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Coordinating a Federal VAT With State and Local Sales Taxes

By Harley Duncan and Jon Sedon

Harley Duncan is a managing director and Jon Sedon is a manager in the State and Local Tax Group of KPMG LLP's Washington National Tax practice.

KPMG LLP's Washington National Tax Office is conducting an initiative to inform the debate over a VAT as a tax reform option in the United States. The project comprises webcasts, publications, speaking engagements, and university instruction, all designed to inform professionals, academics, and policymakers about VAT issues.

A key part of this project is Views on VAT, a yearlong series of articles in Tax Notes on the VAT regimes in foreign countries, the comparison of VAT and U.S. retail sales taxes, VAT administration and compliance issues, how a U.S. national VAT would theoretically be administered, and other issues related to the VAT.

This article explores the issues involved in coordinating state and local sales taxes with a federal VAT in the United States. Modifying state and local sales taxes to emulate a well-designed federal VAT could improve their operation and policy underpinnings. Developing a coordinated federal-state system in the United States will not be simple and may well require new approaches. It may also be achieved only at the expense of some of the autonomy that states exercise over the design and operation of their taxes.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG LLP.

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One of the many questions that will need to be addressed if the U.S. government considers a VAT is how it can be coordinated with current state and local retail sales taxes (RSTs). Adoption of a VAT by the federal government will present states with mixed prospects. On one hand, it would represent a significant increase in the federal government's use of consumption taxes, an area that to this point has largely been the province of states and localities. This could ultimately constrain future state and local government use of those taxes. On the other hand, if state and local RSTs could be modified to emulate and be coordinated with well-designed federal VAT, it could improve their operation as comprehensive tax on individual consumption of goods and services that does not tax business inputs. It might also reduce the burden imposed on sellers involved in collecting the tax and improve compliance with the tax. Experience elsewhere, however, suggests that these gains may be achieved only at the expense of some of the autonomy that states exercise over the design and operation of their sales taxes.

In this Views on VAT, we examine the consequences a federal VAT may have for states and the potential opportunities it might present to aid them in improving their consumption taxes. We look at five questions: (1) Why are states concerned about a federal VAT? (2) What policy improvements could a VAT bring to RSTs? (3) What are the constraints on coordinating RSTs with a federal VAT? (4) What options do the states have for coordinating their sales taxes with a federal VAT? (5) And what other issues might states encounter?¹

State Concerns With a Federal VAT

For a considerable period, some state legislators, governors, and tax administrators have expressed opposition to — or at least hesitation toward — a federal VAT.² The executive director of

the Federation of Tax Administrators, Jim Eads, responding to comments about state interaction with a federal VAT, said:

Sovereignty, in the matter of taxes for the states, is a big deal for us and something the states guard vigorously. . . . The federal government has not seemed inclined to consider state issues in the past and today does not seem anxious to consult with the states about their concerns, so I would be very worried if they began to seriously consider these major reforms. . . . If Congress did adopt a VAT and the president signed it, the states could be seriously harmed economically in the short and long terms.³

As reflected in Eads's statement, the states' main concerns regarding implementation of a federal VAT are state autonomy and state revenue impact.

1. Autonomy. One concern among states is that a federal VAT, or at least coordinating with a federal VAT, explicitly or as a practical matter, could force the states to structure their consumption taxes to piggyback on the federal VAT. Such a requirement could decrease a state's autonomy if the tax rate, the tax base, the administration of the tax, and the allocation of revenue among states is "*de facto* dictated by the national government."⁴ A related concern is that the policy decisions of the national government may not be in a particular state's best interest. For example, the federal government's decision to exempt or zero rate specific items, industries, or activities could cause a state to lose a source of revenue by virtue of its conformity to the federal base.⁵ These concerns are plausible considering the types of coordinated VATs that have been adopted in other countries with a federal system and the degree to which they require uniformity

³Frank Shafroth, "An Interview With FTA Executive Director Jim Eads," *State Tax Notes*, Nov. 30, 2009, p. 669.

⁴William F. Fox and LeAnn Luna, "Subnational Taxing Options: Which Is Preferred, a Retail Sales Tax or a VAT?" *State Tax Notes*, Mar. 10, 2003, p. 875, *Doc 2003-6043*, 2003 *STT* 46-3.

⁵*Id.* This situation, of course, also arises with state income taxes; most states have substantially conformed their individual and corporate income tax bases to the federal income tax.

in the federal and state tax base.⁶ As other commentators have pointed out, a system under which a state VAT or RST is not coordinated with a federal VAT is not necessarily unworkable, but it could significantly damage the administrative advantages of implementing a VAT.⁷

2. Revenue impact. State officials fear that implementation of a federal VAT may diminish consumer spending and cause state revenues to decrease.⁸ Economists, on the other hand, note that unless consumption is expected to be taxed at a lower rate in the future, a general consumption tax will not reduce consumption — at least not significantly more than an equal tax increase in the income tax.⁹ A more indirect concern of states is that a federal VAT may begin to restrain their use of the consumption tax base. The federal government's foray into the consumption tax arena — traditionally the province of the states — could result in an aggregate tax rate that “cannot be enforced satisfactorily” (that is, evasion balloons).¹⁰ From the states’ point of view, “the concern is that if federal reform causes the national government to dominate a base that has traditionally been used primarily by states, it could reduce the fiscal flexibility of states and disrupt the current balance in the intergovernmental system.”¹¹

B. Policy Improvements

From a tax policy perspective, there are generally four features of an effective or well-designed consumption tax: (1) virtually all goods and services purchased for individual use are subject to tax; (2) businesses ultimately bear no burden from the tax (other

⁶See Harley Duncan, “VATs in a Federal System,” *Tax Notes*, Mar. 29, 2010, p. 1643, Doc 2010-5052, or 2010 TNT 61-5 (hereinafter “VATs in a Federal System”).

