

Administrative Mechanisms to Aid in the Coordination of State and Local  
Retail Sales Taxes with a Federal Value Added Tax

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## Administrative Mechanisms to Aid in the Coordination of State and Local Retail Sales Taxes with a Federal Value Added Tax

### **Introduction**

In the United States, consumption taxation is primarily the province of state and local governments. As a consequence, adoption of a broad-based federal consumption tax of any form will be of significant concern to state and local officials and will raise a number of issues regarding the coordination and administration of consumption taxes at the national and sub-national level. The administration and coordination issues are most prominent if the federal government adopts a credit-invoice value added tax (VAT) because the structure, base and administration of a VAT differs so substantially from the retail sales taxes employed by states and localities. By the same token, current state and local retail sales taxes suffer from a variety of substantial policy, structural and compliance defects that could well be mitigated if they more closely resembled the structure and operation of a well-designed VAT.

This paper examines the tax administration issues that adoption of a federal VAT would present for the administration of consumption taxes at the state and local level, including the types of structures and measures that would be necessary or desirable if states themselves were to adopt some form of VAT as well as the structures and mechanisms that could help the states address some of the policy defects in their sales taxes with the adoption of a VAT at the national level. Section I of the paper looks at the current deployment of retail sales taxes by states and localities, including their role in the state and local revenue system and their general structure and administration, paying particular attention to the manner in which they deviate from an ideal consumption tax and the compliance issues they present. It also includes a review of recent state efforts to simplify and make the sales tax more uniform across states as well as current programs for coordinating tax administration between the states and the federal government. Section II describes the various options that would be available to the states for structuring consumption taxes in the context of a federal VAT and the benefits and shortcomings that would arise under each permutation. It examines these issues in the context of three distinct, possible sub-national responses to a federal VAT and evaluates these options against several criteria. Section III of the paper discusses the numerous administrative and legal accommodations that would be necessary or beneficial to coordination of national and sub-national consumption taxes and to allow state consumption taxes to be administered adequately in light of a federal VAT.

### **Section I Current State and Local Retail Sales Taxes**

#### **Background**

At the present time, 45 states and the District of Columbia employ a broad-based retail sales tax as part of their tax system. In 33 states, local governments also utilize the

retail sales tax as a revenue source.<sup>1</sup> In most cases, these are “local option” taxes in which certain types of local governments are authorized by the legislature to impose a retail sales tax with approval of the voters or the governing body of that jurisdiction. In some states, such as California, North Carolina and Virginia, there is a statewide “local” rate with receipts from the local portion returned to the jurisdiction from which it was collected.

All told, more than 9,000 local units of government currently impose a sales tax.<sup>2</sup> For the most part, local taxes are imposed by general purpose units of local government (i.e., cities and counties), but some states have authorized certain special purpose units of government (e.g., transit districts) whose boundaries do not necessarily coincide with the major political subdivisions to impose a sales tax as well. In most cases, the local tax is “piggybacked” on the state tax, meaning that the local governing body is responsible for establishing the tax rate, but the base of the local tax is the same (or nearly so) as the state tax, and the local tax is collected and administered by the state tax administration agency as an adjunct of the state sales tax. In Alabama, Arizona, Colorado and Louisiana, many local governments administer their sales taxes independently, meaning that retailers must file returns and discharge other tax administration responsibilities with each locality in which they do business; this means as well that these local governments retain the right to independently audit retailers operating within their boundaries. There are also several states (e.g., Colorado) in which the local tax base may differ from the state base. As discussed further below, even though most local taxes are piggybacked on the state tax and collected by the state, the existence of the large number of local sales taxes makes compliance quite difficult for many sellers, particularly those operating on a multistate basis.

