor of a VAT. “Attempting to levy a national tax as a supplement to state sales taxes would be folly. There is simply insufficient uniformity in what states tax and exclude to allow a linked federal tax to be fair and efficient. On the other hand, a separate national sales tax would complicate the work of state collection, increase the problems that businesses face in complying with multiple tax bases, and tax on a base not equal to household consumption. Other countries probably have it right when they select VATs ...”).

Two significant and detailed studies, one by Charles McLure the other by Robert Strauss take up Mikesell’s VAT suggestion. Both vote against a federal VAT because of the state and local impact. They take different routes, but reach similar conclusions: all the federal VAT proposals have such highly complex impacts that the *status quo* is preferable. In their minds the case has not yet been made for a federal VAT. Charles E. McLure, Jr., *State and Local Implications of a Federal Value Added Tax*, 38 TAX NOTES 1517, 1526-30 (March 28, 1988) (focusing on the impact that a federal consumption tax would have on state sovereignty, McLure presents a range of conceivable state-federal consumption tax systems. No combination is preferred. Nine permutations are described. An accompanying chart theorizes advantages and disadvantages for each permutation. The options considered are: an uncoordinated dual RST system; a coordinated federal-state RST system; coordinated state-federal collection of RST; a state RSTs combined with a federal credit-invoice VAT; a state RST combined with a federal subtraction VAT; a state surcharge to a federal VAT; state collection of the federal VAT; state-federal tax sharing; state-federal revenue sharing. Technology-intensive solutions to the myriad of compliance problems presented are not

philosophers,¹⁴ much less effort is expended to demonstrate system-wide (local-state-federal) tax harmony. As a result, proposals tend to be stand-alone (federal-only)

considered.); Robert P. Strauss, *Impact of Federal VAT on State and Local Sectors* (pts. 1 & 2), 82 TAX NOTES 1173 (Feb. 22, 1999), 82 TAX NOTES 1343, 1363 (Mar. 1, 1999) (considering much the same ground that McLure does, and with a similar focus: the impact of a federal credit-invoice or a subtraction VAT on state and local revenues and administrations discourages adoption. Path dependencies (cultural and institutional resistance to change) suggest to him that the states might not follow federal changes. "... [T]he difficulties for the states of fundamental federal tax reform loom quite large ... the complexity for taxpayers and tax administrators, and fiscal uncertainty for federal and state budget official could substantially increase in our federal system without attaining the goal of a federal consumption tax. Instead, we might find ourselves with the remnants of a federal corporate and individual income tax coupled with a new federal consumption tax, and a patchwork of state systems that also reflect the old and the new." As with McLure, Strauss' insights lead back to the *status quo*, not to new solutions.) See also Robert P. Strauss, *Implications of a Federal Consumption Tax for State and Local Tax Administration*, 73 TAX NOTES 605 (November 4, 1996); Robert P. Strauss, *Administrative and Revenue Implications of Alternative Federal Consumption Taxes for the State and Local Sector*, 14 AM. J. TAX POL'Y 361 (1997) (developing the administrative argument in further support of the policy analysis presented by McLure and Mikesell).

Federal studies are different. Rather than engage the federal-state issue, they tend to ignore the harmonization problem altogether. Seen within this context, it sometimes appears that the real aim of the state and local commentary has been to provide a counterweight to these shortsighted federal studies. JOINT COMMITTEE ON TAXATION, IMPACT ON STATE AND LOCAL GOVERNMENTS AND TAX-EXEMPT ORGANIZATIONS OF REPLACING THE FEDERAL INCOME TAX, (JCS 4-96, April 30, 1996) *available at* <http://www.house.gov/jct/s-4-96.pdf> (considering the impact of a national retail sales tax, a VAT, the Flat Tax, a cash-flow tax, and a pure income tax on (1) state and local bonds, (2) the services provided by state and local governments and (3) the operation of tax exempt entities, expressing not preference and offering no analysis of the administrative issues of state-federal coordination). CONGRESSIONAL RESEARCH SERVICE, THE FLAT TAX, VALUE-ADDED TAX, AND NATIONAL RETAIL SALES TAX: OVERVIEW OF THE ISSUES 9-10 (RL 32603, Sept. 24, 2004) (ignoring the state-federal coordination issues with only five sentences directed at the states, and concluding that, "[s]tates would either face increased enforcement costs and loose revenues if they retained current rules, or they would have to adapt their systems to the federal system.").

¹³ Steven A. Bank, *The Progressive Consumption Tax Revisited*, 101 MICH. L. REV. 2238, 2241 and 2254 (Reviewing the three occasions in the last century where significant efforts were made to replace the income tax with a progressive consumption tax: (1) soon after the end of World War I, approximately 1921, (2) at the beginning of World War II, approximately 1942, and (3) during the mid-1990's. "In each instance, despite many contemporary scholars' backing, the proposal was dismissed with little debate. ... Each proposal appeared too complex and was considered inequitable either because it used a progressive rate or failed to include some income in the base." In Bank's mind this history leads to a political expediency decision, one that encourages proposals with limited detail and narrow focus. These kinds of proposals provide the narrowest of openings for critics and opponents.)

¹⁴ For example, consider the wide range of theorists marshaled by Andrews and Warren on the relative fairness of the income versus the consumption tax. Andrews and Warren argue about the relevance of Thomas Hobbes' concern that a tax on accumulation is taxing people on their contributions to society, to the common-wealth. Consumers, those people taking from the common-wealth, not those who contribute to the common good should according to the *Leviathan* bear the tax. (Andrews, *Consumption or Cash Flow*, *supra* note 5, at 1166 n.116). Warren agrees, but says that this, "hardly demonstrates that there is no reason to tax accumulation." (Warren, *Fairness and a Consumption-Type or Cash Flow*, *supra* note 5, at 933 n.12). Andrews anticipates this argument and responds with John Stuart Mill's discrimination argument -- an accretion tax is a double tax on savings. (Andrews, *Consumption or Cash Flow*, *supra* note 5, at 1168). Warren accepts the observation, but again provides examples where he concludes that the impact, "... seems real enough, [but] it is probably overstated ..." (Warren, *Fairness and a Consumption-Type or Cash Flow*, *supra* note 5, at 937).

propositions. The theoretical analysis in supports a federal consumption tax therefore tends to consider things from the “top-down,” rather than the “bottom-up.”

Integrated legislative proposals that work to maximize the “administrative fit” of a federal level consumption tax with existing sub-national consumption taxes are rare.¹⁵ The national retail sales tax proposals go furthest in this direction, in large part because they rely on state enforcement expertise. But even here the “fit” is a forced one. Harmonization comes about not by accommodation, but by imposing changes on state and local administrations. The mechanism used is commonly a direct subsidy, or an offer of free federal enforcement if local laws are conforming. Even though the synergistic benefits of federal-state harmonization can be considerable, the emphasis has been on deriving these benefits by imposing uniformity on the states, rather than

And so it goes in a wide ranging theoretical discussion that references the works of NICHOLAS KALDOR, *AN EXPENDITURE TAX* (1955) (cited by Andrews, *Consumption or Cash Flow*, *supra* note 5, at 1117 n.7; 1143 n.69; 1160 n. 108; 1145 n. 72; 1165 n.114; 1168 n. 122; and Warren, *Fairness and a Consumption-Type or Cash Flow*, *supra* note 5, at 934 n.15; 935-36 n. 21; 942 n. 41; 943, n.44); IRVING FISHER AND HERBERT FISHER, *CONSTRUCTIVE INCOME TAXATION* (1942) (cited by Andrews, *Consumption or Cash Flow*, *supra* note 5, at 1117 n.7; 1124 n.18); ARTHUR CECIL PIGOU, *A STUDY IN PUBLIC FINANCE* (1949) (Andrews, *Consumption or Cash Flow*, *supra* note 5, at 1117 n.7; 1149 n.81); WILLIAM S. VICKREY, *AGENDA FOR PROGRESSIVE TAXATION* (1947) (cited by Andrews, *Consumption or Cash Flow*, *supra* note 5, at 1117 n.7 and Warren, *Fairness and a Consumption-Type or Cash Flow*, *supra* note 5, at 936 n.21) and Alfred Marshall, *The Equitable Distribution of Taxation*, (1917) in *MEMORIALS OF ALFRED MARSHALL*, (Alfred Pigou ed., 1925) (cited by Andrews, *Consumption or Cash Flow*, *supra* note 5, at 1117 n.7).

The theoretical centerpieces of the Andrews-Warren debate are Haig-Simons formulation that income equals consumption plus savings and the Cary Brown theorem. Haig-Simons allows both scholars to compare income and consumption taxes. Robert M. Haig, *The Concept of Income – Economic and Legal Aspects*,” in *ECONOMICS OF TAXATION* 54 (1959) (cited by Andrews, *Consumption or Cash Flow*, *supra* note 5, at 1114 n.4); HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* (reprint, University of Chicago Press 1965) (1938) (cited by Andrews, *Consumption or Cash Flow*, *supra* note 5, at 1114 n.2; 1114, n.4; 1115, n.5 and 6; 1119, n.9; 1123, n.15; 1147 n. 76 and Warren, *Fairness and a Consumption-Type or Cash Flow*, *supra* note 5, at 931, n.3).

The Cary Brown theorem allows cash-flow and consumed income proposals to be contrasted. It holds that a consumption tax is equivalent to an income tax that exempts income from capital (in a world where [1] individuals consume all of their income during their lifetime, and [2] the interest rates and tax rates remain constant.) E. Cary Brown, *Business-Income Taxation and Investment Incentives*, in *INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN* 300-316 (Lloyd A. Metzler ed., W.W. Norton, 1948) *reprinted in* *AMERICAN ECONOMICS ASSOCIATION, READINGS IN THE ECONOMICS OF TAXATION* 525 (Richard A. Musgrave and Carl S. Shoup eds., R.D. Irwin 1959) (cited by Andrews, *Consumption or Cash Flow*, *supra* note 5, at 1127, n.22).

¹⁵ None of the “two-tiered” consumption taxes, and none of the value added tax proposals allow businesses to deduct state and local income, property or sales taxes. Neither do they expressly consider the “piggy-backing” of state consumption taxes on the federal tax. There are academic, but not legislative proposals for dual-VATs. They are modeled on foreign VATs that have federal-level VATs coordinated with sub-national VATs. The Canadian and Brazilian examples are the most commonly cited. Avi-Yonah, *Risk, Rents, and Regressivity*, *supra* note 11, at 1665 & n.55. Alan Schenk, *A Federal Move to a Consumption-Based Tax: Implications for State and Local Taxation and Insights from the Canadian Experience*, 3 *STATE & LOCAL TAX LAW* 89, 111-117 (1998) (specifically recommending the dual-VAT Canadian model for the US); Richard M. Bird & Pierre-Pascal Gendron, *Dual VATs and Cross-Border Trade: Two Problems, One Solution?* 5 *INT’L TAX & PUB. FIN.* 429 (1998) (generally discussing VAT in federal systems). The only legislative proposals that consider federal-state integration are in the national RST category, where the states are looked to for administrative assistance with the national RST. See discussion *infra* Part III.

designing a federal proposal that “fits,” or accommodates state and local systems. Why is the “fit” of these proposals not a critical concern at the outset?¹⁶

The answer may lie, in part, in the size of the problem. There are at least 7,588¹⁷ discrete retail sale tax (RST) jurisdictions in the US. Each jurisdiction’s RST tends to balance, in a unique way, local revenue needs with a local sense of what is considered a “fair” way to collect it.¹⁸ These taxes reflect a local political sense of what is “fair,” not necessarily an abstract, or theoretical sense of what is “fair.” Thus, local laws most likely do not implement Thomas Hobbes’ idea that a fair tax is imposed on those who *take* from the commonwealth, not those who *contribute* to it. Similarly it is improbable that local taxes are designed to be sensitive to John Stuart Mill’s perception of the double taxation of investment income. “Fairness” in the local political consciousness is tied more to what is “workable” in the mind of the voting populace. This may vary somewhat from abstract, or theoretical “fairness.” As a result, there are very probably thousands of “fairness formulas” in operation in the US, and because they are “methods tried and true,” these formulas tend to be resistant to change.¹⁹

The reality of the federal-state consumption tax integration problem is amplified when one considers that sub-national consumption taxes in the US are: (a) imposed on non-harmonized bases,²⁰ (b) measured at non-uniform rates,²¹ and (c) implemented

¹⁶ State tax administrators are asking for consideration from the architects of federal reform. *E.g.*, Michael Mazerov & Dan Bucks, *Federal Tax Restructuring and State and Local Governments: An Introduction to the Issues and the Literature*, 33 SAN DIEGO L. REV. 1459 (Fall, 1996) (Mazerov, Director of Policy Research, and Director of Information for the Multistate Tax Commission, and Bucks, Executive Director of the Multistate Tax Commission, set out the MTC Congressional testimony, and criticize each of the proposals before Congress in the late 1990s for not considering the impact on the states. They offer no alternatives, and strongly defend the *status quo*.)

¹⁷ This figure is based on a recent count with the best available information, and represents 47 state level jurisdictions, including Washington, D.C. The figure is composed of 1,732 counties, 5,571 cities, and 229 districts. At one extreme is Texas with 1,370 taxing jurisdictions (124 counties, 1,141 cities, and 104 districts in addition to the state itself), and at the other extreme are states like Connecticut, Hawaii, and Maine where there is only one taxing jurisdiction at the state level.

¹⁸ Walter Hellerstein, *U.S. Subnational State Sales Tax Reform: The Streamlined Sales Tax Project*, 6-8. (International Tax Dialogue VAT Conference, Rome, Italy, Mar. 14-15, 2005) at

<http://www.itdweb.org/VATConference/Pages/Home.aspx>. (There are “... seemingly infinite variations among the individual state sales tax bases [that] ... respond to a myriad of different local political and economic concerns ... [that turns] a simple levy into a tax of Byzantine complexity with virtually no interstate harmony.”); Mikesell, *The American Retail Sales Tax*, *supra* note 12, at 152 (“Although states tend to copy law from their neighbors, no state sales tax exactly matches any other and the different structures take dramatically different shares of their state economies.”).

¹⁹ Strauss, *Impact of Federal VAT*, *supra* note 12, at 1357-63 (discussing the tendency of government organizations to change slowly, and applying this observation to the changes needed in both state and federal tax administrations when implementing a federal VAT); *Cf.* Lucian A. Bebchuk & Mark. J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 *Stan. L. Rev.* 127 (1999) (developing the theory of path dependencies in the context of corporate governance).

²⁰ STREAMLINED SALES TAX PROJECT, CLOTHING AND RELATED ITEMS DISCUSSION PAPER 1-2 (Nov. 22, 2000) at <http://www.streamlinedsalestax.org> (presenting a somewhat famous example of non-harmonized state tax bases, the Discussion Paper considers eight states [Connecticut, Massachusetts, Minnesota, New Jersey, New York, Pennsylvania, Rhode Island, and Vermont], and considers a pair of gloves with fur trim priced at \$120, where the fur has a value of 55% of the total, then the gloves would be:

- taxable in New Jersey, based on the fur content;

through a seemingly random collection of destination and origin-based sourcing conventions.²² Business and government have long wanted to simplify, standardize and harmonize the state and local RSTs, but have not been very successful.

The *Streamlined Sales and Use Tax Agreement* (SSUTA) is the first real effort to bring about this simplicity, standardization, and harmonization.²³ Some success has been recorded, but resistance to change remains strong in many quarters.²⁴ Strangely, no federal consumption tax proposal has considered using concepts developed in the SSUTA debates to devise a comprehensive consumption tax that would meet both state and federal needs in a shared fashion.

What explains this lack of inquiry into inter-governmental synergies? Perhaps the national planners have just been too interested in abstract theory, the issue of the conceptual superiority of an income tax over a consumption tax? Then again, perhaps it is the scope of the problem?²⁵ It is certainly simpler to focus on one large change at federal level, than to grapple with the challenge of engineering a cooperative system that would accommodate the needs of 7,588 inter-related sub-national tax systems.²⁶

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- exempt in Minnesota and Pennsylvania, because the fur content is below the exclusion threshold;
 - taxable in Connecticut, because the price exceeds \$50;
 - taxable in New York and Vermont, because their price exceeds \$110;
 - exempt in Massachusetts, because their price falls below the exclusion threshold;
 - exempt in Rhode Island which has no exclusion threshold.)

²¹General sales tax rates vary from a high of 7% to a low of 2.9%. The vast majority falls between the 4.5% and 6.5% range. However the widespread adoption of local sales taxes in addition to the state level tax elevates this range to between 5% and 10%. 2005-2 STATE TAX GUIDE (CCH) ¶ 60-100.

²² The following states have at least one local jurisdiction imposing a retail sales tax on origin principles: Arizona, Arkansas, California, Illinois, Mississippi, Missouri, New Mexico, Ohio, Pennsylvania, Tennessee, Texas, Utah, Virginia and Washington.

²³ Hellerstein, *U.S. Subnational State Sales Tax Reform*, *supra* note 18, at 8 (“Throughout most of its 70-year history, there has never been a concerted movement to harmonize the US subnational sales tax on a multistate basis.”).

²⁴ Compare NEW HAMPSHIRE SENATE JOINT RESOLUTION 2, A RESOLUTION URGING CONGRESS TO REJECT THE STREAMLINED SALES TAX PROJECT (a February 2005 joint resolution (S.J.R. 2) urges the N.H. congressional delegation to oppose federal legislation that would authorize Streamlined Sales Tax states to require remote sellers to collect and remit sales tax) with SOUTH DAKOTA SENATE CONCURRENT RESOLUTION 5, A CONCURRENT RESOLUTION, URGING THE MEMBERS OF THE SOUTH DAKOTA CONGRESSIONAL DELEGATION TO SPONSOR AND SUPPORT THE STREAMLINED SALES AND USE TAX ACT (a February 2005 resolution (S.C.R. 5) urging the South Dakota Congressional delegation to do just the opposite).

²⁵ Avi-Yonah, *Risk, Rents, and Regressivity*, *supra* note 11, at 1665 (responding that the retail sales tax is an outmoded, useless system that is, “... hopelessly broken and should not be accommodated... [it is] an old tax, adopted in the 1930’s by most states to alleviate the cyclical nature of the income tax during the Depression.... The rise of e-commerce should prompt most states to abandon their obsolete RSTs in favor of VATs, which could be collected by the federal government as a ‘piggyback’ on the federal tax [as is done in several other federal countries.]”).

²⁶ Steven A. Bank, *Taxation: The Progressive Consumption Tax Revisited*, 101 MICH. L. REV. 2238, 2255 (May 2003) (reviewing MCCAFFERY, FAIR NOT FLAT, *supra* note 3) (Placing McCaffery’s book within the historical context of earlier efforts to enact a national consumption tax, Banks notes that, “In *Fair not Flat*, McCaffrey’s most savvy gambit on the complexity issue has been to limit the details of his proposal. Unlike in 1942 and 1995, when the extensive progressive consumption tax proposals were susceptible to opponents’ criticisms regarding the proposal’s apparent complexity, *Fair not Flat* is more descriptive of the

This article works to solve that problem by proposing a federal level Digital VAT (D-VAT). It argues for a technology-intensive modern VAT on a comprehensive base following a European credit-invoice, destination model. The major premise of this proposal is that the application of modern technology within a credit-invoice VAT context provides revenue authorities with a uniquely effective and efficient tax handle: the federal transactional database.²⁷ The transactional database is a universally coded national database of all goods and services transactions.

This article also highlights the advantages of the D-VAT over other consumption tax proposals in terms of administrative simplicity, remote and real-time audit capabilities, as well as the opportunity to provide businesses with audit immunity through the deployment of certified software. An explicit advantage of the D-VAT is that it promotes cooperative multi-level consumption tax systems, allowing existing state and local RSTs to “piggy-back” a comprehensive, federally enforced database.

The D-VAT will allow state and local governments to seamlessly “piggy-back” the federal tax, because the technology and the database are fungible. The D-VAT will facilitate more efficient state and local RST administration, but will not pre-determine the type of local consumption tax (VAT or RST), the scope of the local tax base (the mix of taxable goods or services), the application of single or multiple rates, or the choice of destination or origin sourcing conventions. “Piggy-backing” would not necessarily produce uniformity across consumption tax jurisdictions; it would instead encourage a diversity of finely tuned public finance structures that could be adapted to local understandings of the public good.