⁷*Id.*

⁸Under a well-designed VAT, a reduction in consumption (that is, an increase in saving) does not permanently deprive the government of the revenue — it merely defers taxation until savings are spent. However, even a temporary reduction in state revenues can be problematic, given that most states require a balanced budget.

⁹In some scenarios, a transaction tax is imposed — or at least justified — under the auspices that the taxed item has undesirable social effects (e.g., taxes on alcohol, tobacco, soft drinks, candy, and plastic bags).

¹⁰See, e.g., Charles E. McLure Jr., “State and Local Implications of a Federal Value-Added Tax,” *Tax Notes*, Mar. 28, 1988, p. 1517.

¹¹Duncan, “Federal Tax Reform and State Taxes: A Framework for Analysis,” *State Tax Notes*, Special Supplement, Oct. 3, 2005, p. 5.

than administrative costs); (3) goods and services are taxed on a destination basis (that is, by the jurisdiction where consumption occurs); and (4) compliance and administrative costs are minimized.¹² Current RSTs fall well short of these policy norms.

1. Taxation of goods and services. As was noted in an earlier article,¹³ Views on VAT, although either an RST or a VAT is capable of being structured to apply broadly to the final consumption of goods and services, in practice, state RSTs generally apply to sales of tangible personal property but to only a limited number of enumerated services.¹³ VATs, however, generally apply to a much broader range of goods and services sold for final consumption within the jurisdiction.¹⁴ While in principle there is no reason a state RST could not be applied to services, recent history has shown that to do so have failed.¹⁵ If the federal government adopts a RST, it could provide a vehicle for states to modify their tax laws to include a broad range of services. Besides eliminating the distortion of consumer choices in favor of untaxed consumption, this would allow a lower tax rate to raise a given amount of revenue and decrease the compliance burden on business.

2. Business inputs. State RSTs also fail to meet the requirements of a consumption tax feature of relieving businesses of an undue burden.¹⁷ Generally, taxing business inputs is undesirable because the tax cascades or pyramids through the production process.

¹²See Duncan, “Administrative Mechanisms to Aid in the Coordination of Local Retail Sales Taxes With a Federal Value Added Tax,” *American Tax Policy*, Feb. 2009, at pp. 6-9, available at <http://www.americantaxpolicyinstitute.org/pubs/Policy%20Notes/Policy%20Notes%20-%20Retail%20Sales%20Taxes.pdf> (hereinafter “Administrative Mechanisms”). See also McLure, “Straight Talk About the Taxation of Electronic Commerce: Tax Principles, Current Problems, and Nexus,” 16 *Tax Policy and the Economy* 115 (2002), pp. 115-140; “The Taxation of Electronic Commerce: Background and Proposal,” in *Public Finance: The Internet, Privacy, Taxes, and Contracts* (Nicholas Imparato ed., 2000), pp. 49-54.

¹³See Leah Durner and Bobby Bui, “Comparing Value Added and Retail Sales Tax Notes,” Feb. 22, 2010, p. 983, Doc 2010-2923, or 2010 TNT 35-7.

¹⁴Walter Hellerstein and Timothy H. Gillis, “The VAT in the European Union,” Apr. 26, 2010, p. 461, Doc 2010-7537, or 2010 TNT 79-8. See also Durner and Bui, *supra* note 13.

¹⁵See Duncan, “Administrative Mechanisms,” *supra* note 12, at n.12 (noting that legislatures in Florida, Massachusetts, and Michigan have passed legislation imposing sales tax on a broad array of services, but in each case the tax was implemented shortly before or shortly after it was implemented).

¹⁶See *infra* text accompanying notes 23-25.

¹⁷See Durner and Bui, *supra* note 13.

process as the value added at one stage is taxed at each succeeding stage, which ultimately could distort consumer and producer choices. Although states have enacted some exemptions that exclude business inputs from taxation (for example, sale for resale and manufacturing exemptions), no state exempts all business purchases.¹⁸ In fact, some studies suggest that more than 40 percent of RST revenues result from tax paid on purchases by businesses.¹⁹ While the tax on business inputs is hidden in an RST, a VAT is more transparent because the consumer can see the total tax on the good or service rather than having a tax on inputs simply built into the cost of the good or service. Again, while there is no reason as a theoretical matter that state RSTs could not be reformed to exclude business-to-business transactions, the introduction of a federal VAT may give the states an opportunity to reform their consumption tax bases to exclude purchases by businesses.

It is important to note that because RSTs apply to many business purchases, they may reduce business investment. A VAT, however, tends not to interfere with investment.²⁰ Relieving the tax burden on business inputs has resulted in a marked increase in business investments in Canada.²¹ This evidence suggests that by reforming state consumption taxes (that is, adopting a VAT), U.S. states may experience a similar increase in business investments.²²

¹⁸*Id.* (citing Jerome R. Hellerstein and Walter Hellerstein, *State Taxation*, para. 12.01 (3d ed. 1998-2009)).