State sales tax rates range from 2.9 percent in Colorado to 7 percent in several states, including Mississippi, New Jersey, Rhode Island and Tennessee.<sup>3</sup> Local tax rates, of course, vary considerably across the states and among local governments with most falling in the 1 percent to 3 percent range. A study by one sales tax compliance firm indicates that the average rate (weighted by sales) for state sales taxes was 5.33 percent, for counties imposing a tax it was 1.675 percent and for cities imposing a sales tax it was 1.568 percent for a total of 8.57 percent in 2007.<sup>4</sup> The comparable average tax rate in 1982 was 6.717 percent.<sup>5</sup> Another study of tax rates in the largest city in each state found

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<sup>1</sup> Number drawn from Census Bureau data on general sales tax collections by local governments in 2006. Those states NOT authorizing broad-based local taxes include Connecticut, Hawaii, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Jersey, Rhode Island, Vermont and West Virginia. In Idaho and Mississippi, a limited number of local governments (primarily resort or recreational communities) are authorized to impose a local tax on a select set of products and services. In Alaska, a number of local governments have also imposed a general retail sales tax, but there is no state counterpart tax.

<sup>2</sup> LeAnn Luna, Donald J. Bruce & Richard R. Hawkins, *Maxing Out: An Analysis of Local Option Tax Rate Increases*, 60 NAT’L TAX J. 45 (2007).

<sup>3</sup> Federation of Tax Administrators. See <http://www.taxadmin.org/fta/rate/sales.html>.

<sup>4</sup> VERTEX, 2007 SALES TAX RATE REPORT (2008).

<sup>5</sup> *Id.*

a maximum combined state and local rate of 9.25 percent in Memphis, Tennessee. The combined rate exceeded 8.0 percent in several of the largest cities, including New York City, Los Angeles, Houston and Seattle; the median rate for the largest city in each state was 6.5 percent.<sup>6</sup>

In FY 2008, states collected some \$240.4 billion in general sales and gross receipts taxes; this amounts to 30.8 percent of all state tax receipts in that year. In addition, to the broad-based sales tax, states impose a variety of selective sales and excise taxes on commodities such as motor fuels, tobacco products and alcoholic beverages. In 2008, they collected 15.0 percent of their taxes (\$116.9 billion) from these selective excises.<sup>7</sup>

For state and local governments considered together, general sales tax collections in 2006 (the latest year available) totaled \$282.2 billion or 23.6 percent of all tax revenues. Selective excises accounted for 10.9 percent (\$129.9 billion) of total tax receipts. General sales taxes account for about 11.4 percent of local tax collections, and selective sales taxes account for 4.9 percent. Property taxes are, of course, the mainstay of the local revenue system, accounting for over 70 percent of all receipts.<sup>8</sup>

By contrast, consumption taxation at the federal government level is limited primarily to a series of excise taxes imposed on motor fuels, alcoholic beverages, tobacco products and a range of other commodities as well as customs duties. In FY 2008, these sources generated about \$96 billion in receipts – or just 3.8 percent of all federal receipts.<sup>9</sup> The lack of a broad-based consumption tax, of course, causes the United States to stand apart from the rest of the world in terms of its revenue mix. In 2006, revenues received from taxes on goods and services amounted to 11.4 percent of GDP in all OECD member countries; for the United States alone (considering federal, state and local governments) that number was 4.8 percent.<sup>10</sup>

### **An Ideal Consumption Tax**

A well-designed consumption tax would meet several criteria:<sup>11</sup>

- It would tax virtually all goods and services purchased for individual use;
- By corollary, sales to businesses would be exempt from the tax;

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<sup>6</sup> OFF. OF THE CHIEF FIN. OFFICER, D.C. OFF. OF REV. ANALYSIS, TAX RATES AND TAX BURDENS IN THE DISTRICT OF COLUMBIA – A NATIONWIDE COMPARISON, 2007 (Aug. 2008).

<sup>7</sup> U.S. CENSUS BUREAU, STATE GOVERNMENT TAX COLLECTIONS, 2007.

<sup>8</sup> U.S. CENSUS BUREAU, STATE AND LOCAL GOVERNMENT FINANCES, 2006.