Following a short discussion of the vonSchanz-Haig-Simons and Cary Brown theorems in Part I, this article will assess the major proposals for a federal level consumption tax from the perspective of federal-state synergies. The hybrid or “two-tiered consumption taxes” that developed out of the Hall-Rabushka Flat Tax proposal will

concept than the details. McCaffery writes, ‘... Complexity can wait. The devil may indeed dwell in the details, but we first need to find an angel or two in the abstractions that govern tax.’”).

²⁷ Adapting tax systems to automation is not a new idea. William Vickrey, *Electronic Data Processing and Tax Policy*, NAT’L TAX J. 271 at 271 and 285 (Sept. 1961) (in the early days of modern computer technology Vickrey asked: “Does EDP open up possibilities for reforming the way in which tax liability is defined?” His answer was: “What is required is a re-thinking of the problems of tax policy in terms of socially desirable goals. Once the problem has been defined and alternative choices explored, then the machines can be adapted to fit the requirements of the solution. As automation increases, the whole social structure of our environment will be subject to revolutionary change; tax administration must keep abreast of this change.”). At about the same time, the MIT Center for International Studies made similar observations in the context of a tax advisory mission to Indonesia. Benjamin Higgins, *Self-Enforcing Incentive Tax System for Underdeveloped Countries*, in *ECONOMIC DEVELOPMENT: PRINCIPLES, PROBLEMS AND POLICIES*, 524-44, 531-32 (Benjamin Higgins ed., 1959) (“It became apparent that conceptually simple extensions of existing statistical operations would permit the government to follow the flow of goods through every stage of the economy, providing the base for a completely efficient system of income, sales and excess inventory taxes. ... With these materials an appropriate system of coding and [IBM computer] cards, it would be technically possible to compute for any period after the starting date, the average stocks, sales, and incomes of every firm.”).

be considered in Part II, followed by the proposals for a national retail sales tax in Part III, and then the proposals that urge the adoption of a European-styled credit-invoice VAT in Part IV. A concluding section, Part V, will present and explain the details of the D-VAT.

PART I: THE IMPACT AND THE DISTRACTION OF THE HAIG-SIMONS AND THE CARY BROWN THEOREMS

The Haig-Simons theorem sets out the equivalence between income and consumption taxes. The Cary Brown theorem allows easy comparisons to be made among types of consumption taxes.²⁸ Together these theorems have provided tax academics with a banquet of theoretical possibilities and analytical positions. This feast has proven somewhat distracting.

These theorems function like toggle switches. The Haig-Simons theorem (income equals consumption plus savings) facilitates the comparison of consumption taxes with accretion-type income taxes. The Cary Brown theorem (expensing the cost of an asset is equivalent to exempting from income the future annual return on that asset) facilitates comparisons among of types of consumption taxes. The Cary Brown theorem has particular value when assessing “two-tiered” consumption taxes.

More than the basic formulation of the Cary Brown theorem, by far the greatest academic interest has arisen over the assumptions that control the Cary Brown outcome. Papers have been written based entirely on the impact that a different assessment of a critical assumption has on a proposal.²⁹ The two most important assumptions are: (a) that individuals consume all of their income during their lifetime, and (b) that interest rates and tax rates remain constant over time.³⁰ Thus, depending on how one feels about the validity of these assumptions, whether they reflect or contradict reality, one’s impressions of a particular consumption tax proposal can be colored for better or worse.

For example, if one expects that interest rates will rise over time, then a consumption tax that exempted returns on capital (a yield exemption tax) appears “unfair.” Such a tax would favor those with large income and large amounts of savings.

²⁸ Cary Brown, *Business-Income Taxation*, *supra* note 14, at 532-33 (although the Cary Brown theory is only one-and-a-half pages in the original text (309-10), it is critical to an understanding of the role of interest rates in tax policy discussions: tax deferral, the time value of money, as well as the taxation of financial instruments, including derivatives).

²⁹ Calvin H. Johnson, *Soft Money Investing Under the Income Tax*, 89 U. ILL. L. REV. 1019 (1990) (an extensive analysis of the Cary Brown theorem applied to expenses).

³⁰ MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES*, 306-07 (1995) (extending the list of assumptions to six: (1) tax rates must remain constant; (2) interest rates must remain constant; (3) the deduction (or exclusion) must produce an immediate tax savings equal to the deduction or the exclusion times the tax rate; (4) taxpayers must be concerned with their after-tax positions and have the ability to invest the savings from the deduction or exclusion at a rate equal to the rate of return on the original investment (not more, not less); (5) if borrowing is involved, then the ratio of borrowing to after-tax investment must be the same under both methods (yield exemption and immediate deduction); (6) the system must be ‘closed,’ tax is collected at the same rate from earnings from an asset and from amounts received at the close of the transaction).

However, a theoretically equivalent tax, one that would tax consumption when it actually occurred (a consumed income tax) could be constructed. Such a tax would appear to be more “fair,” if the “constant interest rates” assumption of the Cary Brown theorem is replaced with a belief that interest rates are rising.

The standard three-part example applying these theories, an exercise undertaken in almost all introductory law school courses in federal income taxation, is set out below.

[Part 1: Application of the Haig-Simons theorem]. Suppose a taxpayer earns 100, and the tax rate is 50%. Suppose also, that the taxpayer can always invest at a constant 10% return. Under an income tax the 100 is subject to a tax of 50. If the remaining 50 is invested, it will yield 5 after one year. This 5 is also subject to the 50% income tax, leaving the taxpayer with an after-tax amount of 52.50.

The essential difference between an income tax and a consumption tax has to do with a perception of “double taxation” in this example. First there is a tax of 50% on the 100 earned. Then there is a further tax of 50% on the 5 in income that is generated by the further investment of the previously taxed income. This second tax is asserted to be a disincentive to investment. A consumption tax eliminates the second tax.

There are two principal ways to accomplish this result with a consumption tax. The first method is called the “cash flow” method; consumption taxes designed under this method are called “post-paid” consumption taxes or “consumed income taxes.” The other method is called the “yield exemption” method; consumption taxes designed under this method are called “pre-paid” consumption taxes.

[Part 2: First application of the Carey Brown theorem]. Under a “post-paid” or “consumed income” (CIT) type of consumption tax the 100 is not taxed when earned, if (and only if) it is immediately invested, or saved. The 100 will return 10 after investing. Neither the 100 nor the 10 will be taxed unless they are used for consumption. Removing the full 110 from investment after one year and using it for consumption will result in a tax of 55.

The taxpayer’s after-tax consumption of 55 is 2.50 more than the after-tax consumption under the income tax (52.50). Taxes designed in this manner are called “cash flow” taxes, because tax is only imposed when money flows out of investment and into consumption.

[Part 3: Second application of the Carey Brown theorem]. Under a “pre-paid” or “yield exemption” (YET) type of consumption tax the result is the same, but the way we get there is different. Here the 100 is immediately taxed when earned. The remaining 50 is invested, and will return 5 after one year because the rate of return in this economy is 10%. This 5 is not subject to further tax. The yield is exempt from tax. Thus, if the full amount is removed from investment (or savings) after one year and used for consumption, the taxpayer will again enjoy 55 in after-tax consumption. This result under the YET is the same result obtained under as under the CIT.

This example, or variations on it, forms the centerpiece of most consumption tax studies in academic literature. Beginning in the famous Haig-Simons formulation, and extended with the Cary Brown theorem, this theoretical matrix of principles and assumptions allows for so many comparisons among consumption tax proposals and the accretion income tax that very little time is ever left to consider how a proposal “fits” with the pre-existing state and local RSTs. Although academically interesting, these theoretical approaches have become a practical distraction.

PART II: THE TWO-TIERED CONSUMPTION TAXES: BUSINESS TRANSACTION TAXES TIED TO EITHER CASH FLOW OR CONSUMED INCOME TAXES

William Andrews’ 1974 article “A Consumption or Cash Flow Personal Income Tax,” in the *Harvard Law Review* set the stage for most of the current consumption tax proposals.³¹ Andrews outlines a consumption-type personal income tax, and contrasts it with the prevailing ideal; an accretion-type income tax. Using the personal income tax as a template, Andrews suggests changes in a number of accretion provisions, effectively reconstituting the tax base so that it becomes a tax on cash flow. Business, investment and capital outlays are immediately deductible. Returns from business, investment and capital are fully included in income.³² Andrews argues that fairness, administrative simplicity, and economic efficiency make this kind of cash-flow consumption tax superior to an accretion-type income tax. Andrews does not consider the corporate tax.³³

Soon after Andrews’ article the US Treasury completed a study of the US tax system, under the guidance of David F. Bradford called *Blueprints for Basic Tax Reform*.³⁴ The second edition of this study also proposed a model cash flow consumption tax. Under the *Blueprint* model, the income tax on individuals, corporations and trusts would be abolished.³⁵ In determining the tax base the treatment of savings or investment under the *Blueprint* model permitted taxpayers to choose between a yield exemption and a consumed income methods of reporting.³⁶ Rates would be progressive.³⁷

In 1983 Robert E. Hall and Alvin Rabushka’s³⁸ Flat Tax took two additional steps. First, they designed a comprehensive consumption tax that would be reflected in “two-tiers:” one similar to the present individual income tax, the other similar to the

³¹ KALDOR, AN EXPENDITURE TAX, *supra* note 14 (credited with the original development of the essential concept extended by Andrews).

³² Andrews, *Consumption or Cash Flow*, *supra* note 5, at 1149.

³³ *Id.* at 1123 (indicating that his “... argument may have implications with respect to the corporate income tax or a general sales or value-added tax, but these are not stated or explored.”).

³⁴ BLUEPRINTS (1977), *supra* note 2.

³⁵ BLUEPRINTS (1984), *supra* note 2, at 101-28.

³⁶ *Id.* at 10, 107-17.

³⁷ *Id.* at 123 (without specifying rates, the study’s clear presumption is that the progressive rate structure under the current tax will be retained because, “the progressivity of any individual tax is to a large degree determined by the rate structure.”).

³⁸ HALL & RABUSHKA, THE FLAT TAX (1995) *supra* note 3 (first published as ROBERT E. HALL & ALVIN RABUSHKA, LOW TAX, SIMPLE TAX, FLAT TAX (1983), republished in 1985 and 1995 as THE FLAT TAX).

present corporate income tax. Secondly, they imposed a single rate of tax on business and individual income, thus the name Flat Tax. This concept quickly captured public attention.

As time went on, however, two variant versions of the Flat Tax proposal developed. Both versions imposed a subtraction method VAT on business. At the individual level, one group advocated a yield exemption (pre-paid) design [Subtraction VAT + YET], while the other group favored a consumed income (post-paid) design at the individual level [Subtraction VAT + CIT].

If one accepts Cary Brown's assumptions as true reflectors of economic conditions, then in present value terms, these two groups are proposing equivalent taxes [Subtraction VAT + YET = Subtraction VAT + CIT]. The key to appreciating their equivalence as well as their common contrast with the traditional income tax, is to observe that both sets of proposals intend to remove the accretion elements from the current income tax, leaving only on a consumption base.

Subtraction VAT + YET

Hall-Rabushka's Flat Tax. The Hall-Rabushka Flat Tax is a true "two-tiered" consumption tax. The business level tax, sometimes called a business transfer tax (BTT),³⁹ functions as a subtraction method VAT⁴⁰ with a full deduction for compensation paid.⁴¹ The compensation deducted from the business tax base is the base for the individual tax.⁴² Under the Hall-Rabushka Flat Tax, compensation is taxed under the "pre-paid," or "yield exemption" method (YET).

In addition, under the Hall-Rabushka Flat Tax compensation is taxed progressively, but with a flat rate.⁴³ A substantial standard deduction removes earned

³⁹ The Business Transfer Tax, S. 1102, 99th Cong. (1985), *available at* <http://thomas.loc.gov/bss/d099/d099laws.html> (proposed by Senator William V. Roth and credited with originating the expression "business transfer tax" or BTT, a subtraction method VAT that was to replace the corporate income tax). *See also* The Uniform Business Tax (UBT), H.R. 3170, 102d Cong. (1991), *available at* <http://thomas.loc.gov/bss/d102/d102laws.html> (proposed by Congressman Richard T. Schultz a few years later, and similarly proposing to replace the corporate income tax with a subtraction VAT).

⁴⁰ Alan Schenk, *Japanese Consumption Tax: The Japanese Brand of VAT*, 42 TAX NOTES 1625 (March 27, 1989) (Explaining that Japan is the only country that has adopted a credit-subtraction VAT, one that closely resembles the business portion of the Hall-Rabushka Flat Tax. It uses a single rate. This VAT is not transactional, rather it is imposed at the business level on a tax period basis. The Japanese Consumption Tax is not separately stated on invoices.)

⁴¹ HALL-RABUSHKA, THE FLAT TAX (1995), *supra* note 3, at 142 (§101 of the proposed statute defines compensation broadly. It includes "... all cash amounts paid by an employer or received by an employee, including wages, pensions, bonuses, prizes and awards.").

⁴² Lawrence Zelenak, *The Selling of the Flat Tax: The Dubious Link Between Rate and Base*, 2 CHAP. L. REV. 197, 202-03 (1999) (observing that this essentially makes the individual portion of the Flat Tax into a wage tax).

⁴³ Hall-Rabushka describe the Flat Tax as a "progressive consumption tax." This is not an entirely accurate. The "consumption" attribution is based on an assumption that all wage, salary and other compensation is actually consumed. To the extent this is not the case, the Hall-Rabushka tax is imposed on non-consumption (savings, or investment). In addition, the Hall-Rabushka tax is not imposed on consumption derived from borrowed funds, a measure of consumption easily included in VAT and RST

income from the individual tax base.⁴⁴ Because standard deductions have relatively more value to low than high-income earners, the deduction effectively produces a graduated tax. In other words, even though the rate of tax imposed on all income (business and personal) is the same (flat)⁴⁵ rate, the tax burden is graduated. The tax rests more heavily on the wealthy than the poor. In this manner the Flat Tax blunts one of the main arguments against all consumption taxes; its perceived regressivity.

Two streams of legislative proposals have developed out of this type of two-tiered yield exemption consumption tax. One branch closely follows Hall-Rabushka's Flat Tax.⁴⁶ The other branch varies from the Hall-Rabushka model by allowing additional deductions for individuals,⁴⁷ notably for charitable contributions⁴⁸ and home mortgage interest.⁴⁹

A final variant of the Hall-Rabushka Flat Tax is the late Professor David Bradford's X-tax.⁵⁰ The X-tax remained a continual "work-in-progress" throughout Bradford's life. It developed conceptually out of the *Blueprints* study, but accommodated many of the Hall-Rabushka ideas as it was taken forward. The X-Tax accepts a subtraction VAT at the business level. At the individual level, the most recent version of the X-tax: (a) uses the yield exemption method for taxing savings or investment, (b) would allow deductions for charitable contributions and home mortgages as well as permits an earned income tax credit,⁵¹ and (c) employs graduated rates. Under Bradford's scheme, tax rates would rise along with income, eventually leveling off (becoming "flat") at a point where the highest individual rate would equal the "flat"

bases. If borrowed funds are included in the base, then adjustments for negative consumption need to be allowed when loans are repaid.

⁴⁴ HALL-RABUSHKA, THE FLAT TAX (1995), *supra* note 3, at 59, 144 (§ 201(a) of the proposed act provides for a \$25,500 allowance for a family of four. This amount reflects an allowance of \$16,500 for married taxpayers filing jointly, \$14,000 for head of households, \$9,500 for single taxpayers, and \$4,500 per dependent.)

⁴⁵ HALL-RABUSHKA, THE FLAT TAX (1995), *supra* note 3, at 59, 64, 144 (§§ 202 and 203(b) impose a rate at 19% on both business and personal returns).

⁴⁶ The Flat Tax, H.R. 4585, 103rd Cong. (1994), available at <http://thomas.loc.gov/bss/d103/d103laws.html> (proposed by Representative Dick Armey (TX)) reintroduced as S. 488, 104th Cong. (1995), available at <http://thomas.loc.gov/bss/d104/d104laws.html> (sponsored by Senator Arlen Specter (PA)); The Tax Simplification Act of 2003, H.R. 3060, 108th Cong. (2003); S. 1040, 108th Cong. (2003), available at <http://thomas.loc.gov/bss/d108/d108laws.html>.

⁴⁷ The Flat Tax Act of 2003, S. 907, 108th Cong. (2003), available at <http://thomas.loc.gov/bss/d108/d108laws.html> (proposed by Senator Arlen Specter (PA)) (§ 2 of the proposed law would allow a basic standard deduction at amounts between \$17,500 for joint return filers, and \$10,000 for individuals. An additional standard deduction is provided at \$5,000 for each dependent, with inflation adjustments and adjustments for the cost-of-living).

⁴⁸ *Id.* at § 3 (charitable deductions are limited to \$2,500; \$1,250 for a married individual filing separately).

⁴⁹ *Id.* at § 4 (mortgage interest deductions are limited to the interest on debt of up to \$100,000).

⁵⁰ DAVID F. BRADFORD, UNTANGLING THE INCOME TAX, (1986) (presents the earliest version of the X Tax); DAVID F. BRADFORD, FUNDAMENTAL ISSUES IN CONSUMPTION TAXATION (1996) and David Bradford, *Consumption Taxes: Some Fundamental Issues*, in FRONTIERS OF TAX REFORM, 123-150 (ed. Michael J. Boskin 1996) (presenting the most developed versions of the X Tax).

⁵¹ David Bradford, *The X Tax in the World Economy*, 3, 5 CSEPS Working Paper No. 93 (August 2003) available at <http://www.princeton.edu/~ceps/workingpapers/93bradford.pdf>.

business rate.⁵² Although this tax is no longer “flat” in the same sense that Hall and Rabushka use the term “flat tax,” Bradford’s progressive rate structure provides a traditional answer to the regressivity problem.⁵³

Subtraction VAT + CIT

An alternate design for the “two-tiered” consumption tax involves defining the individual tax base in a “cash flow” manner, as advocated by William Andrews in his 1974 article. Under this approach all money received by an individual would be treated as taxable when received. An exception is provided. Taxpayers can exclude an unlimited amount of income, provided the funds are saved or invested. Thus, only income used for consumption is taxed. This is a “post-paid” or “consumed income tax.”

Two legislative versions of this hybrid consumption tax have been proposed, the USA Tax Act of 1995⁵⁴ proposed by Senators Sam Nunn and Pete Domenici, and the Simplified USA Tax Act of 2003⁵⁵ proposed by Congressman Phil English. The central feature of these proposals is the unlimited savings allowance (USA) deduction from which both proposals take their name.

The unlimited savings allowance under Nunn-Domenici’s USA Tax departs from theoretical purity most notably in its treatment of borrowing. Under a consumed income tax borrowing needs to be included in income while loan repayment is deducted from income. Alvin Warren pointed this out very convincingly.⁵⁶ The treatment under the USA Tax essentially allows individuals to avoid the tax completely by saving (deducting) all new income and funding all consumption through borrowings.⁵⁷

A similar problem arises in transition when individuals are allowed to consume from pre-USA Tax income, while saving all current income. Again, the individual would pay no tax. Called the “old savings” problem, Nunn-Domenici’s solution was a complex series of transition rules.⁵⁸ This is the most notable problem that Congressman English

⁵² *Id.* at 3.

⁵³ *Id.* at 2-7.

⁵⁴ USA Tax Act of 1995, S. 722, 104th Cong. (1995), *available at* <http://thomas.loc.gov/bss/d104/d104laws.html> (proposed by Senator Sam Nunn (GA) and Pete Domenici (NM)).

⁵⁵ Simplified USA Tax Act of 2003, H.R. 269, 108th Cong. (2003), *available at* <http://thomas.loc.gov/bss/d108/d108laws.html> (proposed by Congressman Phil English (PA)). Similar earlier proposals include Simplified USA Tax Act of 2001, H.R. 86, 107th Cong. (2001) and Simplified USA Tax Act of 1999, H.R. 134, 106th Cong. (1999) (both proposed by Congressman English).

⁵⁶ Alvin C. Warren, *The Proposal for an Unlimited Savings Allowance*, 68 TAX NOTES 1103 (Aug. 28, 1995).