¹⁹See Durner and Bui, *supra* note 13 (citing Hellerstein and Hellerstein, *supra* note 18, at para. 12.01, in turn citing Raymond J. Ring, "Consumers' Share and Producers' Share of the General Sales Tax," 52 *Nat'l Tax J.* 79 (1999), and Ring, "The Proportion of Consumers' and Producers' Goods in the General Sales Tax," 42 *Nat'l Tax J.* 167, 175 (1989)). See also Duncan, "Administrative Mechanisms," *supra* note 12, at n.22, (citing Andrew Phillips, Robert Cline, and Thomas Neubig, *Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2007*, at 1 (Ernst & Young and Council On State Taxation, 2008)).

²⁰See Leah Durner, Bobby Bui, and Jon Sedon, "Why VAT Around the Globe?" *Tax Notes*, Nov. 23, 2009, p. 929, *Doc 2009-24645*, or 2009 *TNT* 223-7. See also McLure, *supra* note 10.

²¹Richard M. Bird and Michael Smart, "The Impact on Investment of Replacing a Retail Sales Tax With a Value-Added Tax: Evidence From Canadian Experience," 62 *Nat'l Tax J.* 591 (Dec. 2009).

²²*Id.*

3. **Destination-based taxation.** Through the technique of rating under the VAT, exports enter world markets free of VAT of their country of origin. Imports bear the same domestically produced goods. By comparison, exports to states and nations bear the RST embedded in their price imports do not bear these embedded taxes.

4. **Reduce compliance burden.** Complying with current and local RSTs is complex. A retailer operating in multiple jurisdictions must be aware of the tax base and tax rate in each jurisdiction, retain proper documentation of exempt sales properly and timely file returns and payments.²³ Evidence suggests that the average cost of collection of RSTs is more than 1 percent of the total tax collected.²⁴ The compliance burden of a VAT could arguably be considered greater. While a VAT requires documenting and reporting sales, a VAT further requires documenting and reporting inputs as well as detailed information on exports.²⁵ If state RSTs are not coordinated with a federal VAT, taxpayers will have to deal with compliance costs at the federal level and separately among the states. However, states choose to instead adopt state-level VATs and displace state RSTs, businesses would not have to comply with separate systems. Most of these savings could be realized if state were to adopt the integrated sales tax (IST) described in the IST. Although it resembles an RST in its effect, the IST is a VAT-type mechanism to eliminate tax on business-to-business transactions. Further, to the extent that states were to coordinate the federal VAT base, it would alleviate the need to monitor compliance with what are now different RST bases in each state.

C. Constraints to Imposing a Coordinated VAT

The previously discussed concerns of state officials regarding political authority and autonomy as well as concerns regarding revenue flows will likely act as constraints on the adoption of a coordinated federal-state consumption tax system. Also, the

²³Duncan, "Administrative Mechanisms," *supra* note 12.

²⁴*Id.* (citing Peter J. Merrill, PricewaterhouseCoopers National Economic Cost Study, *Retail Sales Tax Compliance Costs: A National Estimate* (Apr. 7, 2006)).

²⁵Duncan, "Administrative Mechanisms," *supra* note 12.

other features of the current environment that could affect the design of a coordinated approach. These include:

- **Diversity in states' approaches.** Not all states impose an RST.²⁶ Likewise, even if some states opt to convert their RST to a VAT, it is highly unlikely that all will do so, especially at the outset.²⁷ The resulting patchwork will probably make it impractical to implement approaches that would involve a uniform system nationwide.
- **Local government concerns.** As discussed below, the large number of local governments that use an RST will compound exponentially some of the complexities involved in ensuring the final taxation on a destination basis. Put another way, the large number of local government RSTs effectively precludes the adoption of some border-tax adjustment mechanisms needed to produce destination-based taxation at the local level²⁸ and requires alternative arrangements.

D. Options Available to the States

The central issue to be addressed in designing a coordinated national-subnational VAT structure for a country with a federal system is dealing with interstate sales, or more specifically, ensuring that interstate sales are taxed on a destination basis.²⁹ Other countries have not always been successful in achieving a smoothly functioning destination-based tax.³⁰ Nonetheless, there are experiences in other countries (notably experiences in

²⁶Alaska, Delaware, Montana, New Hampshire, and Oregon do not levy a broad-based RST at the state level.

²⁷The Canadian experience is instructive here in that most provinces chose to retain their RSTs when the federal government adopted the goods and services tax. In 1997 Nova Scotia, New Brunswick, and Newfoundland replaced their RSTs with a single federal-provincial harmonized sales tax collected by the federal government. In 2009 Ontario and British Columbia announced that they would replace their RSTs with an HST beginning July 1, 2010. Martin A. Sullivan, "VAT Lessons From Canada," *Tax Notes*, May 3, 2010, p. 493, *Doc 2010-9497*, 2010 TNT 84-3. See also Duncan, "VATs in a Federal System," *supra* note 6, at pp. 1649-1650.

²⁸For a discussion of the border tax adjustment process and its role in achieving destination-based taxation, see Harley Duncan and Jon Sedon, "How Different VATs Work," *Tax Notes*, Dec. 21, 2009, p. 1367, *Doc 2009-26730*, or 2009 TNT 243-3.

²⁹See Duncan, "VATs in a Federal System," *supra* note 6.

³⁰*Id.* at pp. 1650-1651 for a discussion of current arrangements in Brazil and India where the state-level taxes are origin-based taxes.