<sup>9</sup> FIN. MGMT. SERV., U.S. DEP'T OF TREASURY, MONTHLY TREASURY STATEMENT 5 (Sept. 2008).

<sup>10</sup> OECD, REVENUE STATISTICS, 1965-2007 (2008).

<sup>11</sup> Adapted from Charles E. McLure, Jr., *Coordinating State Sales Taxes with a Federal VAT: Opportunities, Risks and Challenges*, 36 STATE TAX NOTES 907 (June 20, 2005). See also William F. Fox and LeAnn Luna, *Subnational Taxing Options: Which is Preferred, a Retail Sales Tax or VAT?*, 27 STATE TAX NOTES 875 (March 10, 2003).

- Sales would be taxed on a destination basis, meaning exports from one jurisdiction to another would be exempt and items would be taxed at the rate in the jurisdiction in which the consumption occurs;
- Administration of the tax would not be unduly complex or burdensome.

### **Deviations from the Ideal**

***Taxation of Individual Consumption.*** State and local sales taxes deviate considerably from the norms of an ideal consumption tax, particularly with regard to the definition of the tax base. U.S. sales taxes have their origin in the Great Depression of the 1930s, and most current sales taxes were in place by the end of the 1960s, a time when the service component of the U.S. economy was much smaller and less important than it is at the present time. Consequently, at the outset, most sales taxes were imposed primarily on sales of tangible personal property, and few if any services were included in the base. Despite several notable efforts to broaden the base in several states,<sup>12</sup> that remains the situation today. According to data compiled by the Federation of Tax Administrators, only four states – Hawaii, New Mexico, South Dakota and West Virginia – impose the sales tax on 100 or more of 168 enumerated services, and they are the only states that tax any from a list of ‘professional services.’ Fewer than 15 states broadly tax admissions, amusements, utilities, and labor and repair services.<sup>13</sup>

In addition to excluding services from taxation, states have enacted a large number of statutory exemptions from the sales tax base. Over one half of the sales tax states exempt food for home consumption from the sales tax, nearly every state exempts prescription drugs from the tax, and several exempt clothing purchases as well.<sup>14</sup> Many states also have a variety of “use-based” exemptions to the sales tax in which purchases by certain types of entities are exempt, provided the purchased item is used for a particular purpose. For example, most states will exempt items purchased for use in agriculture if used for agricultural purposes (e.g., feed and seed), but would tax the same purchase if not used for agricultural purposes (e.g., home gardening, golf courses). Similarly, many states exempt purchases by a wide range of non-profits provided the purchased item will be used in pursuit of the charitable, educational or other mission of the non-profit. Finally, a number of states have in recent years instituted “sales tax holidays” which are effectively temporary, time-limited exemptions for certain products.

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<sup>12</sup> In Florida (1988), Massachusetts (1992) and Michigan (2008), the legislature passed legislation to broadly impose the sales tax on a wide range of services, including professional and other services primarily purchased by businesses. In each case, the tax was repealed either before or shortly after it was implemented. The reasons for the repeal varied, but generally included issues of opposition from the business community, difficulty in sourcing certain professional services and concerns about the taxation of business services.

<sup>13</sup> FED’N OF TAX ADM’RS, FTA SURVEY OF SERVICES TAXATION – UPDATE, BY THE NUMBERS (July 2008), available at <http://www.taxadmin.org/fta/pub/services/btn/0708.html>. FTA periodically surveys states on the taxation of a list of service transactions. A searchable data base of the results is available on the FTA Web site, <http://www.taxadmin.org/>.

<sup>14</sup> For state treatment of many commonly exempt items, see 2009 STATE TAX HANDBOOK, at 531-599 (CCH, 2008).

The most common ‘holiday’ is an exemption for “back to school” holiday for children’s clothing and certain school supplies that is normally offered for several days in the late-summer or early-fall prior to the opening of schools. Holidays have also been offered for such items as “energy-efficient appliances,” “computers and accessories,” and “hurricane-preparedness” products.<sup>15</sup> In addition to narrowing the tax base, these exemptions often create considerable complexity for retailers, as discussed below.