⁵⁷ This is what happens under a traditional RST or VAT. Tax is due on consumption regardless of the source of funds. The omission of this treatment under the USA Tax makes it significantly different from a true consumption tax. The USA Tax deals with this problem through an extremely complicated "Schedule S." This schedule tries to prevent households from using borrowing to finance tax-free consumption. More than anything else it was "Schedule S" that gave the USA Tax its reputation for complexity, and led to the rejection of this tax reform.

⁵⁸ Nunn & Domenici, USA Tax Act of 1995, S. 722 *supra* note 54, at §§ 290-293.

addresses in the Simplified USA Tax proposal. In this instance, unlimited Roth IRA's⁵⁹ funded only with current income replace the unlimited savings allowance. The Simplified USA Tax, unlike the USA Tax, also repeals the estate and gift tax. Many observers note that taxing estates and gifts, as was continued under the USA Tax, was inconsistent with imposing a tax based on consumption.⁶⁰

Also inconsistent with theoretical purity are the deductions for mortgage interest,⁶¹ charitable contributions,⁶² and tuition paid for college and post-secondary vocational education⁶³ under the Simplified USA Tax. Each of these deductions represents a form of consumed income that should be subject to tax. The annual limit on these deductions range from \$ 4,000 per person to \$ 12,000 for a family.⁶⁴

The treatment of loans in a cash flow tax is also a problem for Professor Andrews. He departs from true cash flow treatment when considering consumer loans and credit purchases and repayments. Professor Andrews proposes:

Business and investment loans would be treated, just like ordinary investments, on a simple cash flow basis. Loan proceeds would be reported as income in the year received, and repayments of interest and principal would be deducted when paid. This treatment is unfamiliar, but would represent a clear net simplification for reasons similar to those favoring cash flow accounting for ordinary investments. ... A strict computation of current consumption would seem to require that consumer loans and credit, like business and investment loans, be treated as income when incurred and deductible when repaid. But it is much simpler and quite acceptable just to leave ordinary consumer loans and credit arrangements out of account. The effect of that is to treat payments on account of consumer loans, rather than the use of loan proceeds, as taxable consumption expenditures.⁶⁵

Alternately, Edward McCaffery has proposed a two-tier consumption tax that does treat loans properly from a theoretical standpoint.⁶⁶ McCaffery's two-tiered proposal differs in the types of consumption taxes he mixes. Where each of the earlier proposals derived from Hall-Rabushka's Flat Tax were based in annual account

⁵⁹ English, Simplified USA Tax Act of 2003, H.R. 269 *supra* note 55, at § 30 (contributions are limited only by the adjusted gross income for the current year).

⁶⁰ LAURENCE A. SEIDMAN, THE USA TAX: A PROGRESSIVE CONSUMPTION TAX 11 (1997); Bank, *Progressive Consumption Tax*, *supra* note 13, at 2252; J. Clifton Fleming, Jr., *Scoping Out the Uncertain Simplification (Complication?) Effects of VATs, BATs, and Consumed Income Taxes*, 2 FLA. TAX REV. 390, 428-429 (1995).

⁶¹ English, Simplified USA Tax Act of 2003, H.R. 269 *supra* note 55, at § 9.

⁶² *Id.* at § 11.

⁶³ *Id.* at § 10.

⁶⁴ *Id.* at § 8.

⁶⁵ Andrews, *Consumption or Cash Flow*, *supra* note 5, at 1153-54.

⁶⁶ MCCAFFERY, FAIR NOT FLAT, *supra* note 3, at 132-34.

consumption taxes (a business level subtraction VAT tied to either a yield exemption or consumed income individual tax), McCaffery suggests imposing a broad-based, flat rate national transaction tax (RST or VAT) together with a progressive rate consumed income tax.

The consumed income tax in McCaffery's proposal: (1) would be net of a deduction for savings placed in a "Trust Account"⁶⁷ similar in design to the Roth IRA mechanism of the Simplified USA Tax, which built upon the unlimited savings allowance of the USA Tax, and (2) would include in income all loan proceeds, deducting debt repayment, including interest. McCaffery breaks with theory however by allowing deductions for consumption in the form of medical expenses and charitable contributions.⁶⁸

McCaffery's proposal is progressive in two respects: (1) like Hall-Rabushka's Flat Tax there would be a sizable standard deduction (a family of four would exclude the first \$20,000),⁶⁹ and (2) like David Bradford's X-tax, the USA and Simplified USA Tax rates would be graduated⁷⁰ on consumption over \$80,000.⁷¹ In this respect McCaffery's proposal resembles Michael Graetz's VAT proposal that retains the current income tax for income in excess of \$100,000.

Impact of the Adoption of a Hybrid, Two-Tiered Consumption Taxes on Existing State and Local Revenue Systems

Adopting a hybrid, two-tiered consumption tax at the federal level would significantly impact the structure of state revenue systems. It is very likely that most states would need to abandon their current income taxes and design new taxes mirroring the federal tax scheme. The primary reason for this is the fiscal "piggy-back" relationship that has developed between federal and state governments.⁷² For better or worse American fiscal federalism exhibits strong strains of both independence and dependence. State level tax experimentation⁷³ co-exists with extensive state piggy-backing on the federal system of taxation.

Corporate tax piggy-back: Each of the hybrid, two-tiered consumption taxes derived from the Hall-Rabushka Flat Tax proposal (Armev's Freedom and Fairness

⁶⁷ *Id.* at 98.

⁶⁸ *Id.* at 98.

⁶⁹ *Id.* at 101.

⁷⁰ *Id.* at 101 (under McCaffery's proposal these rates would range from 10 to 50%).

⁷¹ *Id.* at 100-101.

⁷² JOINT COMMITTEE ON TAXATION, IMPACT ON STATE AND LOCAL GOVERNMENTS, *supra* note 12, at 70. ("Because most of the states that collect individual and corporate income taxes model their state income tax systems on the Federal income tax system, any significant restructuring of the Federal income tax system could have considerable corollary implications for such states ... the elimination of a Federal income tax and replacement with a consumption-based tax would entail a considerable increase in the complexity and expense of administering a state income tax system.")

⁷³ Supreme Court Justice Louis Brandeis stated, "It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country." *New State Ice Company v. Liebman*, 285 US 262, 311 (1932) (Brandeis, J., dissenting).

Restoration Act; Smith and Shelby's Tax Simplification Act; Spector's Flat Tax Act; Bradford's X-Tax; Nunn and Domenici's USA Tax Act; and English's Simplified USA Tax Act) replace the corporate income tax with a subtraction VAT. Most states currently base their corporate taxes on the federal scheme. 39 of the 45 states imposing corporate net income taxes directly incorporate federal law, and start their income calculations with federal income determinations.⁷⁴ This piggy-back relationship has not been without its problems, but benefits have clearly outweighed burdens.⁷⁵

If the federal corporate tax were to be replaced with a sales-subtraction VAT, commentators⁷⁶ believe that most states would migrate to similar sub-national subtraction VATs.⁷⁷ Some state level VAT issues have already been resolved. For example, rather than getting involved in complex sourcing issues, the tax base would probably be divided among the states through an apportionment formula. In 1991, the US Supreme Court approved the use of a three-factor formula (property, payroll and sales) to apportion a state level addition VAT, Michigan's single business tax (SBT).⁷⁸

Additionally, if the states followed federal adoption of a subtraction VAT then revisions would be needed in PL 86-272.⁷⁹ This law sets the minimum standards that must be met before a state can tax the out-of-state operations of a foreign (out-of-state)

⁷⁴ STATE TAX GUIDE (CCH) Para. 10-050, 10-108 (2004)

⁷⁵ JEROME AND WALTER HELLERSTEIN, STATE TAXATION, I CORPORATE INCOME AND FRANCHISE TAXES, par. 7.02. (3rd ed. 1998 & Cumulative Supplement 2004) (compares state decisions to adopt a "moving federal tax base" or a "static federal tax base" as well as issues about conformity to the related federal regulations); Frank Shafroth, *The Tax Doctor: To Conform or not to Conform – That is the Question*, 2003 STATE TAX NOTES 711, 713 (Sept. 8, 2003) ("[S]tate corporation income taxes exhibit a high degree of conformity to the federal tax code. For the large part, state corporate income taxes begin with federal taxable income; a series of adjustments is then made to account for constitutionally exempt income, deductions for various state and federal taxes, and other state-defined deductions. As a consequence, changes to the federal tax base commonly flow through to the state level.").

⁷⁶ David A. Weisbach, *Ironing Out The Flat Tax*, 52 STAN. L. REV. 599, 659 (2000) ("The most significant issue facing the state and local governments would be the elimination of their ability to base their tax systems on the federal income tax. ... Unless states switched to a base similar to the Flat Tax, few of the implementation benefits of the Flat Tax would be achieved."); Robert P. Strauss, *Administrative and Revenue Implications of Alternative Federal Consumption Taxes for the State and Local Sector*, 14 AM. J. TAX POL'Y 361, 423-426 (Fall, 1997); Michael Mazerov and Dan Bucks, *Federal Restructuring and State and Local Governments: An Introduction to the Issues and the Literature*, 33 SAN DIEGO L. REV. 1459, 1470 (1996) ("Without this [federal] infrastructure, it is unlikely that states would be able to administer an income tax without substantial additional capacity and without additional complexity to taxpayers. ... the proposed federal tax changes will narrow the diversity of tax policies available to the states, and the entire federal/state fiscal system will shift to various forms of consumption taxes."); Schenk, *A Federal Move to a Consumption-Based Tax*, *supra* note 15, at 107 (analyzing the increase in complexity, and in compliance costs if the states decide to retain their income tax structures when the federal income tax is withdrawn); Julie Roin, *The Consequences of Undoing the Federal Income Tax*, 70 U. CHI. L. REV. 319, 333-34 (2003) ("The only way to avoid the administrative complications [caused by the adoption a federal consumption tax] would be for the states to eliminate their income tax systems and piggyback on whatever the federal tax rules happen to be.").

⁷⁷ *But see* Strauss, *Impact of Federal VAT*, *supra* note 12, at 1357 (contending that "path dependencies" make this transition not an assured outcome, although agreeing that there will be considerable complexity added to the system, along with compliance and enforcement problems).

⁷⁸ *Trinova Corp. v. Michigan Department of Treasury*, 498 U.S. 358, 111 S.Ct. 818 (1991).

⁷⁹ 15 U.S.C. § 381.

business. P.L. 86-272 is specific to net income taxes, and once again Michigan's SBT provides guidance in this regard. The SBT has been determined to be outside the scope of PL 86-272.⁸⁰ Statutory change would be needed here.

Individual tax piggy-back: Most states⁸¹ also impose an income tax on individuals. This tax too commonly piggy-backs the federal tax.⁸² There are a number of different ways that this piggy-backing occurs: 27 states⁸³ adopt the federal adjusted gross income as their tax base, 10 states⁸⁴ base their tax on federal taxable income, and 2 states⁸⁵ impose a tax only on federally defined interest and dividends. The remaining 5 states⁸⁶ do not conform to the federal income tax. At one time, 3 states⁸⁷ had a complete federal piggy-back arrangement, and simply took a percentage of the federal tax as their state tax. Each of these three states moved away from this arrangement after Congress approved the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) with its large, multiyear revenue reductions.

Although 10 states do not begin their income determination with a direct reference to the federal return, even these states widely adopt federal rules, definitions, and interpretations. No state imposes a completely freestanding individual income tax.

If the federal government replaces the personal income tax with either a yield exemption (pre-paid) or consumed income (post-paid) tax, state piggy-backing on the federal system would still be possible. However, in doing so the state individual tax would change from an income-based to a wage-based tax.

Each time there has been serious federal consideration of a national consumption tax states have made preparations to follow suit by piggy-backing on the federal system. State legislative commissions produce studies for state tax changes based on federal

⁸⁰ *Gillette Co. v. Department of Treasury*, 497 N.W.2d 595 (Mich. App. 1993) (determining that PL 86-272 does not apply to the SBT because it is a consumption tax, and PL 86-272 is applicable only to net income taxes); *Guardian Industries Corp. v. Department of Treasury*, 499 N.W.2d 349 (Mich. App. 1993) (reaffirming the *Gillette* decision).

⁸¹ Seven states do not impose an income tax on individuals: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

⁸² FEDERATION OF TAX ADMINISTRATORS, STATE PERSONAL INCOME TAXES: FEDERAL STARTING POINTS (January 1, 2005), at http://www.taxadmin.org/fta/rate/stg_pts.pdf (last visited Aug. 29, 2005); U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS TO THE JOINT COMMITTEE ON TAXATION, SELECTED MATERIALS RELATED TO THE FEDERAL TAX SYSTEM UNDER PRESENT LAW AND VARIOUS ALTERNATIVE TAX SYSTEMS, 82 (JCS-1-96: Joint Committee Print, Mar. 14, 1996), available at <http://www.house.gov/jct/s-1-96.pdf>.

⁸³ Arizona, California, Connecticut, Delaware, District of Columbia, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Missouri, Montana, Nebraska, New Mexico, New York, Ohio, Oklahoma, Rhode Island, Virginia, West Virginia, and Wisconsin.

⁸⁴ Colorado, Hawaii, Idaho, Minnesota, North Carolina, North Dakota, Oregon, South Carolina, Utah, and Vermont.

⁸⁵ New Hampshire and Tennessee.

⁸⁶ Alabama, Arkansas, Mississippi, New Jersey, and Pennsylvania.

⁸⁷ North Dakota (changed to a federal taxable income base), Rhode Island (changed to a federal adjusted gross income base), and Vermont (changed to a federal taxable income base).

proposals. See, for example, recent studies from the states of Arizona,⁸⁸ California,⁸⁹ Hawaii,⁹⁰ Virginia,⁹¹ Washington⁹² and Wyoming⁹³ on this matter.

PART III: RETAIL SALES TAX PROPOSALS

A retail sales tax has been proposed as a replacement to the federal corporate and individual income taxes since at least the 1990's. There are two very similar lines of retail sales tax proposals, (a) The National Retail Sales Tax proposal of Representatives

⁸⁸ STEPHEN SLIVINSKI, POLICY REPORT: THE RIGHT CURE FOR WHAT AILS US: A PRESCRIPTION FOR COMPREHENSIVE TAX REFORM IN ARIZONA 14-24 Goldwater Institute, No. 182 (June 9, 2003), *available at* <http://www.goldwaterinstitute.org/pdf/materials/292.pdf> (last visited Aug. 29, 2005). CITIZENS FINANCE REVIEW COMMISSION, WORKING PRINCIPLES, *available at* http://www.azcfrfrc.gov/documents/CFRC_WORKING_PRINCIPLES.html (last visited Aug. 29, 2005) (Proposals to replace the state personal and corporate income taxes, as well as the the state sales tax. The options considered were (1) a 3% Hall-Rabushka-style Flat Tax [Subtraction VAT + YET], (2) a 3% consumed income tax [Subtraction VAT + CIT], and (3) a comprehensive 3% retail sales tax on all goods and services.)

⁸⁹ FINAL REPORT OF THE CALIFORNIA COMMISSION ON TAX POLICY IN THE NEW ECONOMY PRESENTED TO GOVERNOR SCHWARZENEGGER, 38-43 (Dec. 2003), *available at* <http://www.library.ca.gov/CaTax/index.cfm> (last visited Aug. 29, 2005) (Looking in detail at various Flat Tax proposals [VAT + YET and VAT + CIT] which had been proposed at the federal level and working with Dr. Arthur Laffer in April and July of 2003 to determine the rates needed to generate equivalent revenue yields (determined to be approximately 5.81 to 6%), California determined that the rates would have to be uniform across the state and pre-empt local taxing authority. The Michigan SBT was examined, and Dr. Laffer rejected adoption of a similar origin-based VAT in California, proposing instead a dual destination-type consumption taxes at business and personal levels.)

⁹⁰ TAX REVIEW COMMISSION, REPORT OF 2001-2003, 14-16, 18, *available at* http://www.state.hi.us/tax/pubs/trc_rpt_2003intro.htm (last visited Aug. 29, 2005) (Experiencing revenue shortfalls in 2000-2001 Hawaii took a serious look at the current tax structure with particular attention to minimizing business-to-business sales tax collections under the GET, and in significantly increasing the conformity of the Hawaiian tax structures with the federal system. The first of these issues recognized the vitality of a VAT structure, and the second indicated that Hawaii would be more than ready to "piggy-back" federal changes if they were to be initiated.)

⁹¹ REPORT OF THE JOINT SUBCOMMITTEE TO STUDY AND REVISE VIRGINIA'S STATE TAX CODE, 17-18, 25, and 43 (Dec. 2002), *available at* <http://dls.state.va.us/groups/taxcode/report02.pdf> (last visited Aug. 29, 2005) (Virginian revenue shortfalls contributed to a movement to increase conformity of the state tax system with the federal, seeking increased revenue and reduced compliance burdens for taxpayers through federal piggy-backing.)

⁹² THE WASHINGTON STATE TAX STRUCTURE STUDY COMMITTEE, TAX ALTERNATIVES FOR WASHINGTON STATE: A REPORT TO THE LEGISLATURE, (Nov. 2002) Vol. 1 of 2, at 35-47 and 48-70, *available at* http://dor.wa.gov/content/statistics/WAtaxstudy/Final_Report.htm (last visited Aug. 29, 2005) (Considering three versions of VAT to replace the Business and Occupation Tax: (1) a subtraction VAT; (2) a GST of the credit-invoice type, and (3) a progressive VAT similar to that proposed under the "cash flow" alternatives to the Flat Tax, and proposing strong consideration of the subtraction VAT model in contrast to various flat rate corporate and personal income tax suggestions.)

⁹³ TAX REFORM 2000 COMMITTEE, BUILDING WYOMING'S TAX STRUCTURE FOR THE 21ST CENTURY, 22-25 and 29 (June 1999), *available at* <http://legisweb.state.wy.us/1999inte/t2000/final1.htm> (last visited Aug. 29, 2005) (concerned with the state's dependency on mineral severance taxes and the absence of an income tax at the corporate and individual levels, proposals are advanced for a balanced consumption tax in tandem with an income tax where significant advantages were attributed to following federal consumption tax rules, if they were to be enacted.)

Dan Schaefer, Billy Tauzin, and Dick Chrysler⁹⁴ and (b) the Fair Tax proposal of Representatives Linder and Peterson.⁹⁵

The primary differences between these proposals are in the rates they impose, the pre-existing taxes they eliminate, and the administrative provisions they envision. The National Retail Sales Tax is imposed at a 15% tax inclusive rate,⁹⁶ which corresponds to a 18% tax-exclusive rate. The Fair Tax rate is stated in tax-exclusive terms at 30%.⁹⁷ This in turn corresponds to a tax-inclusive rate of 23%.⁹⁸ Thus depending on how one looks at these taxes, the rates are either 15% and 23%, or 18% and 30%. To be revenue neutral, the Fair Tax needs a higher rate. Unlike the National Sales Tax, the Fair Tax eliminates the payroll tax in addition to federal income taxes.⁹⁹

The tax base under both the National Retail Sales Tax and the Fair Tax is broadly defined to include both goods and services. Both taxes are normatively pure consumption taxes, imposing tax on final consumption. Under the National Retail Sales Tax taxable property includes all property (including rents and leasehold),¹⁰⁰ and services

⁹⁴ The National Retail Sales Tax, H.R. 4168, 108th Cong. (2004), *available at* <http://thomas.loc.gov/bss/d108/d108laws.html> (proposed by Congressmen Billy Tauzin (LA) and Dan Schaefer (CO)) (earlier versions of this legislation include: H.R. 3039, 104th Cong. (1996) *available at* <http://thomas.loc.gov/bss/d104/d104laws.html>; H.R. 2001, 105th Cong. (1998) *available at* <http://thomas.loc.gov/bss/d105/d105laws.html>; H.R. 1467, 106th Cong. (1999) *available at* <http://thomas.loc.gov/bss/d106/d106laws.html>).