Canada and proposals in India) from which the United States could draw in designing a coordinated consumption tax regime if the federal government did adopt a VAT.³¹ Further treatment of intra-Community supplies of goods and services in the European Union may also provide guidance in dealing with the national-subnational coordination issues in the United States.³²

Based on those experiences, states would have four choices available to them for retaining or modifying their RSTs if the government were to adopt a VAT: (1) maintain the status quo and retain their sales taxes as they exist; (2) harmonize their sales taxes with the VAT and have them treated essentially as a component of the federal VAT; (3) adopt state-level VATs that are coordinated with and emulate the federal VAT but are administered separately by the states; and (4) adopt ISTs, which, as described below, are a type of RST that relies on some VAT techniques to achieve the aims of an ideal RST in terms of taxing international consumption. Experience in Canada and traditions of U.S. states suggest that not all states would choose the same course, meaning that some states would retain an RST while others would select among other options.³³

1. Status quo. States could, if they so desire, maintain their RSTs and make no changes in their operation, structure, or administration in response to adoption of a VAT by the federal government. This approach characterizes the initial policy response among the Canadian provinces after adoption of the federal goods and services tax in 1991. Five of the nine provinces retained sales tax when the GST was adopted simply maintained provincial sales taxes.³⁴ In 1997 three provinces — Nova

³¹*Id.* at pp. 1648-1652.

³²For a discussion of the treatment of cross-border sales in the EU, see Heller, Gillis, *supra* note 14. See also Sijbren Cnossen, "VAT Coordination in Common and Federations: Lessons From European Experience," American Tax Policy June 2009, at pp. 8-11, available at <http://www.americantaxpolicyinstitute.org/VAT/Cnossen.pdf>.

³³See Duncan, "VATs in a Federal System," *supra* note 6, at pp. 1648-1650 Sullivan, *supra* note 27.

³⁴The provinces maintaining their RSTs were British Columbia, Manitoba, Prince Edward Island, and Saskatchewan. See Duncan, "VATs in a Federal System," *supra* note 6, at 1647.

essentially a surcharge applied to the provincial portion of the federal GST base. As applied to the United States, the relevant HST features are that the tax base is identical (or so) with the federal tax,³⁷ the tax is administered by the government on behalf of the states, and the state is responsible for establishing the rate at which sales of goods and services to the state are taxed.³⁸ Federal legislation creating a system could provide that on interstate sales involving more states that have adopted the HST, the tax of the HS of origin would not be collected and that the tax of the HS of destination would be collected along with the federal tax, thus eliminating the *Quill* restriction for these states.³⁹ If international exports would be zero rated for both the federal and state taxes; imports by registered traders would be reverse charged; and U.S. Customs and Border Protection, part of the Department of Homeland Security, could collect the federal and state tax (an HST state) on international imports by others.⁴⁰

Adoption of the HST approach by states would seem to be the most policy benefits to the overall consumption tax because, presuming a well-designed federal VAT, it would significantly move states toward a consumption tax that conformed with the standard policy norms of taxing all final purchases of goods and services, while not imposing an undue burden on intermediate business purchases and inputs. Moreover, the HST approach is adopted by a significant number

³⁷Some variations are accomplished in Canada through point-of-sale rebates.

³⁸The Atlantic provinces in Canada adopted the same HST rate by mutual agreement rather than being required to do so by law. By agreement they also place limits on their ability to increase or decrease their HST rate. Ontario and British Columbia have determined their own rate for HST, and Nova Scotia has set its own rate, effective 1, 2010. Duncan, "VATs in a Federal System," *supra* note 6, at 1649.

³⁹See *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

⁴⁰These provisions would achieve a destination-based tax. They are similar to those in Canadian HST provinces except that the Canada Border Security Agency collects the provincial HST only on sales to nonregistered traders and final consumers. See Duncan, "VATs in a Federal System," *supra* note 6, at 1649. An additional issue would need to be addressed is how to distribute the HST revenues to the participating states. In Canada, HST revenues are distributed on the basis of a formula intended to estimate taxable consumption by province rather than by trade reporting sales and tax collections by province.

New Brunswick, and Newfoundland — harmonized their sales taxes with the GST, and in 2009 British Columbia and Ontario announced that they would harmonize their RSTs with the GST.³⁵

Because this route requires no action by a state and no modification of the state's tax structure, it seems to be the likely initial position of many states. If states maintain their RSTs, the primary impact will be on U.S. businesses, which will be required to comply not only with the federal VAT, but also with what is acknowledged to be an exceedingly complex RST system. The impact will be most acute for businesses involved in multistate retailing. In short, if states maintain their RST systems, there will be few policy dislocations, at least from an RST standpoint. There will be no tax policy improvements at the subnational level, and the combined federal and state compliance burden faced by multistate sellers could increase significantly.

2. Harmonized sales taxes. A second option, which is at the opposite end of the spectrum of policy responses, would be for states to harmonize their sales taxes with the federal VAT. We use the term "harmonized" to mean a system that is similar in key aspects to the harmonized sales tax system in place for Canada's three Atlantic provinces, to be expanded to British Columbia and Ontario in July 2010.³⁶ In that arrangement, the provincial tax is

³⁵*Id.* at n.47 (citing British Columbia, "Harmonized Sales Tax: Creating Jobs, Lowering Prices," available at <http://www.gov.bc.ca/hst/>; Ontario Ministry of Revenue, "What Is the HST?" available at <http://www.rev.gov.on.ca/en/taxchange/hst.html>). For a discussion of the HST system, see *infra* text accompanying notes 36-47. See also Sullivan, *supra* note 27.