A further impediment to comprehensive sales taxation of individual consumption are the legal requirements and restrictions imposed on states and localities. The U.S. Supreme Court has held that states may not require a seller that does not have a substantial nexus with the state – which it defined as a physical presence in the state -- to collect sales or use tax on items sold to in-state residents, in part because of the burden that would be imposed on non-resident sellers to comply with multiple state and local tax regimes was deemed by the Court to constitute an impermissible burden on interstate commerce.<sup>16</sup> As a result, on Internet or mail order purchases where the seller does not have a physical presence in the taxing state (either of its own or of representatives acting on its behalf) and the seller has not collected tax, the individual consumer is supposed to report and pay the use tax directly to the state on her/his individual purchases. The same holds for taxable purchases by business where the seller does not have the requisite nexus with the state into which the item is shipped. Compliance with these self-reporting obligations is understandably less than optimal, leaving a substantial volume of transactions effectively untaxed. A number of states provide taxpayers an opportunity to use their individual income tax returns to report the tax they owe for having made purchases from out-of-state sellers where tax was not collected. A Minnesota study found that less than 1 percent of taxpayers included an estimated amount of tax due in most states offering such an option, and the highest proportion was only 9 percent of taxpayers in Maine.<sup>17</sup> Similarly, of 18.9 million income tax returns filed in California in 2008, only 44,000 (0.2 percent) voluntarily included sales tax payments on their return.<sup>18</sup>

As a result, state tax bases deviate substantially from a goal of taxing all individual consumption (with the attendant distortions and equity issues that creates), and the deviation is growing over time. One analysis finds that the “implicit state tax base” (collections divided by rate) had declined from 55 percent of personal income in 1970 to 40 percent of personal income in 2007.<sup>19</sup> The impact of these choices is most graphically

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<sup>15</sup> See Federation of Tax Administrators Web site, *2009 State Sales Tax Holidays*, <<http://www.taxadmin.org>>.

<sup>16</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

<sup>17</sup> Nina Manzi, *Use Tax Collection on Income Tax Returns in Other States*, Minn. H.R. Research Dep’t Policy Brief, Dec. 2004, at 10.

<sup>18</sup> John Howard, *State to Target Untaxed Goods*, CAPITOL WEEKLY, Jan. 9, 2009, available at <http://www.capitolweekly.net>.

<sup>19</sup> John L. Mikesell, *Dynamic Patterns in State Sales Tax Structures: Tax Policy Change and Convergence, 1979-2007*, 51 STATE TAX NOTES 175 (Jan. 19, 2009). Mikesell goes on to point out that this persistent narrowing of the base and resulting inelasticity of the sales tax is a major factor in the increasing statutory sales tax rate among the states.

seen in the exclusion of personal services from the tax base. In 1970, services other than housing and medical care amounted to \$95.7 billion or 14.8 percent of total personal consumption expenditures. By 2008, the amount spent by American consumers on services other than housing and medical care had increased 300-fold to \$2.8 trillion and 28 percent of all personal consumption expenditures.<sup>20</sup>

***Taxation of business inputs.*** When it comes to and the taxation of purchases by businesses, states also deviate substantially from the ideal consumption tax, meaning that the retail sales tax is imposed on a wide range of business consumption. Nearly every state has a series of statutory exemptions aimed at trying to exempt certain business inputs so that the tax is ultimately imposed a single time at the final stage of consumption, but these input exemptions are largely limited to a retailing and manufacturing environment. Thus, states will exempt “sales for resale,” items that become “ingredient and component parts” of another item of tangible personal property, products that are “consumed” in the process of fabricating a product for sale at retail, and (in a number of states) machinery and equipment used “directly in the manufacturing process.” While these exemptions mitigate against the taxation of business inputs in manufacturing and (to a more limited extent) retailing, they leave large categories of business inputs subject to tax, including products not used “directly” in manufacturing (e.g., other capital equipment and utilities to light and heat a manufacturing facility), other inputs in the retail sector (capital equipment, packaging, utilities, etc.), and nearly all purchases by service-producing businesses. In short, states largely tax those goods and services where the business may be considered the final consumer of the product.<sup>21</sup> The most recent estimate is that taxes on business inputs account for 44 percent of the total of sales and use taxes collected in the United States.<sup>22</sup> The result is understatement of the true cost of government, distortion of production decisions, including an incentive for self-supply, and interjection of an origin-based element into what is ostensibly a destination-based sales tax.