⁹⁵ The Fair Tax, H.R. 25/ S. 25, 109th Cong., (2005), *available at* <http://thomas.loc.gov/bss/d109/d109laws.html> (proposed by Congressman John Linder (GA) and Senator Saxby Chambliss (GA)) (earlier versions of this legislation were HR 2525, 106th Cong., (1999) *available at* <http://thomas.loc.gov/bss/d106/d106laws.html>; HR 2525 107th Cong., (2001) *available at* <http://thomas.loc.gov/bss/d107/d107laws.html>; HR 25, 108th Cong., (2003) *available at* <http://thomas.loc.gov/bss/d108/d108laws.html>).

⁹⁶ Tauzin & Schaefer, The National Retail Sales Tax, H.R. 4168, *supra* note 94, at § 1.

⁹⁷ The 30% rate is the tax exclusive rate. For example, if an item costing \$100 is purchased and an additional \$30 is due because of a sales tax, the tax exclusive rate is 30%. However, if the price for the item is stated to be \$130, with \$30 of that amount set aside for sales taxes, then the rate of tax is 23% of the tax inclusive price. Most retail sales taxes state their rates in tax exclusive terms.

⁹⁸ Linder & Chambliss, The Fair Tax, H.R. 25/ S. 25, *supra* note 95, at § 1(b)(1).

⁹⁹ WILLIAM G. GALE, THE NATIONAL RETAIL SALES TAX: WHAT WOULD THE RATE HAVE TO BE? Urban-Brookings Tax Policy Center (Apr. 27, 2005), *available at* <http://taxpolicycenter.org/publications/template.cfm?PubID=9251> (questioning the adequacy of these rates, Gale concludes in the opening abstract that, “[e]ven if there were no avoidance and no evasion, however, the required tax rate for this proposal [H.R. 25, The Fair Tax] over the next 10 years would be 31 % tax-inclusive (44% tax-exclusive). If the rate were set at 23% (tax-inclusive) the revenue shortfall would exceed \$7 trillion over the next decade relative to current law.... [T]he commonly-cited 23% tax-inclusive rate in HR 25 was derived using a set of assumptions about changes in the price level that are not consistent with each other and that lead to an estimated tax rate that is systematically and substantially too low.” Gale estimates a sales tax rate of 65% (tax-exclusive) to replace current federal taxes with a national retail sales tax. To get his 65% number, Gale assumes only 20% base erosion (from loopholes, incentives, and fraud). That 20% figure may strike political realists as absurdly low. Nevertheless, the rate is estimated at over 50% with an estimate of only 10% base erosion.)

¹⁰⁰ Tauzin & Schaefer, The National Retail Sales Tax, H.R. 4168, *supra* note 94, at § 21(n)(1)(A).

(including financial intermediation services).¹⁰¹ Taxable property does not include intangible property.¹⁰² For all practical purposes the Fair Tax base is identical.¹⁰³

Exemptions under both proposals are provided for business purchases for resale,¹⁰⁴ purchases to produce taxable property or services,¹⁰⁵ and exports.¹⁰⁶ Expenditure on education is exempt as an investment.¹⁰⁷ Expenditure abroad by U.S. residents and half of foreign travel is exempt, but domestic expenditure by non-residents is taxed. Both proposals tax all federal, state, and local government consumption, as well as government investment in equipment and structures.¹⁰⁸

Although mechanisms differ, both proposals respond directly to concerns about the regressivity of a consumption tax by making direct refunds to families with income levels at or below the poverty level. The National Retail Sales Tax provides a Family Consumption Refund,¹⁰⁹ the Fair Tax provides a Family Consumption Allowance.¹¹⁰

*Impact of the Adoption of a National-level Retail Sales Tax
On Existing State and Local Revenue Systems*

State Individual and Corporate Income Tax Extinction. As discussed above,¹¹¹ the state income tax is highly dependent on the federal system. Both national retail sales

¹⁰¹ *Id.* at § 21(n)(1)(B).

¹⁰² *Id.* at § 21(n)(1)(A).

¹⁰³ Linder & Chambliss, *The Fair Tax*, H.R. 25/ S. 25, *supra* note 95, at § 2(a)(14)(A) (defines taxable property or service to include, “any property [including leasehold of any term or rents with respect to such property] ...”); §§ 2(a)(14)(A)(i)(I) and (II) (excluding intangible property and used property); § 2(a)(14)(B)(including financial intermediation services as taxable services).

¹⁰⁴ Linder & Chambliss, *The Fair Tax*, H.R. 25/ S. 25, *supra* note 95, at §§ 201 (a) and 202; Tauzin & Schaefer, *The National Retail Sales Tax*, H.R. 4168, *supra* note 94, at § 2(b)(1).

¹⁰⁵ Linder & Chambliss, *The Fair Tax*, H.R. 25/ S. 25, *supra* note 95, at §§ 201(a) and 202; Tauzin & Schaefer, *The National Retail Sales Tax*, H.R. 4168, *supra* note 94, at §§ 2(a)(1) and (b)(2)-(3).

¹⁰⁶ Linder & Chambliss, *The Fair Tax*, H.R. 25/ S. 25, *supra* note 95, at § 102(a)(1); Tauzin & Schaefer, *The National Retail Sales Tax*, H.R. 4168, *supra* note 94, at § 2(a)(2).

¹⁰⁷ Linder & Chambliss, *The Fair Tax*, H.R. 25/ S. 25, *supra* note 95, at § 2(a)(4); Tauzin & Schaefer, *The National Retail Sales Tax*, H.R. 4168, *supra* note 94, at § 21(e)(4).

¹⁰⁸ Linder & Chambliss, *The Fair Tax*, H.R. 25/ S. 25, *supra* note 95, at §§ 2(a)(7) and 101(d)(1); Tauzin & Schaefer, *The National Retail Sales Tax*, H.R. 4168, *supra* note 94, at § 3(a)(1).

¹⁰⁹ Linder & Chambliss, *The Fair Tax*, H.R. 25/ S. 25, *supra* note 95, at §§ 13 and 15(c). (Under the National Retail Sales Tax proposal’s family consumption refund, wage-earners are entitled to a rebate equal to the sales tax rate times the lower of their wages or the poverty level. The poverty level will be determined by Department of Health and Human Services. The rebate would be provided in each worker’s paycheck by making adjustment to the payroll tax at the employer level sufficient to fund the rebate. The Treasury would reimburse the Social Security Administration for the rebate amounts to ensure that the balance of the trust fund remained unchanged.)

¹¹⁰ *Id.* at § 301. (The refund mechanism under the Fair Tax is different because this proposal eliminates the payroll tax. The payroll tax is the mechanism for rebates under the National Sales Tax. Under the Fair Tax the government would mail to each household checks sufficient to offset the burden of sales taxes on consumption up to the poverty level. This rebate mechanism has been open to criticism. Under the Earned Income Tax Credit similar rebate checks are mailed to approximately 22 million American. The GAO estimates that fraud and error problems are found in about 25% of the refunds.); GAO, *FEDERAL BUDGET: OPPORTUNITIES FOR OVERSIGHT AND IMPROVED USE OF TAXPAYER FUNDS*, 13 GAO-03-922T (June 18, 2003).

¹¹¹ *See infra* text at note 72.

tax proposals eliminate the federal income tax. Without the opportunity to piggy-back the federal income tax, most commentators expect that state income tax systems either will not survive,¹¹² or will survive in a more costly to administer, less efficient form.¹¹³ Others simply believe that the retail sales tax is just a bad choice for a national tax, without predicting the future.¹¹⁴ There is a consensus that the States will eventually be forced to recover lost revenue by broadening their retail sales tax base, typically by taxing a wider range of services. To do so it is expected that the states will piggy-back the broader federal base. Both proposals anticipate, and encourage this movement.¹¹⁵

State and Local Sales Tax Expansion. Under both the National Sales Tax and Fair Tax proposals the states would be the primary administrators of the federal tax. The federal government would be an administrator of last resort for those states unwilling or unable¹¹⁶ to assist.¹¹⁷ Three inducements are offered: (a) a fee is paid out of federal

¹¹² Peter L. Faber, *Effect of Federal Tax Reform on State and Local Government*, 79 TAX NOTES 109, 113 (Apr. 1998) (citing Harley Duncan in HARLEY DUNCAN, *FUNDAMENTAL TAX REFORM: WHAT ARE THE RAMIFICATIONS FOR THE STATES?* (1995) and the testimony of Harley T. Duncan, *Impact on State and Local Governments and Tax-Exempt Entities of Replacing the Federal Income Tax: Hearings Before the House Comm. On Ways and Means*, 104th Cong. 262 (1996)] (as the Executive Director of the Federation of Tax Administrators Harley Duncan takes an extreme position, on that Peter Faber agrees with, noting that Duncan, "... assumes, not unreasonably that the imposition of a national sales tax at the level contemplated by Sen. Lugar would in effect require the states to abandon their current income tax structures as well as their current sales tax structures."); Schenk, *A Federal Move to a Consumption-Based Tax*, *supra* note 15 at 89, 106-7 (takes a more moderate view, and indicates that, "[i]f federal tax reform repeals existing individual and corporate income taxes, individuals and businesses will not be calculating tax liability for federal purposes in the same fashion. This kind of radical federal reform may limit state tax options. In fact, one commentator suggested that states will not be able to maintain their income taxes if Congress repeals the federal income taxes.").

¹¹³ McLure, *State and Local Implications*, *supra* note 12, at 1528 ("In short, uncoordinated imposition of both state and Federal retail sales taxes appears to be quite unmanageable. ... Coordinated imposition of retail sales taxes by the two levels of government would be a far superior option. ... The primary problem seems to be the risk of excessive evasion resulting from the high combined rate of Federal, state, and local taxes."); Julie Roin, *The Consequences of Undoing the Federal Income Tax*, 70 U. CHI. L. R.EV. 319, 333 (2003) ("There is also the matter of the states' administrative capacity to maintain their own income taxes in the absence of a federal income tax. ... State systems will become more expensive to run; the additional expense may cause states to move to another revenue-raising mechanism, a decision that may itself have collateral consequences.").

¹¹⁴ Mikesell, *The American Retail Sales Tax*, *supra* note 12, at 162 ("Structural problems, however, suggest that [retail sales taxes] would not be the best sort of general consumption tax if the federal government were to replace its income tax.").

¹¹⁵ *Contra* Oliver Oldman & Alan Schenk, *The Business Activities Tax: Have Senators Danforth & Boren Created A Better Value Added Tax?* 10 TAX NOTES INT'L 1547, 1564, n.166 (1994) (observing that states are not anxious to piggy-pack federal tax law if along with the piggy-backing comes a significant loss of tax sovereignty, Oldman and Schenk observe, "[i]n the United States, no state accepted the federal government's offer to collect a qualified (harmonized) state individual income tax without charge. [See: IRC, subchapter E (§§ 6361-6365), repealed by P.L. 101-508, § 11801(a)(45).] This experience suggests that the states would strongly resist any pressure on them to harmonize their RST with a federal VAT or piggyback on a federal VAT. State opposition based directly or indirectly on anticipated loss of jobs of state sales tax officials might be significantly reduced if the federal government offered to train and absorb state employees to administer a federal VAT.").

¹¹⁶ Five states have no retail sales tax at the state level, and presumably could not be relied upon to assist the federal government in this effort. Those states, called the NOMAD states from an acronym derived from the first letters of their respective names, are: New Hampshire, Oregon, Montana, Alaska and

revenues,¹¹⁸ (b) information sharing arrangements are enhanced, and (c) the broader federal base will facilitate state base expansion.

The clear expectation of both the National Sales Tax and the Fair Tax is that fiscal federalism, the inclination of the states to piggy-back federal income tax schemes will carry over to the national sales tax. Both proposals rely on piggy-backing states to volunteer to collect and remit the federal tax. These states are called the “administering states”¹¹⁹ in both proposals.

Differences in the definition of an “administering state” critically define and distinguish these proposals. These differences reflect degrees of skepticism over how anxious the states will be to adopt and “administer” the federal sales tax.¹²⁰ Under the National Sales Tax “administering states” *must adopt* the federal sales tax “in all significant respects”¹²¹ in order to enter into a “cooperative agreement” to collect and remit the federal tax.¹²² Under the Fair Tax “administering states” *need not adopt* the federal tax, but only “maintain a sales tax,”¹²³ in order to enter into a cooperative agreement to collect and remit the federal tax.¹²⁴ If adopted and successfully operational, the National Sales Tax would usher in two significant changes in state sales tax regimes, one in the tax base, another in sourcing conventions.

(1) The National Sales Tax and Harmonized Tax Bases

Bringing all states retail sale tax base into harmony would be a major undertaking. Under federal proposals the sales tax base covers about 84% of GDP, whereas the average state base covers about 36% of GDP. Thus, if the National Sales Tax became fully operational the state sales tax bases would expand by about 50%.¹²⁵

Delaware. Alaska is different from the other NOMAD states in that it has local retail sales taxes. The other four have no retail sales taxes at any level of government.

¹¹⁷ Tauzin & Schaefer, *The National Retail Sales Tax*, H.R. 4168, *supra* note 94, at §31-34; Linder & Chambliss, *The Fair Tax*, H.R. 25/ S. 25, *supra* note 95, at §§ 401-407 (both proposals rely on state administration for success with appropriations for the Internal Revenue Service terminated under the National Retail Sales Tax at §3, and the 16th Amendment repealed under The Fair Tax at §2(f)).

¹¹⁸ Tauzin & Schaefer, *The National Retail Sales Tax*, H.R. 4168, *supra* note 94, at § 31(e)(1); Linder & Chambliss, *The Fair Tax*, H.R. 25/ S. 25, *supra* note 95, at § 401(d)(2) (both would pay states a 1% fee for tax administration services).

¹¹⁹ Tauzin & Schaefer, *The National Retail Sales Tax*, H.R. 4168, *supra* note 94, at § 31; Linder & Chambliss, *The Fair Tax*, H.R. 25/ S. 25, *supra* note 95, at § 401(b).

¹²⁰ Mikesell, *The American Retail Sales Tax*, *supra* note 12 at 152 and *infra* text at n.81 (examining this well founded skepticism and concluding that if state income tax piggy-backing of the federal income tax is used as a measure then it is appropriate to assume that the states may well not cooperate, because no state has even adopted (fully) the federal definition of income, at least after the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001).

¹²¹ Tauzin & Schaefer, *The National Retail Sales Tax*, H.R. 4168, *supra* note 94, at § 31(b)(1).

¹²² *Id.* at § 31(b)(2).

¹²³ Linder & Chambliss, *The Fair Tax*, H.R. 25/ S. 25, *supra* note 95, at § 401(b)(1).

¹²⁴ *Id.* at § 401(b)(2).

¹²⁵ Compare William Fox, *Should the Hawaii General Excise Tax Look Like Other State's Sales Taxes?* in STATE OF HAWAII, TAX REVIEW COMMISSION 12 (Oct. 15, 2002) available at http://www.hawaii.gov/tax/pubs/trc_app_a2003.pdf (charts setting out current sales tax base of U.S. States as a percentage of personal income) with Chris Edwards, *Options for Tax Reform*, 106 TAX NOTES 1529, 1548 (Mar. 28, 2005) (indicating the European VATs cover about 41% of GDP).

Conformity would also narrow the tax base of “administering states.” Business purchases are included in most state bases, and account for up to 40% of state sales tax revenues.¹²⁶ Taxing business inputs causes a “pyramiding” effect of tax-upon-tax and pulls the current system significantly out of conformity with normative consumption tax theory. This aspect of the current system is badly in need of repair, and the National Sales Tax would contribute significantly to improvement in this regard.

(2) The National Sales Tax and Harmonized Sourcing Rules

An equally significant change would be the adoption of destination-based sourcing conventions by “administering states.” This is the international norm, and the majority position in US jurisdictions. Destination sourcing means that US exports would be exempt from tax, while tax would be imposed on imports. Under the National Sales Tax “administering states” are required to apply destination rules to allocate revenue within and among the states.¹²⁷ A Federal Office of Revenue Allocation is established to resolve disputes among the “administering states.”¹²⁸

(3) The Fair Tax -- A Non-Harmonized Approach:

Reliance on State-level Only Systems and One-Stop-Shops

Proponents of the Fair Tax demand far less tax harmony among state and federal systems than do the proponents of the National Sales Tax. “Administering states” under the Fair Tax are free to adopt or reject both the federal tax base and the federal destination-based sourcing rules. The only requirement is that they have a sales tax.

This approach is more cautious about state acceptance, but is it any more realistic? The vast majority of sales tax systems are local, and change comes slowly to local revenue systems, particularly when those systems have been reliable sources of revenue over many years. There are 7,588 discrete retail sale tax jurisdictions in the US. Of this number 7,451 are local jurisdictions, and forty-seven (47), including the District of Columbia, are state level systems. The Fair Tax, like the National Sales Tax, relies on these forty-seven states to implement the bulk of the federal tax.

¹²⁶ Raymond J. Ring, *Consumers’ Share and Producers’ Share of the General Sales Tax*, 52 NAT’L TAX J. 79, 85 (1999) (estimating that on an aggregate level final consumption represents 59% of the national RST base with 41% of the tax born by business inputs, based on underlying data that shows a range of tax burdens with a low consumer burden of 28% in Hawaii to a high consumer burden of 89% in West Virginia.); Raymond J. Ring, *The Proportion of Consumers’ and Producers’ Goods in the General Sales Tax*, 42 NAT’L TAX J. 167, 171(1989) (presenting the results of a similar study performed ten years earlier showing the same aggregate national results [a 59% burden on final consumption and a 41% burden on business inputs], even though the underlying data was different, and demonstrating that Wyoming had the lowest consumer burden at 35%, and Massachusetts with the highest at 82%.)

Collectively, the Ring studies indicate that moving to a comprehensive national tax base, imposed on final consumption, not business inputs would present states like Hawaii and Wyoming with a significant adjustment. States like West Virginia and Massachusetts, which already depend primarily on final consumption in their retail sales tax would find this adjustment easier.

¹²⁷ Tauzin & Schaefer, *The National Retail Sales Tax*, H.R. 4168, *supra* note 94, at § 53(a).

¹²⁸ *Id.* at § 53(b).

Thirteen (13) states have a state level tax without local taxes. These thirteen states should encounter the least amount of local resistance to state administration of the federal tax. The other thirty-four (34) states is where many of the problems will be encountered. In these jurisdictions the state tax overlaps with further overlapping county, district, and city levies.¹²⁹ Fortunately for the Fair Tax and National Sales Tax proponents twenty-five (25) of these have “one-stop-shop” mechanisms where the state government acts as the tax collector for the locals.¹³⁰ Single state-level returns, uniform in-state sourcing rules, harmonized definitions of what could be included in a local tax base, single state-level audits, and simplified automated filing opportunities are reasonably common in these states.

The Fair Tax appeals directly to these thirty-eight (38) states (the thirteen states with only a state-level tax, and the twenty-five “one-stop-shop” states). Unlike the National Sales Tax proposal, it offers these states immediate status as “administering states” in the federal system without any state or local level law changes in the tax base or sourcing conventions. These states need only to agree to administer another level of tax, admittedly one with a different, broader base, and frequently one with different sourcing rules, but the perception is that the state tax administrative structure is already in place to collect such a federal tax.

Greatest administrative difficulties for the federal tax will be encountered the three remaining groups of states. In five (5) states¹³¹ there is a mixed administrative system, where the state collects taxes for some locals, but not for others. In four (4) states¹³² all local jurisdictions are fully autonomous. In one of these, Alaska, there is no state level retail sales tax, making state coordination of local sales taxes in this state as remote as state administration of the federal tax in the final group of four (4) states where there is neither state nor local retail sales tax systems.

Summary: 50 States and District of Columbia

Only State-level RST	State & Local RST's			Only Local RST	No RST at any level of government
	Full One-Stop-Shop	Partial One-Stop-Shop	No One-Stop-Shop		

¹²⁹ The 13 states that have only a state level retail sales tax are: Connecticut, Hawaii, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, Mississippi, New Jersey, Rhode Island, and West Virginia, as well as the District of Columbia. There are some limited exceptions to this rule. Some counties in Indiana are authorized to levy miscellaneous local taxes on specified transactions. IND. CODE ANN. § 6-9-34-1 (2003). In Mississippi even though general sale taxes at the local level are not permitted, some counties and cities are authorized to impose hotel-motel occupancy and taxes on restaurant sales. MISS. CODE ANN. § 27-65-73 (1984). In New Jersey only Atlantic City is permitted to impose a local levy, and only on specific types of retail sales. N.J. REV. STAT. § 40:48-8.15 (1947). In Rhode Island an additional 1% levy is added to meals and beverage sales for local use. R.I. GEN LAWS § 44-18-36.1 (2004). Effective on July 1, 2005 a general sales and use tax may be imposed by municipalities in West Virginia. W.VA. CODE ANN. § 8-13C-4 (2004).