³⁶For an extremely thoughtful and comprehensive article on the Canadian GST and RST experience, see Richard M. Bird and Pierre-Pascal Gendron, "Sales Taxes in Canada: The GST-HST-QST-RST System," American Tax Policy Institute, May 29, 2009, at 27, available at <http://www.american taxpolicyinstitute.org/pdf/VAT/Bird-Gendron.pdf>. Bird and Gendron, the leading authorities on the Canadian consumption taxes, have written extensively on the topic. While we have attempted to cite the articles from which we drew pieces of our analysis, we wish to acknowledge that Bird and Gendron are sources for virtually all of our analysis related to Canada. Other articles consulted include Bird and Gendron, "VATs in Federal States: consulted include Bird and Gendron, "VATs in Federal States: International Experience and Emerging Possibilities," 1 *Ca. St. Univ. Int'l Studies Program*, Working Paper No. 01-4 (2001); Bird and Gendron, "Dual VATs and Cross-Border Trade: Two Problems, One Solution?" 5 *Int'l Tax & Pub. Fin.* 429 (1998); and Bird, Jack M. Mintz, and Thomas A. Wilson, "Coordinating Federal and Provincial Sales Taxes: Lessons From the Canadian Experience," 59 *Nat'l Tax J.* 899 (2006).

that creates countless differences among the base from s state.⁴⁵ The importance of this authority to state policyma demonstrated by the fact that an underlying principle Streamlined Sales and Use Tax Agreement (SSUTA), the far-reaching effort ever to promote consistency and unifor sales tax practices across states, is that states should be determine their own tax base.⁴⁶ While SSUTA contains u definitions for some products that states are required to u determination of whether an item is taxed in a state is reser the state legislature.⁴⁷ Adopting an HST would also expose to potential revenue swings if the federal government w enact laws that affect the shared HST and VAT base.⁴⁸

not be imposed on the U.S. government or its instrumentalities. Federal statu also limits state sales tax bases in some areas, as in prohibiting the imposition taxes on purchases made under some federal nutrition programs. See 7 U.S.C. 2011-2025 (Food Stamp Act); 42 U.S.C. section 1786 (special supplemental program for women, infants, and children).

⁴⁵For a flavor of the different treatment accorded different products from state, see CCH, *2009 State Tax Handbook*, at pp. 531-599. In addition to exemptions, states also provide exemptions to various types of entities purchases and sales, and in many cases, the taxability of a product is based on to which it is put. See McLure, "The Nuttiness of State and Local Taxes — Nuttiness of Responses Thereto," *State Tax Notes*, Sept. 16, 2002, p. 841, Doc 200 or *2002 STT 179-2* (hereinafter "The Nuttiness of State and Local Taxes"). Duncan, "Administrative Mechanisms," *supra* note 12, at pp. 6-9.

⁴⁶For a complete discussion and description of SSUTA, see Walter Hellers John A. Swain, *Streamlined Sales and Use Tax* (2006-2007). The principle determination of the tax base is contained in section 103 of SSUTA, *ava* <http://www.streamlinedsalestax.org>.

⁴⁷Some observers argue that state ability to establish the tax base should, n overriding concern and that the focus should instead be on preserving states' a to establish tax rates, as that is the key element of state autonomy — the ability to the level of spending and how to finance it. McLure, for example, argues, "The state autonomy over tax rates is taken as axiomatic." McLure, "How to Coordin and Local Sales Taxes With a Federal Value Added Tax," American Tax Policy I Feb. 2009, at 6, *available at* <http://www.americantaxpolicyinstitute.org/pd> McLure.pdf (hereinafter "How to Coordinate"). He argues further that states h used their authority to establish the tax base wisely and that the taxation of t inputs and the innumerable exemptions that cause the tax to be less than compre in the taxation of individual consumption contribute needlessly to complexity in the taxation of individual consumption. *Id.* See also McLure, "The Nuttiness of State and Local agency, and distortions. *Id.* See also McLure, "The Nuttiness of State and Local *supra* note 45, and McLure, "Understanding the Nuttiness of State Tax Policy States Have Both Too Much Sovereignty and Not Enough," 58 *Natl' Tax J.* 565

⁴⁸McLure, "How to Coordinate," *supra* note 47, argues that this would not b — certainly not as likely as under the income tax.

states, it could reduce the administrative and compliance complexity facing multistate sellers in the United States by reducing the number of different tax bases and regimes with which they are expected to comply.⁴¹ Finally, if implemented as in Canada, where the federal government administers and collects the HST on behalf of participating provinces, the HST approach would relieve participating states of the cost of administering their RSTs, a feature being used as a selling point for harmonization in British Columbia and Ontario.⁴²

Although the HST approach holds potential for substantial improvements in subnational consumption taxes in the United States, it requires states to surrender to the federal government much of the authority to define their own consumption tax base and tax administration. The HST approach can be effectively implemented only if the state and local HST tax base is uniform in nearly all regards with the federal VAT base. Compliance with the HST would become far more complicated if each state defined its own tax base, and it would become much more difficult, if not impossible, to have a single level of government administer and enforce the tax.⁴³ This requirement alone (not to mention possible concerns about such matters as foregoing state administration of the tax, the manner and timeliness with which revenue is distributed to the states, and the quality of federal enforcement) makes it seem unlikely that a significant number of states would opt for the HST approach, at least at the outset. As any observer of state and local sales taxes knows, states have used their near-plenary authority⁴⁴ over the RST base in a fashion

⁴¹The reduction in compliance burden is due largely to the assumed condition that the HST base is identical with the federal VAT base. Sellers would still be required to determine the appropriate state and local tax rate to apply. Determining the appropriate local tax rate to apply could still be problematic. See *trifra* discussion at notes 86-90. Reductions in complexity would also be frustrated to the extent that a state was allowed to use multiple HST rates for different types of goods and services.