***Retailer Compliance.*** The U.S. sales tax system is obviously complex. A retailer operating in multiple states must stay abreast of the tax base in each state (and possibly some local governments), track tax rates in each state and local jurisdiction, accurately capture and retain documentation of exempt sales, file all the requisite returns and payments and be prepared for an audit by each state in which it operates – while at the same time monitoring those purchases it makes on which it might owe tax. As a result, it is considered to be quite costly for retailers to comply with the various administrative and tax collection requirements in each state – particularly for retailers that have operations in

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<sup>20</sup> BUREAU OF ECON. ANALYSIS, U.S. DEP’T OF COMMERCE, NATIONAL INCOME AND PRODUCT ACCOUNTS, TABLE 2.3.5, PERSONAL CONSUMPTION EXPENDITURES BY MAJOR TYPE OF PRODUCT, *available at* <http://www.bea.gov/national/nipaweb/index.asp>.

<sup>21</sup> Some have argued that this feature of state sales taxes substitutes to a degree for the fact that most services are excluded from the tax in most states. It is, at best, an imperfect solution since it leads to distortions, pyramiding and compliance issues.

<sup>22</sup> Andrew Phillips, Robert Cline & Thomas Neubig, *Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2007*, at 1 (Ernst & Young and Council on State Tax’n, 2008).

multiple states. The most recent comprehensive study<sup>23</sup> of the costs that retailers actually incur in collecting state and local sales taxes found that the average cost of collection for all retailers surveyed was 3.09 percent of the total tax collected. Those costs ranged significantly based on the size of the retailer. For sellers with less than \$1 million in sales, the costs of sales tax collection averaged 13.47 percent, for those with sales between \$1 million and \$10 million in sales, the collection costs totaled 5.2 percent, and for those with over \$10 million in sales, the average costs dropped to 2.17 percent of the tax collected.<sup>24</sup>

Retailers, particularly multi-state sellers, have over time identified a number of the features of the state and local tax system that they consider to be complex and to lead to noncompliance with the tax and excessive costs for those retailers involved in collection.<sup>25</sup> These include:

- The differing tax bases among states is a significantly complicating feature in that a sellers' point of sale equipment or other system for identifying taxability must be able to accommodate differences across states. This general complexity increases exponentially if local governments are allowed to deviate from the state tax base, since they (in effect) become "another state" for purposes of the seller's tax decision matrices. A more narrow, but frequent intricacy for the multistate seller is that states commonly define various items that may be exempt from the tax base (or included in the tax base in the case of a service) in a slightly different fashion. For example, in two states that exempt food for home consumption, one may require a fruit drink to be 100 percent fruit juice in order to qualify for the exemption while another will require only that the product be 50 percent natural juice to qualify. Finally, what constitutes an exempt entity and the various use-based exemptions vary from state to state. These nuances make it inordinately complicated to automate the point of sale and tax decision process. They also lead to errors, non-compliance and customer service and confusion issues.
- Most states require that purchases by exempt entities or those persons claiming a use-based exemption as well as certain other exemptions such as "sale for resale" be evidenced by having the purchaser complete an exemption certificate identifying the purchaser and including such items as the reason for exemption and whatever number the tax authority uses to identify the purchaser. The seller is then required to retain these certificates and produce them to document the

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<sup>23</sup> PETER J. MERRILL, ET. AL., PRICEWATERHOUSECOOPERS NAT'L ECON. CONSULTING, 1 RETAIL SALES TAX COMPLIANCE COSTS: A NATIONAL ESTIMATE (Apr. 7, 2006), prepared for the Joint Cost of Collection Study.