¹³⁰ The 25 states are: Arkansas, California, Florida, Georgia, Illinois, Iowa, Kansas, Missouri, Nebraska, Nevada, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, and Wyoming.

¹³¹ The 5 states are: Alabama, Arizona, Colorado, Minnesota, and Wisconsin.

¹³² The 4 states are Alaska, Idaho, Louisiana, and Vermont.

13	25	5	3	1	4
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Recognizing that implementation of a national sales tax through the states would be easiest if state and local tax bases were permitted to remain the same, and if local sourcing conventions were not changed, the Fair Tax hopes to entice at least the first thirty-eight states in the above chart to become “administering states.”

The Double-Edged Sword of Harmonization

The National Sales Tax proposal requires tax base and sourcing harmonization at state and local levels before allowing a state to administer the federal sales tax. At the present time no state meets both of these requirements. Each “administering state” will be required to change state and sometimes local tax laws before becoming an “administering state.”

The importance of harmonizing tax bases and sourcing rules, and the difficulty of accomplishing this task is the double-edged sword that cuts deeply into the viability both the Fair Tax and the National Sale Tax proposals.¹³³ Not harmonizing the combined federal-state-local sales tax bases and sourcing rules seriously wounds the Flat Tax. Considerable complexity is brought into the system as fundamentally different federal rules are laid atop pre-existing state and local systems. However, imposing harmonized tax base and source rules on state and local jurisdictions that have a history of resisting change seriously cripples the National Sales Tax.

Sourcing Conventions:

Why Must Source Rules Be Harmonized? Why Will Harmonization Be Resisted?

The Supreme Court has imposed uniform sourcing rules on all state and local sales tax regimes in one instance; where tangible property is sold across state lines.¹³⁴ These rules do not apply to services.¹³⁵ Nor do these rules apply to intra-state sales; sales

¹³³ GALE, WHAT WOULD THE RATE HAVE TO BE? *supra* note 99, at abstract & 4-5 (indicating that this is apart from a consideration of the federal tax rate, which, under his analysis, seems unlikely to be less than 50% regardless of the tax adopted, either the National Sales Tax or the Fair Tax).

¹³⁴ *Evco v. Jones*, 409 U.S. 91 (1972). *Evco* entered into contracts outside of New Mexico to produce camera-ready text that were delivered to an out-of-state location. All work necessary to produce the texts was performed within New Mexico. The procedural history of this case is important.

The Commissioner’s assessment was upheld at the New Mexico Court of Appeals as properly imposed on the sale of tangible personal property (473 P.2d 911). At the Supreme Court the New Mexico Attorney General conceded that a tax on tangible personal property would be improper, but in this instance the tax was properly imposed on services (not tangible personal property) within the state. The Supreme Court vacated the lower court’s judgment and remanded on the question of whether tangible personal property (the camera-ready texts) or services (the development of the camera-ready texts) were being sold (402 U.S. 969). The Court of Appeals reaffirmed their decision, finding (a) as a factual matter what was sold was tangible personal property, and (b) as a matter of law the distinction between sales of property and sales of services was irrelevant.

The Supreme Court disagreed. Citing *Department of Treasury v. Ingram-Richardson Manufacturing Co.*, 313 U.S. 252 (1941) the court stated, “Our prior cases indicate that a State may tax the proceeds from services performed in the State, even though they are sold to purchasers in another State.” (409 US at 93). Thus, it concluded, “since the Court of Appeals approved the imposition of a tax on the proceeds of the out-of-state sale of tangible personal property, its judgment is reversed.” (409 US at 94).

¹³⁵ *Ingram-Richardson*, 313 US 252 (1941); *Evco*, 409 US 91 (1972).

of tangible personal property or services entirely within a single state. Under the interstate commerce clause, sales of tangible personal property between states must be taxed on a destination basis. Other than this one situation, states are free to source sales under either origin or destination principles. Left to their own means, the states are split nearly evenly on the adoption of origin and destination sourcing conventions. Of the 7,588 US jurisdictions imposing retail sales taxes, 53.8% use destination rules, and 46.2% have adopted origin conventions.¹³⁶

The difference between these methodologies can be demonstrated in the following example. If a business in city X sells to a customer in city Y: (a) under origin principles tax will be imposed in city X, using city X's tax rate, if the sale is included in X's tax base, however (b) under destination principles tax will be imposed in city Y, using city Y's tax rate, if the sale is included in Y's tax base.

Both proposals for a national sales tax impose tax on a destination basis. It is apparent that it will be far easier for an "administering state" to collect a destination-based federal sales tax if the underlying state system also determines liability on destination principles, and if the state's tax is imposed on the same tax base as the federal tax. However, in at least half of the US jurisdictions "administering states" will be determining taxability for state and local purposes based on the seller's obligations at one location and determining taxability for federal purposes based on the purchaser's characteristics at a different location.

Is harmonization likely? The answer might be found in the effort that has been underway for half a decade to harmonize state sourcing rules around the destination principle through the Streamlined Sales Tax Initiative (SSTI). The *Streamlined Sales and Use Tax Agreement* (SSUTA), which is the product of the SSTI, is a voluntary agreement among the states to simplify, harmonize and modernize the retail sales tax. The SSUTA seeks uniform destination-based sourcing rules¹³⁷ for all goods and services.¹³⁸ As of August 2004 fifteen states¹³⁹ representing 24% of the US population¹⁴⁰ had passed conforming legislation. There have been delays in effective dates and some threats to reverse course. A key issue delaying the implementation of SSUTA is the provision for

¹³⁶ This determination of origin jurisdictions is based on a recent count with the best available information, and represents 573 counties, 2,793 cities, and 141 districts. At one extreme is Texas with 1,243 origin jurisdictions (1,141 cities, and 101 districts). At the other extreme are states like Pennsylvania where just the city of Philadelphia is origin, and Mississippi where just the city of Tupelo is origin.

¹³⁷ Walter Hellerstein & John A. Swain, *The Streamlined Sales and Use Tax Agreement's Sourcing Rules*, 2004 STATE TAX NOTES 375 (Oct. 13, 2004) (presenting a comprehensive discussion of the destination sourcing rules in the Streamlined Sales and Use Tax Agreement).

¹³⁸ Streamlined Sales and Use Tax Agreement (adopted November 12, 2002, amended November 19, 2003 and further amended November 16, 2004) available at <http://www.streamlinedsalestax.org>. § 309(A) (indicating that the same sourcing rules apply to both tangible personal property and services); § 310(A) (setting out a uniform five-step sourcing hierarchy to be followed in all cases, comprised of four sequentially applied destination-based rules and an origin-based rule to be applied as a last resort).

¹³⁹ The 15 states with conforming legislation are: Indiana, Iowa, Kansas, Kentucky, Michigan, Nebraska, North Carolina, Ohio, Oklahoma, South Dakota, West Virginia, Wyoming, Montana, Tennessee, and Utah.

¹⁴⁰ SSUTA *supra* note 138, at § 701 (establishing the 10 state, 20% rule); § 805 (requiring that state legislation must be "substantial compliance" with the SSUTA).

destination sourcing. Opposition is strongest in Ohio, Kansas, Texas, Tennessee, Utah, and Washington.¹⁴¹

Strong resistance to harmonized destination sourcing rules among the small number of states most committed to broad sales tax reform is not a good sign. Even with SSUTA success, fifteen states representing twenty-four percent of the US population is nowhere near the number needed to implement even a marginally effective tax of the National Sales Tax design. Major sales tax states like California, Texas, and Illinois are also expected to have difficulties with SSUTA's destination sourcing, if and when they propose conforming legislation. As Charles Collins indicates:

The [SSUTA] effort has been ongoing since March 2000, when the project was organized. After five years, the project is at a pivotal point. In order for the [SSUTA] to become effective, ... at least 10 states with 20 percent of the population of states with sales taxes must be in compliance with the requirements of the agreement The target date to reach that threshold is July 1, 2005. ... The agreement provision that has resulted in the most controversy in several states is the sourcing of intrastate shipments on a destination basis.¹⁴²

Thus, the pattern of resistance to harmonized, destination-based sourcing rules, apparent in the SSUTA negotiations, makes successful implementation of the National Sales Tax proposal unlikely. However, the non-harmonized approach considered by Fair Tax proponents presents daunting administrative burdens. For at least half of all US

¹⁴¹ Letter from Bob Taft, Governor of Ohio, to Conforming States and the Streamlined Sales Tax Project Representatives (Jan. 5, 2005) at <http://tax.ohio.gov/channels/business/documents/doj50016:Gov%27sapptSSTP.pdf> (last visited Aug. 29, 2005, and on file with author) (Governor Taft's letter explained that Ohio, which had enacted destination rules for sourcing, had enacted a delay in their adoption. This delay was quickly followed by a similar delay in Utah. The reason for the delay was that destination rules would have a significant impact on small businesses that sold mostly in local markets and only an occasional distance sale. These businesses would now have to collect sales and use taxes in Ohio locations, where they had never filed before. Governor Taft asked for "an amendment that would provide relief for small businesses. This relief could take the form of a longer transition period or a permanent *de minimis* exception for small retailers. Such a modification of the Agreement would be very welcome by Ohio's small business community, and would help ensure Ohio's continued full participation in the SSTP.").

Ohio's problem with destination sourcing are outlined in NOTES ON OHIO REQUEST TO AMEND SSUTA FOR SOURCING TRANSACTIONS," at <http://tax.ohio.gov/channels/business/documents/doj50016:Gov%27sapptSSTP.pdf> (last visited Aug. 29, 2005 and on file with author) ("It is unclear at this point in time whether software will be available and affordable for vendors. We have contacted numerous Point of Sale vendors to check on the status of software development, but we have had limited response. [In addition,] despite a massive education effort, there are still some unresolved issues that make the switch difficult for small businesses. We have sent more than a million letters to vendors, have provided brochures, have conducted seminars for the general public and interested groups, and have developed an Internet application to determine tax rate and track sales, as well as paper solutions. ... Larger/national vendors in their dealings with multiple states and the differences between those states do not have the same problems that sellers with single or limited locations have in making the change from origin to destination sourcing [small sellers].").

¹⁴² Charles Collins & Carolyn Iafra, *Will the Failure of Some States to Enact Destination-Based Sourcing Prevent the Streamlined Agreement From Becoming Effective July 1? 2005 STATE TAX NOTES 967* (March 28, 2005) [2005 STT 58-2].

jurisdictions the “administering states” under the Fair Tax will need to roughly double their audit and collection efforts, as they will determine tax on both origin and destination basis for the same sales transaction.

Tax Base Harmonization:

The Efficiency Need to Harmonize and the Political Resistance to It

Both the Fair Tax and the National Sales Tax rely on state expertise in enforcing retail sales taxes to make the federal tax work. However, the federal tax base under both the Fair Tax and the National Sales Tax is both broader and narrower than the current state and local tax base. The federal base will cover 84% of GDP whereas the average state and local base covers 36% of GDP.¹⁴³ In addition, business purchases are exempt from the federal base,¹⁴⁴ but average up to 40% of the state and local base, with individual state amounts reaching between 65% and 72%.¹⁴⁵

If state and local jurisdictions harmonize their base with the federal, as is assumed under the National Sales Tax, then efficiency claims like the following from Burton and Mastromarco are easy to understand: “Since the marginal cost to a state of collecting the federal tax in addition to their own sales tax (for which they already incur costs) would be quite small, the 1% fee should constitute a strong incentive to become a conforming and administering state.”¹⁴⁶ However, if base harmonization is not presumed, as under the Fair Tax, then it is unlikely that “the marginal costs to a state to collect the federal tax ... would be quite small.”

This is because harmonizing with the federal base would be a major undertaking in most jurisdictions. Taken as a percent of GDP, state bases range from a low of 26% of GDP in New Jersey to a high of 71% of GDP in New Mexico.¹⁴⁷ Most of the reason for this range has to do with the inclusion of services in the New Mexico base, for example and the omission of services, or at least a very limited inclusion in most other states.

A study conducted by the Federation of Tax Administrators focused on state taxation of service. This study isolated 164 different potentially taxable services and found that Hawaii had the highest rate of taxing them (157 out of 164), and that Nevada was at the low end (11 out of 164).¹⁴⁸ Considered another way, Hawaii and three other states were at the high end. These states were the only states to tax physicians and dental

¹⁴³ Edwards, *Options for Tax Reform*, *supra* note 125, at 1548 (further citing statistical work of Fox, *Should Hawaii Look Like Other State’s Sales Taxes?* *supra* note 125, at 12).

¹⁴⁴ Linder & Chambliss, *The Fair Tax*, H.R. 25/ S. 25, *supra* note 95, at §§ 201 (a) and 202; Tauzin & Schaefer, *The National Retail Sales Tax*, H.R. 4168, *supra* note 94, at §§ 2(a)(1); 2(b)(1) and (b)(2)-(3).

¹⁴⁵ Ring, *Consumer’s Share*, *supra* note 126, at 85 (a 1999 study finding a high of 72% in Hawaii); Ring, *Proportion of Consumer’s*, *supra* note 126, at 171 (a 1989 study finding a high of 65% in Wyoming).

¹⁴⁶ David R. Burton & Dan R. Mastromarco, *The National Sales Tax – Moving Beyond the Idea*, TAX NOTES at paragraph 22 (May 28, 1996) [96 TNT 104-88].

¹⁴⁷ Edwards, *Options for Tax Reform* *supra* note 126, at 1548 (further citing statistical work prepared by Fox, *Should Hawaii Look Like Other State’s Sales Taxes?* *supra* note 126, at 12 indicating that European VATs cover about 41% of GDP).

¹⁴⁸ FEDERATION OF TAX ADMINISTRATORS, 1997 SALES TAX OF SERVICES REPORT (not updated after 1997), at <http://www.taxadmin.org/fta/pub/services/services.html> (last visited Aug. 29, 2005).

services.¹⁴⁹ Similarly accountants and lawyers services were taxed in only five jurisdictions.¹⁵⁰ At the other extreme, all 50 states taxed hotel, motel, and lodging services, 46 taxed general repair services, and 45 taxing printing and video rentals. The states with the broadest coverage of services are Hawaii, New Mexico and South Dakota. Those with the least coverage include California and Nevada.¹⁵¹ Under both of the federal sales tax proposals doctors, lawyers, dentists and accountants will be taxed just as comprehensively as are hotels, motels and lodging services under the current system.

Thus, if local decisions about the tax base do indeed reflect the local political sense of what is “fair,” then one might expect more resistance to the National Retail Sales Tax and the Fair Tax in California and Nevada, but not so much in Hawaii, South Dakota or New Mexico. For either of these taxes to be considered “fair” in this sense it would require considerable accommodation with the thousands of “fairness formulas” in operation in the US.

Reaching this consensus will require more than mere legislative change. There is a political cost to extending sales tax to services. Grassroots resistance has overpowered good theoretical arguments made in favor of the expansion of a traditional tangible property sales tax base to services; arguments like broadening the tax base, lowering the tax rate, or minimizing substitution effects have not always held sway. On occasion, however, theory has prevailed.¹⁵² At least three states today do successfully tax a broad range of services.¹⁵³

Both Massachusetts and Connecticut added professional services to the sales tax base for a short period of time. The laws were quickly suspended or repealed.¹⁵⁴ However, it is the 1987 Florida experience with taxing services that is the one that resonates most in state tax circles. During its regular 1987 session the Florida legislature enacted a sales and use tax on a broad range of services consumed in the state. Walter Hellerstein records:

The storm of controversy surrounding Florida’s sales tax on services did not subside with its enactment and implementation. Indeed, it intensified. ... Coca-Cola, General Foods, Kraft, Lever Brothers, and Proctor & Gamble cancelled or reduced their advertising in Florida to protest the tax. Media trade associations ... cancelled at least 60 conventions they had booked in the state. Advertisers and media were

¹⁴⁹ Delaware, New Mexico and Washington are the other states in the survey.

¹⁵⁰ Hawaii, South Dakota, Delaware, New Mexico and Washington are the states in the survey.

¹⁵¹ JOHN F. DUE AND JOHN L. MIKESSELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 89-90 (2nd Edition 1994).

¹⁵² Kirk J. Stark, *Florida Services Tax: The Uneasy Case for Extending the Sales Tax to Services*, 30 FLA. ST. U. L. REV. 435, 437-438 (2003) (summarizing these arguments as, “[c]urrent calls for reforming the sales tax harkens back to the proposals made by those who advocated a ‘comprehensive tax base’ as a principal goal of federal income tax reform. The idea here is the same – all else being equal, it is generally preferable for the tax base to be as broad as possible. In addition to enabling lower rates, broadening the base minimizes the likelihood that close substitutes will be taxed differently. As a result, a broad base will generally result in fewer behavioral distortions than a narrow base.”).

¹⁵³ Hawaii, New Mexico and South Dakota all tax a broad range of services.

¹⁵⁴ DUE AND MIKESSELL, SALES TAXATION (1994), *supra* note 151, at 90.

joined by lawyers, realtors, and homebuilders in assailing the tax. ... [T]he tax became effective July 1, 1987 ... Responding to the public outcry against the tax ... Governor Martinez, whose initial support of the sales tax on services was critical to its enactment, reversed course. In late August 1987, the Governor called for a public referendum ... By mid-September he had taken a position in favor of outright repeal. ... On December 11, 1987, the Florida legislature enacted legislation ... raising the sales tax rate from five to six percent and repealing the sales tax on services effective January 1, 1988.¹⁵⁵

This was more than an emotional grass roots resistance to extending the retail sales tax to services. The movement in Florida was buttressed by sound economic analysis¹⁵⁶ pointing to a critical flaw in the taxation of services through the retail sales tax. As Due and Mikesell note, “ ... it is virtually impossible to delineate services that are production inputs from those that are consumption purchases.... Only the value-added tax form of a sales tax can successfully distinguish effectively between business input and consumer services.”¹⁵⁷

PART IV: EU-STYLE CREDIT-INVOICE PROPOSALS

The leading academic proponents of an EU-style credit-invoice VAT for the US are Professors Michael Graetz (Yale),¹⁵⁸ and Reuven Avi-Yonah (Michigan).¹⁵⁹ The

¹⁵⁵ Walter Hellerstein, *Florida's Sales Tax on Services*, 41 NAT'L TAX J. 1, 14-15 (1988) (as an interested observer of the Florida services tax Hellerstein notes, “In the interest of full disclosure, it should be noted that I played a significant role in drafting Florida's tax on services, and that I served as counsel to the Florida Department of Revenue in connection with its legal defense of the statute.”).

Two earlier studies of the Florida services tax are useful. Walter Hellerstein, *Extending the Sales Tax to Services: Notes from Florida*, 34 TAX NOTES 823 (Feb. 28, 1987) (a legal policy paper on the taxation of services under a retail sales tax that uses the Florida services tax as the baseline example); Walter Hellerstein, *A Primer on Florida's Sales Tax on Services*, 35 TAX NOTES, 1219 (May 25, 1987) (a brief but thorough description of the Florida services tax statute).

¹⁵⁶ William F. Fox & Matthew Murray, *Economic Aspects of Taxing Services*, 41 NAT'L TAX J. 19, 33 (1988) (demonstrating that: (1) the administration and compliance costs to taxing services are greater than those associated with simply increasing the rate on the current base, (2) the impact on the development of certain industries is greater with expanding the base to services, than it would be to simply increase the rate on the current base, and (3) that taxing services is regressive for incomes under \$30,000, and proportional for incomes above that amount). *Contra* John Siegfried & Paul Smith, *The Distributional Effects of a Sales Tax on Services*, 44 NAT'L TAX J. 41, 52 (1991) (demonstrating that the overall tax on services in Florida was “slightly less regressive” than the rate increase that replaced the services tax, “but the difference is hardly noticeable.”).