⁴²See Duncan, "VATs in a Federal System," *supra* note 6, at n. 67 and accompanying text.

⁴³The essential uniformity of tax bases is required of an HST province in Canada. It is also being set as a condition for state-level VATs being proposed in India. See Duncan, "VATs in a Federal System," *supra* note 6, at 1652.

⁴⁴State actions in establishing and implementing an RST must comport with the requirements of the U.S. Constitution. The primary constraint in terms of defining the tax base is that a state tax must not discriminate against interstate commerce and may

(Footnote continued on next page.)

Implementing an HST in the United States would seem to be problematic given that there may be a large number of local governments with varying tax rates that would also be included in the HST and given that not all local governments within a state will necessarily levy the HST. This would seem to necessitate the tracking and reporting of sales by state and local jurisdiction, a feature that would make the HST in the United States more complex than in Canada.

3. State-level VAT. If states are reluctant to adopt the HST approach to coordination, the question becomes whether states could implement a state-level VAT that addresses some of the fiscal autonomy concerns, but at the same time brings substantial consumption taxes into closer alignment with accepted policy norms. The international experience with successful administration of a destination-based VAT at the subnational level is limited primarily to the province of Quebec, which administers both the Quebec sales tax (QST) — a destination-based subnational VAT — and the federal GST.⁴⁹

Prof. Charles McLure has devoted considerable effort to the analysis and design of various approaches to a state-level VAT in the United States.⁵⁰ As noted by McLure and others, the central issue to address in designing a subnational VAT is dealing with interstate sales, or more specifically, ensuring that interstate sales are taxed on a destination basis.⁵¹ Three approaches have been developed in the VAT literature to achieving a destination-based subnational VAT:

- the standard border tax adjustment process, employed in the EU and by Quebec, in which an interstate sale would be zero

⁴⁹For further discussion of the QST and provincial administration of the GST, see Duncan, "VATs in a Federal System," *supra* note 6, and sources cited therein. Possible state-level administration of the federal VAT is not considered further here since it seems unlikely to be transported to the United States, given that many states are unlikely to adopt a VAT and some states do not have an RST — not to mention concerns about allowing subnational administration and enforcement of a national tax.

⁵⁰See McLure, "How to Coordinate," *supra* note 47. See also McLure, "Coordinating State Sales Taxes With a Federal VAT: Opportunities, Risks, and Challenges," *State Tax Notes*, June 20, 2005, p. 907, and Duncan, "VATs in a Federal System," *supra* note 6, at n. 25. We draw extensively from McLure's ideas and research regarding state-level VATs.

⁵¹*Id.*

rated in the origin state and subjected to tax in the destination state using a "reverse charge" mechanism in the business-to-business purchases; the seller-supplier would be eligible for a refund on any input tax paid in the state⁵²;

- a viable integrated VAT (VIVAT) in which each state establishes its own tax rate for sales to final consumer unregistered traders, but a uniform VIVAT collected in the origin state would be levied on both intra- and interstate sales between registered traders; sellers would receive credit for all VIVAT paid on their inputs, and a clearinghouse would be responsible for reconciling the credit payments on interstate business-to-business sales⁵³; a
- a compensating VAT (CVAT) in which a state CVAT would be collected on all interstate sales that would be collected by the national government or a consortium of states, with the national VAT; the CVAT would be fully credited on business-to-business purchases.⁵⁴

McLure concludes⁵⁵ that these approaches would not be an optimal way to implement a destination-based VAT at the state and local government levels in the United States for several reasons. The volume of interstate trade in the United States and the resulting VAT refunds on zero rated business-to-business sales would create a substantial risk of fraud and noncompliance, thus making the EU/QST zero rating/reverse charge approach undesirable in his estimation.⁵⁶ Either the VIVAT or the CVAT approach would work best if all states adopted it, which

⁵²Note that in the United States, the *Quill* restriction would presumably apply to further descriptions, see Cnossen, *supra* note 32; Bird and Gendron, *supra* note 28; Duncan and Sedon, *supra* note 28.

⁵³Again, note that in the United States, the *Quill* restriction would presumably apply. The VIVAT was designed for the EU where no overarching central tax is levied on a clearinghouse would be required to ensure that the tax on business-to-business is actually remitted on a destination basis. For further discussion, see Duncan, "A Federal System," *supra* note 6, at 1646, and sources cited in notes 32-35 there.

⁵⁴For further discussion, see McLure, "Implementing Subnational Value Added Taxes on Internal Trade: The Compensating VAT (CVAT)," 7 *Int'l Tax & Pub. Aff.* (2000).

⁵⁵McLure, "How to Coordinate," *supra* note 47, at 18-19.