<sup>24</sup> *Id.* at 9.

<sup>25</sup> This discussion is educated largely by the author's participation in the Streamlined Sales Tax Project (see discussion below) and other efforts to simplify sales tax administration over the last 15 years. These efforts have included substantive, continuing discussions with retailers on the features of state and local tax systems that contribute to complexity. While many of the complications are most applicable to multistate sellers and remote sellers, they are applicable (albeit less frequently) to any seller that may be engaged in selling items from one jurisdiction into another.

- exempt transaction if requested on audit. The documentation forms and requirements vary from state to state; they pose considerable difficulty and costs to retailers to develop systems to manage the exempt transaction documentation.
- Determining the appropriate tax rate to apply to a particular transaction is far from a straightforward proposition. As noted, there are over 9,000 local government jurisdictions imposing a sales tax in the United States, and the rate can in most cases vary from jurisdiction to jurisdiction within a state.<sup>26</sup> Unfortunately, the boundaries of local governments do not conform to U.S. Postal Service Zip Codes (the most common geographic identifier used) so that ensuring application of the correct tax rate requires the deployment of extraordinary resources. Complicating this is that some states have authorized special purpose districts (e.g., transit districts) whose boundaries are not coincident with major political subdivisions to levy a sales tax, meaning that within a county (for example) some residents may be subject to a transit district and some may not. Further, not all states use the same rules for determining to which jurisdiction certain types of transactions are to be sourced for purpose of determining the tax rate to be applied. Some states provide that a mail order sale being shipped intra-state is taxable in the destination jurisdiction while others provide for taxing in the “origin” jurisdiction which may be the point at which the order is accepted or the point from which the item is shipped. Retailers also indicate that applying an incorrect tax rate to a transaction will often result in customer service obligations as well as having frequently resulted in class action lawsuits being brought by groups of customers for the inadvertent over-collection of tax. Only recently have relatively accessible data bases that can provide the appropriate local tax rate for any given physical postal address become available to sellers and begun to ease this burden.
  - At a minimum, a retailer must file returns and make remittances to each state in which it is making sales and collecting tax. In the four states in which many local governments administer their own sales tax, returns and remittances must be filed with each entity in which the seller does business,<sup>27</sup> and some states (e.g., Tennessee) require retailers to file a separate state sales tax return for each business location in the state. As with other features of the sales tax, states and localities often require somewhat different information on the tax return; likewise, as they have moved into electronic filing of sales tax returns, they have adopted somewhat differently to that process.

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<sup>26</sup> Take, for example, a county with two cities in a state where both a city and a county may choose to impose a sales tax. Depending on local choices, sales into these jurisdictions may be subject to only a state tax, a state and county tax, a state and city tax or a state-county-city tax.

<sup>27</sup> Alabama and Louisiana have recently developed utilities that allow a seller to electronically file returns with multiple jurisdictions in a single transaction. In each case, participation by local governments is voluntary.

- Multistate retailers are subject to audit by each state in which they do business.<sup>28</sup> These audits, particularly with multiple audits going on at any one time, are time-consuming and expensive.<sup>29</sup> Of greatest concern to most large, multistate retailers is that given the complexity of state and local sales tax requirements, there will inevitably be errors and audit adjustments which become a bottom line cost to the seller despite their best efforts to comply.
- A final concern of retailers is that a number of states do not compensate sellers for the costs they incur in collecting state and local sales taxes on behalf of the government – particularly given its complexity.<sup>30</sup> They especially point to two cost items that they incur only because of their sales tax obligations and over which they have no control – the banking fees associated with the tax component of credit card transactions and the amount of tax foregone on sales that eventually become an unrecoverable bad debt and the tax has already been paid over to the state. The costs of collection study referenced earlier placed the cost of these two issues at about 1 percent of the total tax collected.<sup>31</sup>