¹⁵⁷ DUE AND MIKESSELL, SALES TAXATION (1994), *supra* note 151, at 91-92; BEN TERRA, *The Superiority of the VAT*, in SALES TAXATION: THE CASE OF VALUE ADDED TAXATION IN THE EUROPEAN COMMUNITY, ed. Ben Terra, 145, 150 (presenting the views of a European VAT scholar who compares the American RST with the European VAT and reaching the same conclusion).

¹⁵⁸ GRAETZ, THE DECLINE (AND FALL ?), *supra* note 3, at 262-67 (as initially proposed, the Graetz VAT was advanced very casually in about four or five pages near the end of this book).

¹⁵⁹ Avi-Yonah, *Risk, Rents, and Regressivity*, *supra* note 11, at 1651 (supporting Graetz, Avi-Yonah favors a credit invoice VAT with revenue enhancing modifications).

leading Congressional proponent is Senator Ernest Hollings.¹⁶⁰ The common characteristic of each of these VAT proposals is that, unlike the Flat Tax, Bradford's X-tax, the USA Tax, the Simplified USA Tax, the National Retail Sales Tax and the Fair Tax, they are not offered as replacements for the income tax.

Professor Graetz's original proposal was for a revenue-neutral credit-invoice, 12% destination VAT¹⁶¹ that would cut corporate tax rates in half, and eliminate individual income tax filings for families with an adjusted gross income of less than \$75,000. The paperback edition of his book contains an essay, "Appendix A: A Tax System for the 21st Century,"¹⁶² where Graetz revises his proposed tax rate to a range of 10 to 15%, and raises the exemption amount to \$100,000 for married filers, \$50,000 for single. For income earned over \$100,000 (or \$50,000) the income tax rate would remain a flat 25%. It would not be progressive.

Avi-Yonah agrees with Graetz's approach, but disagrees with Graetz's revenue neutrality stance. Avi-Yonah believes that the current income tax is not so complex that it needs to be modified, and more importantly he believes that the revenue from a VAT should be used to fund social programs. "To finance the retirement and health needs of the baby boom generation, not to speak about other urgent needs like extending health insurance to all Americans, we face a budgetary gap of US \$70 trillion. There is simply no way to raise that kind of revenue with the existing income tax."¹⁶³

¹⁶⁰ The War Financing Act of 2003, S. 112, 108th Cong. (2003), available at <http://thomas.loc.gov/bss/d108/d108laws.html>; The National Health Insurance Act, S. 169, 103rd Cong. (1993), available at <http://thomas.loc.gov/bss/d103/d103laws.html> (parallel legislation to S. 169 was offered by Representative Dingle, HR 16, 103rd Cong. (1993), available at <http://thomas.loc.gov/bss/d106/d106laws.html>).

There have been earlier proposals for a European-style VAT in the US. In 1980 Representative Al Ullman proposed a tax reform package that included the adoption of a 5-percent European-style value added tax. The VAT was intended to offset cuts in the individual and corporate income taxes and the payroll tax. Senator Hollings proposed a federal VAT in 1991 and again in 1994. The Deficit and Debt Reduction Act of 1991, S.169, 102nd Cong., (1991), available at <http://thomas.loc.gov/bss/d102/d102laws.html>; The Deficit and Debt Reduction and Health Care Financing Act of 1994, S. 2143, 103rd Cong., (1994), available at <http://thomas.loc.gov/bss/d103/d103laws.html>.

Representative Dingell also proposed a European-style credit-invoice VAT to finance national health care. (H.R. 16, 103rd Cong., (1991), available at <http://thomas.loc.gov/bss/d103/d103laws.html>).

¹⁶¹ GRAETZ, THE DECLINE (AND FALL ?), *supra* note 3, at 264-266 (suggesting that a VAT rate of 10% would be sufficient to replace half of the revenue from personal income tax, and that an additional 2% would be needed to reduce the corporate income tax by 50%). *Contra* William G. Gale, *Tax Reform in the Real World*, 15 YALE J. ON REG. 387, 424 and n.231 (1998) (questioning the methodology that Graetz uses to determine rates, but comes to the same number of 12% based significantly on Vito Tanzi's analysis of the European VATs and the need to raise revenue of about 5.1% of GDP [VITO TANZI, TAXATION IN AN INTEGRATING WORLD 50 (1995)]; Daniel R. Feenberg et al. *Distributional Effects of Adopting a National Retail Sales Tax*, 11 TAX POL'Y & ECON. 49, 75 (1997) (estimating the VAT rate for Graetz proposal by assuming his VAT to be roughly equal to a pure retail sales tax on all goods and services, and arriving at a rate of 8.5%, but if demogrants are provided (as is the case under the Graetz proposal) and if 20% of the tax base is exempted from the VAT (as is the case in Graetz proposal), then Feenberg estimates that the VAT rate of 26% would need).

¹⁶² MICHAEL J. GRAETZ, THE U.S. INCOME TAX 303-314 (1999).

¹⁶³ Avi-Yonah, *Risk, Rents, and Regressivity*, *supra* note 11, at 1651.

Both of the recent VAT proposals by Senator Hollings adopt the ABA Model VAT Statute¹⁶⁴ as a template. In one instance a 5% VAT is offered by Hollings as a financing mechanism for the National Health Insurance Act, in the other a 1% VAT is offered as a way to finance the Iraq conflict in the War Finance Act of 2003. The Hollings proposals are not intended as fundamental tax reform proposals, although they have been accepted as such in the ongoing tax reform debate.

Neither the Graetz¹⁶⁵ nor the Avi-Yonah¹⁶⁶ proposals focus on VAT design or administration issues. Both prefer to discuss theory, and engage in discussions that are reminiscent of the debate engage in among the early proponents of the cash-flow or consumed income tax, particularly that of Professors Andrews and Warren in their assessment of the relative fairness of alternate reform proposals.

If we are to take these proposals seriously, we need to come to grips with the fact that the Graetz, Avi-Yonah, and Hollings proposals are, in a very real sense, all looking backward. They offer an assessment of how well the historical European VAT would “fit” within the present day American tax landscape. The European-style VAT that these proposals reference was designed and implemented in a paper world, and the future is clearly digital. The European VAT is moving slowly toward a Digital VAT. However, subject to very limited exceptions, the system today remains paper-intensive; one that is struggling with the addition of 10 new accession countries; one that now has 20 official languages and a wide range of technological ability. At the moment tax laws, regulations, forms and instructions are not only not digital, but they are often available only in local languages.

If the US were to adopt a federal level VAT it should have a forward-looking design. Unencumbered by a currently operating paper VAT, unencumbered by language barriers and cultural differences, the US can look forward to an advanced, fully digital VAT. A Digital VAT is the only federal consumption tax that will “fit” easily into the present state-federal tax landscape without demanding difficult structural and political change.¹⁶⁷

¹⁶⁴ ALAN SCHENK, ABA SECTION OF TAXATION, VALUE ADDED TAX – A MODEL STATUTE AND COMMENTARY, 12 (1989) (“The Model Act is a consumption-style, destination principle, invoice method VAT imposed on the seller’s sale of taxable property and services. The Model Act adheres closely to the economic concept of a destination principle tax, taxing imports and zero rating exports of property and services.”).

¹⁶⁵ GRAETZ, THE U.S. INCOME TAX, *supra* note 162 at 333, n.5 (indicating a preference for the VAT draft statute contained in the BASIC WORLD TAX CODE (Ward Hussey & Donald Lubick eds., 1990)).

¹⁶⁶ Avi-Yonah accepts the Graetz proposal and does not advance a preference for one model statute over another, nor does Avi-Yonah make VAT administration an issue.

¹⁶⁷ Richard Bird & Pierre-Pascal Gendron, *Dual VATs and Cross-Border Trade: Two Problems, One Solution?* 5 INT’L TAX & PUB. FIN. 429, 439 (1998) (A common solution to the “fit” of a federal VAT with state level RSTs is to encourage the States to adopt sub-national VATs in the manner of the Canadian Provinces. Richard Bird and Pierre-Pascal Gendron advocate this Dual VAT solution. It is anticipated that a change like this would be at least as difficult, if not more so, than asking the States to adopt the federal sales tax base and sourcing rules under either the National Sale Tax or the Fair Tax. But according to Bird and Gendron, “... there is no need to be excessively pessimistic about the possibility of decent subnational VATs, (if there is) ... good tax administration ... (and) an overriding central VAT on approximately the

PART V: DIGITAL VAT (D-VAT)

A Digital VAT (D-VAT) is proposed for the US following the basic design and structure of the EU VAT. For ease of reference, this discussion will, when necessary, reference the ABA Model VAT, or the IMF *Vatopia* model.¹⁶⁸ If based on the ABA Model or *Vatopia*, the D-VAT would make significant changes in the administration provisions, but would adopt most other provisions.¹⁶⁹

The premise of this proposal is that if a destination-based national VAT of the credit-invoice type is designed with attention to automated tax collection, digital reporting, technology-intensive audit, and enforcement structures, then many of the problems that have plagued proposals for a national consumption tax in the US can be resolved.¹⁷⁰

same base ... “ But, “... one of the major lessons of the Canadian experience ... not everyone has to follow the same path ... Canada shows, for instance, one can have both a dual VAT (as in Québec) and a “harmonized” (or “common”) VAT (as in several Atlantic provinces). Indeed, one can even have member “states” such as Alberta with no VAT at all, or other members (the other five provinces) with quite independent forms of sales taxation. The Canadian system is complicated. It lacks conceptual purity, and no doubt violates some efficiency and administrative criteria; but it works.”); Richard Bird & Pierre-Pascal Gendron, *CVAT, VIVAT, and Dual VAT: Vertical ‘Sharing’ and Interstate Trade*, 7 INT’L TAX & PUB. FIN. 753, 758 (2000) (further developing the Dual VAT concept and contrasting it with other proposals for VATs in a federal system); Alan Schenk, *Choosing the Form of a Federal Value-Added Tax: Implications For State and Local Retail Sales Taxes*, 22 CAP. U. L. REV. 291, 318 (1993) (suggesting that the Canadian solution might work for the US). Schenk, *A Federal Move to a Consumption-Based Tax*, *supra* note 15, at 111-118 (fully developing the Canadian option for the US); Charles E. McLure, *Coordinating State Sales Taxes With a Federal VAT: Opportunities, Risks, and Challenges*, STATE TAX NOTES 907, 918 (June 20, 2005) (After establishing five principles of an ideal sales tax: (1) imposing the tax on all goods and services at a single rate, (2) exempting all business purchases, (3) uniform destination sourcing, (4) low administrative costs, and (5) freedom at all levels of government to determine the tax rate, he concludes that, “Either a state VAT or an state RST could relatively easily be combined with a federal VAT, as long as both conformed with the principles of an ideal sales tax.” McLure, of course, is assuming his conclusion. The real issues have always involved how to coordinate the 7,588 RSTs in the US, each of which is designed very far from the ideal, and for this McLure has no answer other than to say that, “My conclusions are generally consistent with those that Richard Bird reached a decade ago [in Richard M. Bird, *Cost and Complexity of Canada’s VAT: The GST in International Perspective*, 1994 TAX NOTES INTERNATIONAL 37, 47 (Jan. 3, 1994)] ... ‘agreeing on a common tax base and letting one level of government collect the tax...’ ”).

¹⁶⁸ IMF, TAX LAW DRAFTING SAMPLES: VAT, INCLUDING HYPOTHETICAL TAX LAWS, at <http://www.imf.org/external/np/leg/tlaw/2003/eng/tlvat.htm> (last visited Aug. 29, 2005) (a working paper of the IMF legal staff *Vatopia* has “... not been considered by the IMF executive Board and, hence, [is] not [an] official document of the IMF; and should not be attributed to the IMF as an institution. ... the principle author is Alan Schenk (Professor of Law, Wayne State University, and technical advisor, Legal Department, IMF). Contributors include Lee Burns (University of Sydney) and Victor Thuronyi (IMF).”).

¹⁶⁹ There are many model VATs to choose from. When statutory references are needed, this proposal will make reference to both the ABA Model and *Vatopia*. The ABA Model occasionally varies from the standard E.U. VAT under the *Sixth Directive*. It is notably less detailed, leaving places for political compromise and adjustments. Among the variances are the provisions for casual sales where a threshold provision applies, § 4003(a)(3); the omission of a small trader exception, discussed at pages 57-58; special rules for taxing gambling activities, lotteries and other games of chance, §4011(e).

¹⁷⁰ SCHENK, VALUE ADDED TAX – A MODEL STATUTE, *supra* note 164 at 123, n.305 (The ABA Model anticipates this proposal, although it is unlikely that in 1989 the drafters foresaw the full impact of modern

This is not a case of simply adding technology to any national consumption tax. It is not just the technology that produces a winning solution. It is the specific marriage of technology with the European VAT that does. Because it is transactional, rather than periodic, the credit-invoice VAT is far more receptive to digitization than the subtraction VATs proposed as part of the Hall-Rabushka Flat Tax, or any of the myriad hybrid (or “two-tiered”) consumption taxes.

The D-VAT base is comprehensive and the data collected is fungible. The transactional data can be shared with the states at a primary level, as simply the digital record of all transactions in the economy. Sharing at this level does not necessitate fundamental changes in the nature of the state retail sales taxes. States will be allowed to “piggy-back” on the federal database without requiring the adoption of the federal taxing method (VAT), the federal tax base (comprehensive) or the federal sourcing conventions (destination). Piggy-backing in this manner will allow the 7,588 American retail sales tax jurisdictions to maintain their independence and their diversity. Not that some simplification or harmonization of these rules might be desirable or even necessary in some respects, but that is a separate question.

DIGITAL VAT IN EUROPE

Digitizing the VAT in Europe is part of a broad effort to bring the efficiencies of an information society to the EU. Dubbed the “Lisbon Strategy,”¹⁷¹ this is an effort to make the EU a more competitive, dynamic knowledge-based economy, with improved employment and social cohesion by 2010.¹⁷² A number of changes have been made in the *Sixth Directive* in line with this movement. *Council Directive 2001/115/EC* of December 20, 2001¹⁷³ and *Council Directive 2002/38/EC* of May 7, 2002¹⁷⁴ were two of the key decisions moving the European VAT in the digital direction.

technology. The commentary associated with §4022(c), Tax Invoices, discusses the “self-enforcing” aspect of a VAT as something that needs to be reinforced with traditional audits. “It would be impractical for the Service to audit VAT returns in detail. Sampling will be necessary. To facilitate cross-matching of VAT charged and input tax claimed, large taxpayers could be required by regulations to report transactions on computer tape.”)

¹⁷¹ European Commission, *eEurope - An Information Society for all*, COM(2000)0130 final *available at* <http://europa.eu.int> (last visited Aug. 29, 2005) (indicating that the “Lisbon Strategy” is a shorthand expression for the broad e-commerce policy objectives set out at the Lisbon European Council of March 24 and 24, 2000).

¹⁷² Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions, *eEurope 2005: An Information Society for All. An Action Plan to be Presented in view of the Sevilla European Council, 21/22 June 2002*. COM(2002)263 final, *available at* <http://ue.eu.int> (last visited Aug. 29, 2005) (presenting the specific steps expected to be taken to achieve the “Lisbon Strategy” by 2010).

¹⁷³ Council Directive of 20 December 2001 amending Directive 77/388/EEC with a view to simplifying, modernizing and harmonizing the conditions laid down for invoicing in respect of the value added tax. 2001/115/EC, 2002 O.J. (L 15) 24, *available at* <http://europa.eu.int> (last visited Aug. 29, 2005) [hereinafter *The Invoicing Directive*].

¹⁷⁴ Council Directive of 7 May 2002 amending and amending temporarily Directive 77/388/EEC as regards the value added tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services, 2002/38/EC, 2002 O.J. (L 128) 41 *available at* <http://europa.eu.int> (last visited Aug. 29, 2005) [hereinafter *The Digital Sales Directive*].

Digital notices, digital returns, digital periodic and recapitulative statements. Council Directive 2002/38/EC of May 7, 2002 made four significant changes to the *Sixth Directive* with respect to digitizing the VAT. First, the requirement to provide notice that taxable activity has begun, or has terminated,¹⁷⁵ can now be performed in every Member State electronically, and if a Member State wants to it can require taxpayers to be performed this function electronically.¹⁷⁶ Secondly, VAT returns that formerly were entirely paper, may now be filed in every Member State electronically. And as with the notices of activity beginning and ending, a Member State has the option to require that VAT returns be filed electronically.¹⁷⁷ Similar changes were made in provisions relating to both periodic statements, and recapitulative statements. Each may be filed electronically, or may be subject to a Member State's requirement that they be filed electronically.¹⁷⁸

There is a common theme in these modifications of the *Sixth Directive*. In each instance Council Directive 2002/38/EC applies a two-part structure, first allowing any taxpayer throughout the EU, at their own election, to file documents electronically instead of on paper, and secondly, permitting Member States to go further and mandate an electronic submission of these documents by all taxpayers.

Digital invoices. Far more important to digitizing the VAT are the efforts made under Council Directive 2001/115/EC to begin the process of digitizing the invoice.¹⁷⁹ The bedrock principles of the European VAT are embedded in the invoice.¹⁸⁰ Almost all critical legal, accounting, reporting, and enforcement issues are tied to information found on the invoice.¹⁸¹ An invoice performs three basic functions: (1) it contains the information needed to determine which VAT regime is applicable to a particular

¹⁷⁵ Former Art. 22(1)(a) of the *Sixth Council Directive 77/388/EEC* of May 17 1977, 1977 O.J. (L 145) 1, available at <http://europa.eu.int> (last visited Aug. 29, 2005).

¹⁷⁶ *Id.* *Sixth Directive* at (New) Art. 22, added by The Digital Sales Directive, *supra* note 173.

¹⁷⁷ *Id.* *Sixth Directive*, at (New) Art. 22(4)(a), as amended by The Digital Sales Directive, *supra* note 174.

¹⁷⁸ *Id.* *Sixth Directive*, at (New) Art. 22(6)(a), as amended by The Digital Sales Directive, *supra* note 174 (on periodic statements); Article 22(6)(b), as amended by The Digital Sales Directive, *supra* note 174 (on recapitulative statements).

¹⁷⁹ Proposal for a Council Directive amending Directive 77/388/EEC with a view to simplifying, modernizing and harmonizing the conditions laid down for invoicing in respect to value added tax. (November 17, 2000) COM(2000)650 final at 6, available at <http://europa.eu.int> (last visited Aug. 29, 2005) (referencing a study carried out for the Commission estimated the cost of an electronic invoice at EUR 0.28 to 0.47, as against EUR 1.13 to 1.65 for a traditional invoice resulting in a savings per invoice could be between EUR 0.66 to 1.37).

¹⁸⁰ *Sixth Directive*, *supra* note 174, at (New) Art. 22, as amended by The Digital Sales Directive, *supra* note 173 (listing seven other critical administrative aspects of the European VAT as: (1) registration, (2) identification numbers, (3) keeping accounts, (4) keeping a register, (5) submitting a return, (6) submitting a statement, and (7) submitting a recapitulative statement).

¹⁸¹ SCHENK, VALUE ADDED TAX – A MODEL STATUTE, *supra* note 164, at 120 n.172 (“The seller’s invoice is a key element in an invoice VAT. At levels before the retail sale, the VAT listed on the seller’s invoice can be used to cross-match the seller’s output tax liability against the buyer’s input credit on its purchases. ... Experience in Europe suggests that civil servants do not have much time to cross-match invoices. See Carlson, *Value Added Tax: European Experiences and Lessons for the United States*, reprinted in 1980 Department of Treasury (Office of Tax Analysis) 51. Korean and Taiwan have relied on an elaborate computer system of cross-matching invoices sent to the government by the seller and the buyer.”).

transaction, (2) it enables tax authorities to carry out enforcement controls, and (3) it allows the purchaser to prove their right to deductions.¹⁸²

There is nothing in the original *Sixth Directive* that considers electronic invoicing. Old Article 22(3)(c) is silent.¹⁸³ Through Article 28h *Council Directive 2001/115/EC* amends Article 22(3)(c) to unambiguously authorize the use of electronic invoices, subject to a customer's acceptance.¹⁸⁴ The amendments of Article 28h then go to great lengths to establish a new legal framework within which Member States must accept electronic invoices. "Invoices sent by electronic means shall be accepted by Member States provided that the authenticity of the origin and integrity of the contents are guaranteed [either] by means of advanced electronic signature¹⁸⁵ ... or by means of electronic data interchange¹⁸⁶ (EDI)..."¹⁸⁷

It is clear that these conditions are expected to develop, to change over time. The amendments to Article 22(3)(c) made by Article 28h include a provision that: "The Commission will present, at the latest on December 31, 2008, a report, together with a proposal, if appropriate, amending the conditions on electronic invoicing in order to take account of possible future technological developments in this field."