⁵⁶*Id.* at 22.

unlikely. The VIVAT approach would also require the establishment of a revenue clearinghouse and an agreed-on VIVAT rate, each of which McLure considers unlikely.⁵⁷ Finally, he finds that the CVAT also comes up short in workability in the U.S. setting because it would rely on federal government administration (or administration by a consortium of states) and would be difficult to implement at the local level.⁵⁸

4. **The IST.** To overcome these issues, McLure has developed what he calls the IST that he believes can be used to implement a destination-based state sales tax.⁵⁹ The IST is an RST that uses some VAT approaches to exclude business inputs from tax, and to tax individual consumption on a destination basis. Under the IST, all sales between registered traders (both intrastate and interstate sales) would be zero rated, and only sales to individual consumers and unregistered traders would be subject to a positive tax rate.⁶⁰ States would establish the tax rate on in-state sales to final consumers. States would also administer the IST, but its administration would be closely coordinated with the federal VAT, particularly in the registration of taxpayers.⁶¹ As formulated by McLure, the base of the state tax on sales to consumers would conform to the federal VAT base, in part to facilitate coordination in administering the state and federal taxes.⁶²

For several reasons, McLure believes the IST approach is the optimal choice for those states that want to modify their sales taxes in a way that would be coordinated with a federal VAT. First, the IST approach is consistent with the state tradition of imposing RSTs, while eliminating the problems that characterize the RSTs. Second, not all states would be required to adopt the

⁵⁷*Id.* at 26, n.71.

⁵⁸*Id.* at 27-28.

⁵⁹The IST is most fully explained in McLure, "How to Coordinate," *supra* note 47, at 4 n.19, and 31.

⁶⁰By zero rating all sales to registered traders, the IST uses some of the mechanics of a VAT to achieve the results of an "ideal" sales tax, *i.e.*, a tax collected at a single stage on sales to final consumers and no tax on business inputs. See McLure, "How to Coordinate," *supra* note 47, at 31.

⁶¹*Id.*

⁶²*Id.* at 31 and 51-53.

IST for it to be usable by those desiring to do so, and it does require federal administration of a state tax or a clearinghouse distribute funds among states. The IST also avoids the result that would be necessary under the standard border tax adjustment process, and the resultant exposure to various fraud practices. Finally, like existing sales taxes, it could be used to increase local government level.⁶³

E. Issues for States

As proposed, the IST would appear to bring state consumption taxes into much closer alignment than RSTs with the accounting policy norms for consumption taxes. It does, however, require a radical departure from current RSTs, primarily in terms of composition of the tax base. As such, the IST raises several issues that states would have to carefully evaluate in assessing whether to adopt it in coordination with a federal VAT.

1. **Tax rate.** A primary consideration for states will be the tax rate that would have to be applied to the new tax base of intrastate sales to final consumers in order to compensate for the IST of tax on sales to businesses (which is estimated at 40 percent of all sales tax collections).⁶⁴ As reviewed in an earlier *Vie* VAT,⁶⁵ some analysts believe a well-designed U.S. federal VAT could have a base equal to roughly 60 percent of GDP, which implies a federal VAT base of roughly \$8.6 trillion based on 2008 GDP of \$14.4 trillion, meaning that an average state is equal to about 3 percent of total state revenues to generate revenues equal to the \$240 billion in general sales taxes collected by states in 2008.⁶⁶ As we also said in the earlier article, a federal VAT with a base equal to 60 percent of GDP would be quite comparable with most VATs in place today.⁶⁷ Among countries, the average VAT base is equal to roughly 60 percent of final household consumption. If the U.S. federal VAT base were equal to that, it would translate to a VAT base of about \$6 trillion

⁶³*Id.* at 32.

⁶⁴See *supra* sources cited in note 19.

⁶⁵Duncan and Sedon, *supra* note 28, at 1372-1373.

⁶⁶KPMG calculation based on data from the U.S. Bureau of the Census, Government Tax Collections in 2008.
⁶⁷*Id.*

(based on 2008 data),⁶⁸ meaning an average state tax rate of about 4 percent would be necessary to be revenue neutral given current state RST collections.⁶⁹ (States that currently tax several services would be differentially affected in terms of making up for not taxing business inputs.)

2. Tax base. As noted,⁷⁰ McLure proposes for administrative and policy reasons that the base of the state-level IST would conform to that of the federal VAT. In fact, most if not all experiences with attempts to coordinate national and subnational VATs call for base uniformity, whether it is the HST in Canada, the provincially administered QST/GST in Canada, or the proposals for an integrated GST now being considered in India.⁷¹ This will undoubtedly be a sticking point for states as they consider whether to coordinate with a federal VAT, given the degree to which they jealously guard the ability to define their own tax base.⁷²

As the Canadian experience indicates, some differences in tax base can be accommodated through on-the-spot rebates or varying rebates to some sectors without unduly complicating compliance and enforcement. Because the state IST would apply only to in-state sales to final consumers and would be administered by the states, it may be possible for states to vary to some degree from the federal base without making compliance or administration overly complicated. It would seem necessary, however, to minimize deviations in tax base and state taxation of business-to-business sales. Based on past actions of the states, the state-to-state differences and complexity could soon become overwhelming. Differences in federal and state tax bases would also complicate coordination of enforcement and administration

⁶⁸KPMG calculations based on data on final household consumption as reported by the OECD are available at http://stats.oecd.org/Index.aspx?DataSetCode=SNA_TABLE1.

⁶⁹KPMG calculations. The calculations of the required state tax rate do not make adjustments to GDP for household consumption for the four states (Alaska, Montana, New Hampshire, and Oregon) that do not have a sales tax, because of the lack of data on state GDP or consumption. Given the size of these states, such an adjustment would not be expected to alter the conclusions significantly.

⁷⁰See *supra* text accompanying notes 61-62.

⁷¹See generally Duncan, "VATs in a Federal System," *supra* note 6, for a review of these systems and proposals.

⁷²See *supra* text accompanying notes 4-7.

with the federal government as discussed below. Given that to have a single federal and state taxpayer registration, it is impossible for a state tax base to deviate from the federal base in a manner that would require a seller to register and collect IST when it is not required to register for federal purposes.