The two-part common theme of *Council Directive 2002/38/EC* (allowing any taxpayer at their own election to file electronically and then permitting Member States to mandate an electronic submission) is not carried over into the invoicing adjustments made by *Council Directive 2001/115/EC*. There is no authority for Member States to mandate electronic invoices, nor is the seller authorized on his own account to convert to electronic invoicing. It is the buyer's acceptance of an electronic form of invoicing that is the critical pre-condition to usage.

However, two additional modifications to Article 22 by Directive 2001/115/EC have a direct relationship to electronic invoicing. These adjustments appear to pave the way for standardized electronic invoicing, first by allowing for third-party involvement in

¹⁸² Case 123/87, Léa Jorion, née Jeunehomme v. Belgian State, 1988 E.C.R. 4517 (AG Sir Gordon Slynn famously characterized the invoice as "the 'ticket of admission' to right to deduct.").

¹⁸³ *Sixth Directive*, *supra* note 174, at (New) Art. 22(3)(c), as amended by Article 28h added by The Digital Sales Directive, *supra* note 173 ("The Member State shall determine the criteria for determining whether a document serves as an invoice.").

¹⁸⁴ *Id.* at (New) Art. 22(3)(c), as amended by Article 28h added by The Digital Sales Directive, *supra* note 173 ("Invoices issued pursuant to point (a) may be sent either on paper or, subject to an acceptance by the customer, by electronic means.").

¹⁸⁵ *Id.* at (New) Art. 22(3)(c), as amended by Article 28h added by The Digital Sales Directive, *supra* note 173 (specifically referencing the electronic signatures rules in Article 2(2) of Directive 1999/93/EC, of 13 December 1999 on a Community framework for electronic signatures, 2000 O.J. (L 13)12, available at <http://europa.eu.int> (last visited Aug. 29, 2005)).

¹⁸⁶ *Id.* at (New) Art. 22(3)(c), as amended by Article 28h added by The Digital Sales Directive, *supra* note 173 (specifically referencing electronic data interchange (EDI) as defined in Article 2 of Commission Recommendation 1994/820/EC of 19 October 1994 relating to legal aspects of electronic data interchange 1994 O.J. (L 338) 98, available at <http://europa.eu.int> (last visited Aug. 29, 2005)).

¹⁸⁷ *Id.* at Art. 22(c)(second paragraph), as amended by The Invoicing Directive, *supra* note 172.

preparation of invoices (outsourcing), and secondly by setting out for the first time a set of exclusive, uniform legal requirements for valid invoices.

Original Article 22(3) required the taxable person to issue his or her own invoice. Directive 2001/115/EC amends Article 22(3)(a) in the following manner (additions in italics):

- (a) Every taxable person shall *ensure that an invoice is issued, either by himself or by his customer or, in his name and on his behalf, by a third-party*, in respect of goods and service which he has supplied or rendered to another taxable person or to a non-taxable legal person. Every taxable person shall also *ensure that an invoice is issued either by himself or by his customer or, in his name and on his behalf, by a third party*, in respect of the supplies of goods, ...

Similarly, original Article 22(3)(b) referred to a non-exhaustive list of statements that needed to be mentioned on the invoice. The list could be extended by any Member State if it wished. Amended Article 22(3)(b) harmonizes the statements required on an invoice¹⁸⁸ and removes the authority of local administrations to require additional statements. In addition, the third subparagraph of Article 22(3)(b) stipulates that: “Member States shall not require invoices to be signed.” The Explanatory Memorandum to the Proposal indicated that this provision was needed to remove yet another potential barrier to electronic invoicing.

Is the D-VAT a reasonable way to go? It is far more than the reasonable way to go, it is the inevitable way to go. In 2000 the University of California at Berkeley’s School of Information Management Systems conducted the first study of newly created information, and demonstrated that 93 percent of the three billion gigabytes of data

¹⁸⁸ *Id.* at Art. 22(3)(b), as amended by The Invoicing Directive, *supra* note 172 (listing the 12 items that must appear on an invoice, and two more (13 and 14) that may occasionally appear:

- (1) the date of issuance of the invoice;
- (2) a sequence number that uniquely identifies the invoice;
- (3) the VAT identification number of the seller;
- (4) the VAT identification number of the buyer (if the customer is required to pay VAT on the transaction);
- (5) full name and address of the buyer;
- (6) the quantity and nature of the good/ extent and nature of the services supplied;
- (7) the date on which the supply was completed, or the date on which the payment was made – in so far as that date can be determined and differs from the date of issuance of the invoice, (1) above;
- (8) the taxable amount; unit price exclusive of tax, discounts, and rebates;
- (9) the VAT rate applied;
- (10) the VAT amount payable;
- (11) where either an exemption applies, or where the buyer is liable self-assess the VAT, reference to the section of the *Sixth Directive* or the national law that allows this procedure;
- (12) special rules for the supply of new means of transportation require particulars under Article 28a(2);
- (13) special rules related to margin schemes require reference to national laws;
- (14) in instances where a tax representative is used, then the VAT identification number as well as the name and address of that representative needs to be listed).

generated worldwide (using 1999 data) was computer generated.¹⁸⁹ Updated in 2002, a new study reached much the same conclusions, and indicated (using 2001 and 2002 data) that "... about 5 exabytes¹⁹⁰ of new information [was] created in 2002. Ninety-two percent of the new information was stored on magnetic media, mostly hard disks. ... film represented 7% of the total, paper 0.01%, and optical media 0.002%."¹⁹¹ Thus, it may be presumed that almost all enterprise source data content for operations, accounting, audit, as well as tax filing, financial reporting, regulatory submissions, and almost all other purposes is digitized both in generation and in storage. In other words, there is no paper and ink parentage for this data.

If the provenance of most data today is electronic (or digital), not physical, then it makes sense to determine, collect, report, and enforce tax obligations digitally. The credit-invoice VAT is the consumption tax that most completely tracks these digitized commercial processes. Thus, it only makes good sense that a credit-invoice VAT should be digital tax. Whenever manual intervention is required to resolve returns, reports, and other filings into paper documents, the tax system is being made inefficient and error prone.

TEST CASE FOR THE DIGITAL VAT:
DIRECTIVE 2002/38/EC – ARTICLE 26c

The Lisbon European Council focused the Commission's attention on one particularly troublesome aspect of digital commerce, the sale of digital products to non-taxable EU customers by non-EU businesses. The technical issue was sourcing. The *Sixth Directive* sourced these supplies outside the EU, making them not subject to VAT. Consumption (use and enjoyment) however, was clearly occurring within the EU.¹⁹²

The solution worked out by the Commission had technical and practical aspects. On the technical side, as of May 7, 2002 all electronically supplied services from non-EU businesses were listed within the exceptions of Article 9(2)(e). A special rule dealing with similar B2C transactions was added in Article 9(2)(f). Thus, VAT now became due on these sales, because the source of these supplies had moved within the EU.

¹⁸⁹ Eric Woodman, *Information Generation: Berkeley Study measures gargantuan information boom, EMC2*, at <http://www.emc.com> (last visited Aug. 29, 2005) referencing SCHOOL OF INFORMATION MANAGEMENT AND SYSTEMS AT THE UNIVERSITY OF CALIFORNIA AT BERKELEY, HOW MUCH INFORMATION? (2000).

¹⁹⁰ Peter Lyman and Hal R. Varian, *Executive Summary*, SCHOOL OF INFORMATION MANAGEMENT AND SYSTEMS AT THE UNIVERSITY OF CALIFORNIA AT BERKELEY, HOW MUCH INFORMATION? (2003) (Oct. 27, 2003) available at <http://www.sims.berkeley.edu> (last visited Aug. 29, 2005) ("How big is five exabytes? If digitized, the 19 million books and other print collections in the Library of Congress would contain about ten terabytes of information; five exabytes of information is equivalent in size to the information contained in half a million new libraries the size of the Library of Congress print collections.").

¹⁹¹ *Id.* at *Executive Summary*.

¹⁹² *Sixth Directive*, *supra* note 175, at Art. 9(1) (presenting the specific sourcing issue, the fall back sourcing provision, that placed any service not covered in the series of exceptions that make up the rest of Article 9 into a residual category that sourced the supply where the supplier was located, thereby placing the supply in the US for digital sales by many US companies into the EU).

Working out the practical aspect of this solution was more complicated. B2B transactions from non-EU suppliers, by far the largest part of e-commerce in monetary terms, were handled rather simply through the reverse charge procedure.¹⁹³ B2C transactions were another story. Because consumers do not file VAT returns (they are not “taxpayers” in VAT terms) a reverse charge procedure was not possible. The only solution for B2C sales from non-EU businesses was to require the non-EU business to collect and remit the tax.

For those businesses willing to comply there were essentially two options. They could either (1) establish themselves in a Member State,¹⁹⁴ or (2) register in each Member State where they made taxable supplies.¹⁹⁵ Neither option was optimal. Although under the first option all digital sales would be sourced to one EU jurisdiction, the place where the business was established (Article 9(1)), establishment itself led to direct tax obligations. The formerly non-EU business would become a real EU business for tax and regulatory purposes. Sourcing of sales under this option would be origin-based. The second option also had disadvantages. Under this option a business could conceivably be required to register in 25 Member States, file 25 sets of VAT returns, and do so in as many as 20 different languages. Sourcing of sales under this option would be destination-based.

Article 26c was adopted to provide a third alternative. This was a one-stop-shop option. It allowed non-EU established businesses to select a single “Member State of identification” where they could be registered, but not be established, under a simplified arrangement. VAT from sales made throughout the EU would be determined on a destination-basis using the rates and rules of the jurisdiction where the customer resided. However the VAT collected on these sales would be paid over to the Member State of identification on a single electronic return.

Importantly, Article 26c requires all communication between the taxpayer and the Member State to be electronic, if the taxpayer elects to file according to this special scheme.¹⁹⁶ Registration and all notifications about changes in status,¹⁹⁷ statements and recapitulative statements,¹⁹⁸ filing of returns,¹⁹⁹ payments of VAT amounts due and

¹⁹³ *Id.* at Art. 21 (indicating that a reverse charge is a self-assessment obligation imposed on businesses purchasing taxable supplies).

¹⁹⁴ *Id.* at Art. 9(1) (indicating that in this instance the place of supply for digital services would be the Member State where the supplier is established, thereby subjecting the business to direct taxation in that state).

¹⁹⁵ *Id.* at Arts 9(2)(f) & 21 (indicating that the place of supply of digital services is where the customer resides, and requiring registration and the filing of returns in as many as 25 States).

¹⁹⁶ *Id.* at Art. 26c(B)(1).

¹⁹⁷ *Id.* at Art. 26c(B)(2) (“The non-established person shall state to the Member State of identification when his activity as a taxable person commences, ceases or changes to the extent that he no longer qualifies for the special scheme. Such a statement shall be made electronically.”).

¹⁹⁸ *Id.* at Art. 26c(B)(9) (“The non-established taxable person shall keep records of the transactions covered by this special scheme in sufficient detail to enable the tax administration of the Member State of consumption to determine that the value added tax return referred to in (5) is correct. These records should be made available electronically on request to the Member State of identification and the Member State of consumption.”).

collected,²⁰⁰ and even communications by the Member State to the non-established taxpayer,²⁰¹ must be in electronic form. Article 26c therefore presents in microcosm a fully functional D-VAT. If elected by the taxpayer, Member States are required to accept and engage in this fully digital VAT relationship.²⁰²

WORKABILITY OF A DIGITAL VAT IN THE US

There is doubt that a federal level VAT in the US is a workable option as long as the states remain dependent on revenues from the retail sales tax. Professors Alan Schenk, the reporter for the ABA Model VAT, along with Oliver Oldman set out the two main reasons: (1) administrative and compliance costs, and (2) political resistance.

There are substantial administrative and compliance costs associated with the adoption of a European-style credit-invoice VAT that would operate side-by-side with a wide range of state retail sales taxes (RSTs), especially the costs for retailers who would have to list each tax separately on invoices or cash register tapes. ... States also may view the adoption of a European-style credit- invoice VAT as an intrusion into their sales tax domain.²⁰³

In other writings Professor Schenk suggests that if the US were to adopt a federal level VAT, then the best option would be for the states to follow suit and adopt sub-national VATs with harmonized bases. This is the lesson from Canada where some Canadian Provinces harmonized local transaction taxes with the federal GST after its passage.²⁰⁴

This article offers another option, a D-VAT based on the ABA Model or *Vatopia*.²⁰⁵ The D-VAT makes most of its changes in the reporting, administrative, and payment provisions. Essentially this proposal requires the Model or *Vatopia* to adopt and mandate the electronic tax administration principles set out *Council Directive* 2002/38/EC, and *Council Directive* 2001/115/EC. In addition, the third-party automated

¹⁹⁹ *Id.* at Art. 26c(B)(5) (“The non-established taxable person shall submit by electronic means to the Member State of identification a value added tax return for each calendar quarter ...”).

²⁰⁰ *Id.* at Art. 26c(B)(7) (“The non-established taxable person shall pay the value-added tax when submitting the return. Payment shall be made to the bank account denominated in Euro, designated by the Member State of identification.”).

²⁰¹ *Id.* at Art. 26c(B)(3)(second paragraph) (“The Member State of identification shall notify the non-established taxable person by electronic means of the identification number allocated to him.”).

²⁰² Proposal for a Council Directive Amending Directive 77/388/EEC as regards the rules governing the right to value added tax, 1998 O.J. (C 219)16, available at <http://europa.eu.int> (last visited Aug. 29, 2005) (proposing a similar digital scheme, without provision for a single payment of EU-wide VAT obligations, but with a single return and filing obligations has been proposed by the Commission under Article 22b).

²⁰³ Oldman & Schenk, *The Business Activities Tax*, *supra* note 115, at 1565, text & accompanying note 167.

²⁰⁴ Schenk, *Choosing the Form of a Federal Value-Added Tax*, *supra* note 167, at 318; Schenk, *A Federal Move to a Consumption-Based Tax*, *supra* note 15, at 111-117.

²⁰⁵ SCHENK, VALUE ADDED TAX – A MODEL STATUTE, *supra* note 164, at v (indicating that the ABA Model VAT is more of a “model,” than a formal “proposal” for a US VAT, Walter H. Beaman’s *Transmittal Letter to the Council of the Section of Taxation, American Bar Association*, provides the following: “As instructed, the Committee has avoided taking a position for or against the adoption of a VAT in the United States, but has addressed itself to the task of preparing a statute that the Congress could enact if it decides to propose such a tax.”).

collection and reporting provisions of the *Streamlined Sales and Use Tax Agreement* are to be adopted federally. There are seven specific areas where modifications are needed.

(1) *Electronic notices, returns, periodic and recapitulative statements, tax determinations and payments mandated.* The Digital VAT would require all taxpayers file electronically. This provision would essentially adopt the reporting requirement under Article 26c of the *Sixth Directive*.²⁰⁶ Unlike Article 26c, electronic filing will not be elective, although in some exceptional circumstances paper filing may need to be permitted by regulation.

Two exceptions to the filing rules are anticipated; one for small businesses, and another for invoices issued to final consumers. These exemptions are considered at item (7) below.

(2) *Third-party invoicing, tax calculation, return-filing authorized.* This is a two-part modification. The first element requires the ABA Model or *Vatopia* to adopt the third party invoicing provisions of *Council Directive 2001/115/EC*. These provisions amended Article 22(3)(a) of the *Sixth Directive* allowing third-party “outsourcing” of VAT invoices.

The second modification is the incorporation into the ABA Model or *Vatopia* of provisions dealing with certified service providers (CSP) and certified automated/proprietary systems (CAS and CPS) from the *Streamlined Sales and Use Tax Agreement* (SSUTA).²⁰⁷ The certified service providers (CSPs) provision would authorize third-party collecting agents, certified by the federal government, to assume all VAT functions for the taxpayer, at no cost to the business.²⁰⁸ The certified automated system (CAS)²⁰⁹ and certified proprietary system (CPS)²¹⁰ variations on this theme would also be incorporated. Following the SSUTA provisions, the federal government would certify tax-calculation software, the proper use of which by the taxpayer would effectively insulate the taxpayer from liability from errors in determining the proper tax due.

Although CSP/ CAS / CPS concepts have their genesis within the SSUTA, their operation within the D-VAT would be far more effective. In terms of the critical accuracy of the automated processes, the D-VAT relies on the inherent “self-checking”

²⁰⁶ *Sixth Directive*, *supra* note 175, at Art. 26c, added by The Digital Sales Directive, *supra* note 173.

²⁰⁷ *SSUTA*, *supra* note 138.

²⁰⁸ *Id.* at § 203 (defining a Certified Service Provider (CSP) as “[a]n agent certified under the Agreement to perform all the seller’s sales and use tax functions, other than the seller’s obligation to remit tax on its own purchases.”).

²⁰⁹ *Id.* at § 202 (defining a Certified Automated System (CAS) as a “[s]oftware certified under the Agreement to calculate the tax imposed by each jurisdiction on a transaction, determine the amount of the tax to remit to the appropriate state, and maintain a record of the transaction.”).

²¹⁰ *Id.* at § 207 (defining a Certified Proprietary System (CPS) as the system owned by “[a] seller that has sales in at least five member states, has total annual sales of at least five hundred million dollars, has a proprietary system that calculates the amount of tax due each jurisdiction, and has entered into a performance agreement with the member states that establishes a tax performance standard for the seller.”).

attribute of a credit invoice VAT.²¹¹ Buyers and sellers have an incentive to assure correct determinations in a VAT, whereas under the SSUTA the accuracy of the digital record is dependent on state oversight of the digital service providers, or the certified/proprietary automated systems. This level of technical oversight is not only expensive in the SSUTA, it is dependent on government initiative.

Linear tax enforcement regimes, like that of the RST, have always had an Achilles heal; the government audit staff. Without an adequately trained, vigorous and motivated audit staff revenue expectations are not readily met. The SSUTA does not repair this Achilles heal it only moves it into a software oversight function. The fundamental difference between a VAT and a RST is the way the VAT changes linear tax enforcement, making it a circular, self-checking flow of data that taxpayers (as well as the government) have an interest in assuring its accuracy and completeness. The D-VAT's automation of the invoice flows will allow this self-checking function to be measured, assured, and verified.

(3) *Use of uniform product and service identifier codes.* The Digital VAT would require the digital identification of each good or service sold in the US economy. Codes would be uniformly applied and federally determined. If starting from scratch, this would be a daunting task, however two data-bases are readily available for this purpose, and are commonly used for VAT and trade reporting purposes: the CN8 codes²¹² are used in the EU to identify movements of goods, and the UN CPC²¹³ codes are used to numerically identify services as well as goods transactions. Alternate codes could be developed using UPC codes, for example, but the advantage of adopting an already workable system both for cross-border tax enforcement, and for taxpayer acceptance (particularly for those businesses already using these codes in international VAT compliance) is an important consideration.

²¹¹ ECC FISCAL AND FINANCIAL COMMITTEE, REPORT ON TAX HARMONIZATION IN THE COMMON MARKET (tr., by CCH staff from original French and German texts) Report 21, Document SD-322 (1963) [commonly known as THE NEUMARK REPORT] at ¶ 3458.10- .14 (considering in the formative days of the European Common Market the relative advantages of a multi-state VAT over a single stage RST).

²¹² EUROSTAT, RAMON: CLASSIFICATION SERVER, at <http://europa.eu.int> (last visited Aug. 29, 2005). Norbert Ranier, *Revised System of International Classifications*, at <http://europa.eu.int> (last visited Aug. 29, 2005) (Norbert Ranier (Statistics Austria) presents a recent assessment of developments in global economic classification systems, explaining the effort to harmonize EU and UN classification systems. He indicates that, “[a] thorough revision of the international statistical classifications has recently been completed, with the result that the new classifications have been developed as an integrated system of statistical classifications, whereby a) the various product classifications have been harmonized and b) the central product classifications have been related to the classifications of economic activities by the economic origin criterion. In addition, the European Union's classifications have been harmonized with global classifications. This also applies to the national classifications of the EU Member States.”).