3. Compliance. The state IST would be collected entirely at the final sale to the individual consumer. As a result, there will be a substantial volume of trade moving among registered taxpayers without payment of tax, thus creating opportunities for evasion and compliance risks for states. Some of these compliance risks might be overcome by coordinating the administration of the state IST with a federal VAT.

a. Taxpayer registration. The cornerstone of a cooperative approach to administration would be a common taxpayer registration system in which the federal government and the states would rely on a single registration process and register taxpayers. Possession of a valid VAT registration number would identify the holder as being eligible to engage in zero rated purchases from another registered trader for federal purposes and as eligible for the input credits associated with the federal VAT.⁷³ A common registration and identification number would also be integral to performing any meaningful information exchanges between the federal government and the states to promote compliance.⁷⁴

Establishing a common registration system will create problems that must be addressed. Nearly every country that administers a VAT has a registration threshold, providing businesses with an annual sales volume below some specified level are not required to charge and collect VAT on their sales. Voluntary registration is ordinarily allowed. A registration threshold, while reducing revenues somewhat, simplifies administration of the VAT for both the government and sellers.

⁷³McLure, "How to Coordinate," *supra* note 47, at 33; Duncan, "Administrative Mechanisms," *supra* note 12, at 35-37.

⁷⁴See *id.* at 32-35 for a discussion of the types of exchanges that could be fruitful, and *id.* at 13-14 for a discussion of various information exchanges under the income tax.

⁷⁵See Duncan and Sedon, *supra* note 28. Businesses below the threshold would not receive input credits on those purchases.

the difference in the way the two taxes operate (essentially single-stage RSTs versus multistage VATs), the stakes involved in choosing the threshold are quite different for the states and the federal government. States would likely support a lower threshold than might be optimal for the federal government given the differences in scale between the two levels of government.⁷⁶ Likewise, states are likely to be more interested than the federal government in aggressive sanctions against a broader range of noncompliant taxpayers.⁷⁷ Some accommodation of the different interests would be necessary to a coordinated VAT system.

b. Information sharing. The exchange of information between the IRS and state tax administration agencies is a linchpin of state income tax enforcement, particularly for individual income taxes.⁷⁸ A similar active data exchange program could be beneficial to states in overcoming some compliance issues involved with an IST. Sharing information in taxpayer registration applications; data on purchases, sales, and tax collections by taxpayer; and the results of federal audits and compliance activities could be beneficial to states in augmenting their compliance efforts.⁷⁹

A feature of the state IST under consideration here is that, unlike the current situation under defective RSTs, there will be a substantial volume of cross-border sales between registered traders on which no tax is collected, and no record of the sale is necessary at the state level to claim any input tax credit. The concern is that those goods and services could ultimately be sold

⁷⁶Duncan, "Administrative Mechanisms," *supra* note 12; McLure, "How to Coordinate," *supra* note 47, at 36 and 38. State RSTs generally do not have those thresholds, although they generally exclude casual sales from tax. The revenue loss from such a threshold will be less under a VAT than under an RST because tax will be collected on inputs purchased by sellers under the threshold. As evidence of the importance of this issue, federal legislation that would grant some states the authority to require remote sellers to collect use tax on goods sold into the state has over the recent past provided that sellers with less than \$5 million in remote sales nationally would not be required to collect tax when they were required to by current law. See, e.g., Sales Tax Fairness and Simplification Act, H.R. 3396, 110th Congress. A group of state representatives recently expressed a desire to reduce that threshold to \$100,000.

⁷⁷Duncan, "Administrative Mechanisms," *supra* note 12, at 39.

⁷⁸*Id.* at 12-13. See also Duncan and McLure, "Tax Administration in the United States of America: A Decentralized System," 51 *Bull. for Int'l Fiscal Documentation*, Feb. 1997, for a review of these programs.

⁷⁹Duncan, "Administrative Mechanisms," *supra* note 12.

to final consumers without collection of tax. Information on the types of transactions will, however, need to be made available to the federal government as part of the process of verifying inputs and output tax liability. Consequently, it has been suggested that either the states or the federal government should establish a database on these cross-border sales between registered traders as a compliance aid to states.⁸⁰ Such a database would enable states to monitor the flow of goods and services into and out of the state and to ascertain whether the appropriate tax has been paid and remitted when goods and services are sold to an individual consumer. A database of this sort would be similar to the VAT information exchange system that is in place in the EU and is being considered as part of the VAT reform in India.⁸¹ For a database of this sort to be helpful to states, the information collected will have to include the state of origin and the state of destination — information that would most likely not be required for federal VAT administration purposes only. It will also require considerable planning and technical capacity as well as some level of financial resources.

c. Distance selling. Absent a change in current law, a seller without a physical presence or the requisite substantial nexus in a state with a VAT could not be required to collect VAT on sales to final consumers in that state.⁸² States have long worked to overcome this situation for RSTs, but the issue could be seen as more important to states if they adopted an IST. Because tax would be collected only on sales to final consumers, the rate would need to be higher. However, collecting tax on business-to-business sales would no longer be an issue. To aid compliance with ISTs and to provide an incentive for states to move away from the traditionally defective RST to the IST, the federal government could adopt a "distance selling rule" providing the sellers above some threshold volume of sales would be required to collect the IST on all sales to final consumers, even in state

⁸⁰*Id.*

⁸¹See *IBFD VAT Monitor*, Mar./Apr. 2010.

⁸²*Quill*, 504 U.S. 298.