²¹³ U.N. C.P.C. (Central Product Classification, Version 1.1) (Feb. 21, 2002) 8, at <http://unstats.un.org> (last visited Aug. 29, 2005) (“The main purpose of the CPC is to provide a framework for the international comparison of statistics dealing with products and to serve as a guide for developing or revisin existing classification schemes of products in order to make them compatible with international standards. ... CPC constitutes a comprehensive classification of all godds and services. With regard to services, no international classification covering the whole spectrum of outputs of the various service industries and serving the analytical needs of statistical and other users was available before the development of CPC.”).

Some changes would be required in the ABA Model or *Vatopia* to accommodate uniform goods and services codes. For example, each invoice would need to associate particular goods or services transactions with appropriate numeric identifiers. Tax calculations would be tied to appropriate codes.²¹⁴ Following the European pattern, each periodic and recapitulative statement,²¹⁵ each return,²¹⁶ and declaration would be required to identify taxable activities with numeric identifiers. The records retained under the D-VAT would be electronic. The D-VAT would mandate that these records would be made available electronically (on site and remotely) upon request of taxing authorities.

(4) *State RST piggy-backing encouraged.* The D-VAT would encourage states to piggy-back on the federal database. An important distinction is drawn between the federal *tax base* and the federal *database*. States would not need to adopt the federal tax structure (as occurred in some Canadian Provinces after passage of Canada's federal GST), nor would they need to adopt the federal tax base (as is expected to occur under either the National Sales Tax or Fair Tax proposals). However, should the states decide to follow the federal tax base, it is expected that the D-VAT's tax base will be broader than that under most other consumption taxes.²¹⁷

A D-VAT would affect a very different form of "piggy-backing," but nevertheless a very acceptable one in an American view of fiscal federalism. The D-VAT will assemble uniform, verifiable data on all goods and service transactions. The database will be more comprehensive than any state's retail sales tax base (particularly those of states that impose tax only on the final consumption of tangible personal property).²¹⁸ As a multi-stage consumption tax, the D-VAT will record goods and services transactions along the whole supply chain, not just on transactions between retailers and final consumers. Accurate information on this range of transactions would greatly facilitate state verification of taxes imposed on business purchases, an important consideration in some states where as much as 40% of the tax base is collected at this level.

²¹⁴ SCHENK, VALUE ADDED TAX – A MODEL STATUTE, *supra* note 164 at § 4022 (modification would be needed to this section, as well as referenced IRC § 6652(m) to impose penalties for not including numeric identifiers on the invoice); *Vatopia*, *supra* note 168, at § 29(1) & paragraph 1 of Schedule IV (requiring similar modifications to tie transactions to the uniform good or service code).

²¹⁵ SCHENK, VALUE ADDED TAX – A MODEL STATUTE, *supra* note 164 at §4026 Secretary to be Notified of Certain Events (modification would be needed to require the use of electronic means). *Vatopia*, *supra* note 168, at §§11-12 (registration requirements will need to be changed similarly).

²¹⁶ SCHENK, VALUE ADDED TAX – A MODEL STATUTE, *supra* note 164 (modification would be needed to accommodate electronic filing necessary for filing of returns, payment of the tax, signing of returns, and assessments and deficiencies; *Vatopia*, *supra* note 168, at §§ 32, 60-61 (modifications needed in the returns requirements as well as record keeping requirements needed to accommodate electronic filing and electronic signature).

²¹⁷ Edwards, *Options for Tax Reform*, *supra* note 125, at 1548 (relying on Fox, *Should Hawaii Look Like Other State's Sales Taxes?* *supra* note 125, at 12). The tax base of the Digital VAT should be broader than that of the European VATs, which are imposed on approximately 41% of GDP. The D-VAT base could conceivably cover close to 80% of GDP and be similar in scope to the coverage of a comprehensive retail sales tax. The D-VAT Card allows inclusion of necessities for all but the poorest individuals, limiting the zero-rating of these supplies to those identified to be in most need.

²¹⁸ Edwards, *Options for Tax Reform*, *supra* note 125, at 1548. (indicating that the average state RST base covers about 36% of GDP, ranging from a low of 26% of GDP in New Jersey to a high of 71% of GDP in New Mexico).

In addition, even though the D-VAT is a destination-based consumption tax, the database itself is source-neutral. Companies operating in states with origin-based RST's can report in the same manner as they do today. Origin states can access invoice records in the federal database to confirm total sales of goods and services from a particular business location. Audits could sort this data by product codes for taxable items. The same would occur in destination states, although in this instance the federal database would be accessed on the purchasing side. These audits would be for use tax obligations.

(5) *State access to the federal database at a national level.* Access to the full federal database would allow states to sort for sales sent to consumers within their state. Digital invoices would contain names, and address of the ship-to location. The same information would be available for the bill-to location, if different. State-federal exchange of information agreements would be sufficient to provide access to national data.

Difficulties posed by businesses established in one of the five no-tax jurisdictions where state-to-state exchange agreements are ineffective would be circumvented. In addition, having this information readily accessible would obviate the need to for the US Congress to overturn the US Supreme Court's decision in *Quill v. North Dakota*.²¹⁹ This decision blocks states from requiring out-of-state retailers without nexus from collecting sales and use tax on sales made to in-state locations.

²¹⁹ 504 U.S. 298 (1992). In *Quill* the U.S. Supreme Court for the first time distinguished between nexus for Due Process Clause and Commerce Clause purposes. The Court stated that although closely related, "the clauses pose distinct [constitutional] limits on the taxing powers of the States." (504 U.S. at 312). The Court noted that while the Commerce Clause's "substantial nexus" requirement is "a means for limiting state burdens on interstate commerce," the Due Process Clause "centrally concerns the fundamental fairness of governmental activity" and is often regarded as "a proxy for notice." (504 U.S. at 313). Therefore, "at the most general level, the due process nexus analysis requires that we ask whether an individual's [or corporation's] connections with a State are substantial enough to legitimate the State's exercise of power over [them]." (504 U.S. at 325). In so holding, the Supreme Court overruled its prior holding in *National Bellas Hess v. Illinois*, 386 U.S. 753 (1967) which required physical presence to satisfy Due Process, and imposed a more relaxed standard. The Court reaffirmed the general principle that the taxpayer must have some "minimum contact" with the taxing state so as to "not offend traditional notions of fair play and substantial justice."

(6) *Digital relief from the regressivity of taxing consumption.* Each of the major proposals for a national consumption tax, except the ABA Model, struggle with the regressivity of a federal tax on consumption, and provide relief. The ABA Model takes a different view. The ABA Model is “... imposed on a broad base to permit the adoption of the lowest possible rate. Congress should accommodate social or economic concerns, such as the regressive effects of a VAT, outside the VAT regime.”²²⁰ The universal complaint levied against all attempts to counter the regressivity of a consumption tax from within the tax itself is that the relief is never well targeted. Effective relief requires overly broad exemptions, narrowing the base and raising the rates.

The D-VAT is different. The D-VAT allows surgical targeting of relief at the federal level, and if states piggy-back on the federal database, then similarly effective relief will be available at state and local levels also.

Subtraction VAT + YET Proposals

The Hall-Rabushka Flat Tax contains a significant standard deduction for all individuals. It imposes a flat tax on all income in excess of the deduction.²²¹ David Bradford’s X-tax differs from the Hall-Rabushka model by providing more deductions and a graduated rate, and then levels off with a flat rate equal to the business rate.²²²

Subtraction VAT + CIT Proposals

The USA Tax,²²³ the Simplified USA Tax²²⁴ and the proposal by Professor McCaffery²²⁵ each respond to regressivity concerns with graduated rates, in a manner similar to Bradford’s. They also provide deductions for mortgage interest,²²⁶ education,²²⁷ and charitable contributions.²²⁸

Sales Tax Proposals

²²⁰ SCHENK, VALUE ADDED TAX – A MODEL STATUTE, *supra* note 164, at 11.

²²¹ HALL & RABUSHKA, THE FLAT TAX (1995), *supra* note 3, at 59 & 144 [§ 201(a) of the proposed statute] (providing a \$25,500 allowance for a family of four, reflecting an allowance of \$16,500 for married taxpayers filing jointly, \$14,000 for head of households, \$9,500 for single taxpayers, and \$4,500 per dependent).

²²² Bradford, *The X Tax in the World Economy*, *supra* note 51, at 3-5 (providing similarly a standard deduction, regular deductions, and even an earned income tax credit).

²²³ Nunn & Domenici, USA Tax Act of 1995, S. 722, *supra* note 54, at § 15 (providing rates in three tiers, 19%, 27% and 40%, falling each year for five years reaching rates of 8%, 19% and 40%).

²²⁴ English, Simplified USA Tax Act of 2003, H.R. 269, *supra* note 55, at § 15 (providing rates in three tiers of 15%, 25% and 30%).

²²⁵ MCCAFFERY, FAIR NOT FLAT, *supra* note 3, at 100-101 (proposing rates in five tiers, with the 0% rate extending to \$80,000 (for a family of four), followed by rates of 10%, 20%, 30%, and 40% with the 40% rate being effective for amounts over \$1,000,000).

²²⁶ Nunn & Domenici, USA Tax Act of 1995, S. 722 *supra* note 54, at § 9; English, Simplified USA Tax Act of 2003, H.R. 269, *supra* note 55, at § 9; MCCAFFERY, FAIR NOT FLAT, *supra* note 3, at 98.

²²⁷ Nunn & Domenici, USA Tax Act of 1995, S. 722 *supra* note 54, at § 10; English, Simplified USA Tax Act of 2003, H.R. 269, *supra* note 55, at § 10; MCCAFFERY, FAIR NOT FLAT, *supra* note 3, at 98.

²²⁸ Nunn & Domenici, USA Tax Act of 1995, S. 722 *supra* note 54, at § 11; English, Simplified USA Tax Act of 2003, H.R. 269, *supra* note 55, at § 11; MCCAFFERY, FAIR NOT FLAT, *supra* note 3, at 98.

The National Sales Tax²²⁹ and the Fair Tax²³⁰ provide direct rebates of estimated sales tax amounts. The rebates are not limited to individuals who have income levels below the poverty level. They are calculated using poverty level indicators, and are provided to all wage earners.

Credit Invoice VAT Proposals

Professor Graetz uses VAT revenues to eliminate income tax obligations for families earning less than \$100,000 (\$50,000 for single individuals), essentially granting everyone a very large standard deduction. Graetz also counters the regressivity of his VAT with a direct refund through the payroll tax.²³¹ In addition he would zero-rate goods and services that are perceived to be necessities.²³² Professor Avi-Yonah believes the "... Graetz proposal is sensible ...but the wrong way to go ... [because] we cannot afford it...."²³³ Professor Avi-Yonah does not go into more detail, but it seems fair to say that Professor Avi-Yonah would grant few of the concessions that Graetz does.

Neither the ABA Model nor *Vatopia* has a direct refund mechanism for the poor. Neither the ABA Model nor *Vatopia* allows for multiple rates. Neither model zero-rates necessities like food,²³⁴ although *Vatopia*, through regulation, allows consideration for medical care.²³⁵ Considerations like this are necessary to preserve a broad tax base. The D-VAT addresses regressivity concerns differently. Technology and universal product codes proved the D-VAT with a mechanism to remove the tax from selected purchases by designated individuals.

²²⁹ Tauzin & Schaefer, The National Retail Sales Tax, H.R. 4168, *supra* note 94, at §§ 13 and 15(c) (providing for a family consumption refund equal to the sales tax rate times the lower of wages or the poverty level is provided to be added to each worker's paycheck through an adjustment to the payroll tax at the employer level).

²³⁰ Linder & Chambliss, The Fair Tax, H.R. 25/ S. 25, *supra* note 95, at § 301 (providing for the federal government to annually mail checks to each household sufficient to offset the burden of sales taxes on consumption up to the poverty level).

²³¹ Graetz, *100 Million Unnecessary Returns*, *supra* note 7 at 291, n.141 (borrowing and modifying concepts from the National Retail Sales Tax a standard deduction is provided in a flat amount, rather than by multiplying the poverty level times the tax rate. "This tax relief and wage subsidy for low-income workers would be administered by having employers adjust their employees paychecks to provide 'negative withholding,' or additional take-home pay. Individuals would be eligible for this benefit if they earned wages of \$20,000 or less. An additional amount would be provided based upon the worker's number of children. To avoid an abrupt termination of relief with attendant high marginal rates on wages, families with children might be eligible for some tax offset with wages up to about \$50,000.").

²³² *Id.* at 288, n.123 (indicating that, "[e]xpenditures on education and religion would be exempt from the consumption tax, as would most expenditures on health care. However, rather than exempting food or clothing, as many foreign VATs and state sales taxes do to reduce the tax burden on necessities, low-income people should be protected from tax increases through a reduction in payroll tax withholdings.").

²³³ Avi-Yonah, *Risk, Rents, and Regressivity*, *supra* note 11, at 1665, n.56.

²³⁴ SCHENK, VALUE ADDED TAX – A MODEL STATUTE, *supra* note 164, at 70-71; *Vatopia*, *supra* note 168, at § 9 (providing for only one rate of tax on all goods and services with food neither exempt nor zero-rated).

²³⁵ SCHENK, VALUE ADDED TAX – A MODEL STATUTE, *supra* note 164, at 71-72 and *Vatopia*, *supra* note 168, at §2(b) (Schedule II) (allowance is made for zero-rating supplies of medical goods and services).

Digital VAT

The D-VAT will surgically target tax relief to those determined to be most in need, and for purchases which society feels relief should be granted. No other consumption tax proposal can make this claim. The digital core of the D-VAT allows the use of procurement card technology to remove the tax from selective transaction types. The D-VAT can do this on an individual-by-individual, economic and socially determined need basis.

For example, assume a low income individual qualifies for exemption from the D-VAT on purchases of necessities, determined in this case to be certain food, clothing items and necessary medical services. This individual would be issued a card, similar to a credit or a purchase card that would, when scanned at the point of sale, remove the D-VAT from the purchase. In effect, the purchase of designated items by this individual would be zero-rated.²³⁶ Other individuals purchasing the same items would be subject to tax. Thus, the D-VAT Card functions the same way that preferred customer cards function at most supermarkets. Because universal product codes would identify all goods and services transactions in the economy, exemptions could be tailored to the specific circumstances of the qualifying individual. D-VAT Cards would be valid nationally, because universal products codes identify the same goods and services in every state.

D-VAT Cards could be issued monthly, allowing welfare agencies the opportunity to regularly re-evaluate an individual's status. Dollar limitations could be associated with these cards, so that an individual in a particular income bracket would qualify for D-VAT exemptions up to, but not exceeding certain limits. In addition, a D-VAT Card would require no cash refunds, no adjustments to payroll tax withholdings, and no annual or periodic returns seeking reimbursement. Relief is narrowly targeted to those in need, immediately provided at the point of sale, and narrowly tailored to the items for which that person's need has been recognized. This attribute of the D-VAT Card assures the expansion of the VAT base to food and other necessities purchased by the well-to-do.

Technology to accomplish this task is already available commercially. It is used by all international businesses that have VAT reporting obligations, and any commercial enterprise in the US that has automated systems to determine sales and use tax obligations. It is a very simple matter to associate a zero rate of tax with a particular purchase when an authorizing card is passed, and a standard rate of tax when no card is passed. In the D-VAT this technology would be made available to those who do not already have it through a CSP. The D-VAT would accommodate proprietary systems that are certified (CPS), and would certify other automated systems (CAS) to perform this function in-house.

²³⁶ Because this transaction is zero-rated rather than exempted the retailer selling to low-income or high-income purchasers would be indifferent. A zero-rated sale allows the seller to reclaim the whole amount of the VAT (input credit) that was paid on the purchase of inventory, in exactly the same manner as a sale to a regularly taxed transaction.

(7) *Small business and final consumer exemptions added.* Two exemptions need to be added to the ABA Model VAT under the Digital VAT, one for small businesses, and the other for invoices issued to final consumers. Others may be needed in certain circumstances.

The ABA Model VAT differs from most VAT systems by not allowing a small business exemption. The commentary to the Model VAT explains, “[i]f a small business exemption is included in a VAT system, the exemption creates opportunities for abuse, produces multiple taxation, and distorts competition between taxable and exempt traders.”²³⁷

The D-VAT however, needs a small business exemption. The exemption however, will not be to exempt small businesses from charging VAT, rather it will be to exempt a small business from the mandatory electronic filing requirements. Very small businesses, businesses where automation would be a hardship, would be allowed to submit paper returns, statements and reports, in lieu of the digital documentation requirements generally required in the D-VAT.

There is no reason to disagree with the ABA Reporter who explains, “[t]he Model Act does not contain a *de minimus* or small business exemption [from the tax itself]. The states have been highly successful in collecting retail sales taxes, even from small retailers with minimal record keeping. While the record keeping and reporting requirements under a VAT may be somewhat more complicated because of the input credit, there does not seem to be any significant compliance problem that should prompt Congress to remove small businesses from the tax rolls.”²³⁸ However, the burden of digital compliance, as opposed to traditional paper compliance may indeed be burdensome to some.²³⁹

A second exemption, again to dispense with the general requirement to perform all reporting functions electronically, should be allowed for sales to final consumers. Invoices (sales receipts) issued to the final consumers transactions (supermarket receipts, department store sales slips, etc.) should be permitted in paper. The retailer’s record of the transaction would still be required to be maintained digitally. The reason for this exception is to make the transition to the D-VAT as smooth as possible. In addition, final consumers are not taxpayers in a VAT system. They file no returns, reports or statements with the taxing authority, and would have no need for a digital record of purchases. Thus

²³⁷ SCHENK, VALUE ADDED TAX – A MODEL STATUTE, *supra* note 164, at 87.

²³⁸ *Id.* at 90.

²³⁹ Regulations should determine the scope of exemption. Advances in technology could make the exemption unnecessary, so a firm rule need not be placed in the statute. Authority to regulate other hardship variances from digital recordkeeping should be allowed. Religious objections could be anticipated from some, like the Amish, who have objected to proposed changes in sourcing rules in the Ohio sales tax statute, because new rules (destination sourcing) anticipate the use of a modern technology that is at odds with their beliefs. Steven S. Woo, *Ohio Lawmaker Calls for Sourcing Amendment to Streamlined Agreement*, STATE TAX NOTES (Nov. 1, 2004) [Doc. 2004-20829; 2004 STT 211-1]; Emily Dagostino, *Tax Officials: Streamlining States Struggle With Sourcing Provisions*, STATE TAX NOTES (Aug. 19, 2004) [Doc. 2004-16766; 2004 STT 161-1].

the omission of digital records on the final consumer's side of this transaction will have no impact on the integrity of the D-VAT.

CONCLUSION

This proposal for the US adoption of a D-VAT is intended as an administrative supplement to proposals for a European-style, destination based, credit-invoice VAT. As drafted, it is not concerned with achieving revenue neutrality, a concern of the President's Advisory Panel on Federal Tax Reform, nor is it concerned with the issue of revenue generation sufficient to allow the replacement of all or part of the federal income tax system, as has been a staple argument in the consumption tax debate over the past decades. This proposal for a D-VAT does not disagree with the VAT proposals advanced by Professor Graetz and Avi-Yonah, or with those proposed in Congress by Senator Hollings. What it does suggest is that if the US is contemplating going in the direction of a national consumption tax, and if that direction is for a VAT, then the administrative design should be an intensely digital one. This article has set out the efficiency, equity, state-federal harmonization, and tax administrability reasons for the adoption of a D-VAT.

The intent has been to focus attention on the opportunity that the US has to design a truly modern VAT, one that will not only achieve the self-enforcing promise of the earliest advocates of this tax, but one that will re-enforce the diversity of tax design that has been a hallmark of American fiscal federalism. The D-VAT provides a mechanism for achieving the broadest possible consumption tax base. The D-VAT Card provides a surgical answer to tax regressivity. The D-VAT Card is a mechanism for immediate, point-of-sale relief to those determined to be in greatest need. These are opportunities that the US should not miss out on, if a national VAT is in the future.