In short, state and local sales taxes exhibit substantial deviations from the norm of what is commonly defined as the ideal consumption tax base – taxing far less than all personal consumption and including a substantial volume of business inputs in the base. In addition, state sales taxes differ in myriad ways from one another regardless of the vantage point chosen. This is not surprising to those familiar with the U.S. system of federalism. Nonetheless, it has real consequences for retailers trying to comply with the complex systems and for compliance with the tax. It also has substantial implications for consideration of a federal-level consumption tax in the United States and the manner in which that tax may be coordinated state and local taxes as discussed below.

### **Streamlined Sales Tax Project**

Since 2000, state and local governments have joined with the business community generally and retailers in particular in an effort to simplify and to improve the uniformity of state and local sales taxes. The cooperative effort, known as the Streamlined Sales Tax Project (SSTP), has two principal aims: (1) to provide a forum and a vehicle to develop and implement methods to simplify compliance with state and local sales and use taxes – particularly for multistate sellers; and (2) to develop an interstate agreement

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<sup>28</sup> The Multistate Tax Commission administers a joint audit program that audits retailers on behalf of multiple states. The Commission performs about 12-15 audits per year, and about 8-10 states commonly participate in each audit. The large majority of audits of retailers are by individual states.

<sup>29</sup> It is not uncommon for large, nationwide retailers to have 10 or more individual state audits underway at any one time.

<sup>30</sup> Twenty-six states and the District of Columbia currently authorize retailers to retain a portion of the tax they collect to compensate them for the costs they incur in collecting the tax. The rates of compensation range from 0.5 percent in Nevada and Wisconsin to 3.33 percent in Colorado with a median rate of about 1.5 percent. Thirteen states limit the amount of compensation a seller may receive. The limits range from \$800 per year in New York to \$240,000 per year in Michigan. See FTA Web site, *State Sales Tax Rates and Vendor Discounts*, [http://www.taxadmin.org/fta/rate/sale\\_vdr.html](http://www.taxadmin.org/fta/rate/sale_vdr.html).

<sup>31</sup> MERRILL, *supra* note 23, at 12.

requiring participating states to adopt various simplifications and uniformity measures that would then be the basis for Congress to use its authority under the Commerce clause to overturn the Supreme Court's ruling in *Quill* and authorize states participating in the agreement to require remote sellers without a physical presence in the state to collect tax on sales into the state.<sup>32</sup> Over 40 of the states with a sales tax have participated in the efforts of the SSTP. The reasons that some sales tax states have not participated in the Streamlined effort are rather diverse. In some cases, there is reluctance to participate in the joint decision making process required for fear of its impact on a state's structures while in others, the concern is primarily one of political aversion to expanding tax collection responsibilities to remote sellers.

The work of the SSTP resulted in the adoption of the Streamlined Sales and Use Tax Agreement (SSUTA) by the participating states in November 2002.<sup>33</sup> The SSUTA contains a wide range of administrative simplifications and uniformity measures that have been approved by the member states. To become a member of the Agreement, a state must amend its sales and use tax laws to incorporate the requirements of the Agreement into state law. To remain a member, a state must also incorporate subsequent amendments to the SSUTA into its sales tax law, rules, policies and procedures. As of October 1, 2009, there are 20 "full member" states of the Agreement, meaning they had incorporated all features of the SSUTA into state law and policies.<sup>34</sup> There are also three "associate member" states that are expected to become full member states in the future.<sup>35</sup>

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<sup>32</sup> In *Quill*, the Supreme Court held that authorizing states to require such sellers to collect was clearly within the authority of Congress to regulate under its Commerce clause authority. Since the *Quill* ruling in 1992, several measures have been introduced in Congress that would authorize states to require remote sellers to collect under certain conditions. The most recent versions, S. 34 and H.R. 3396 in the 110th Congress, would authorize states to require certain remote sellers to collect if the state is a participating member of the Streamlined Sales and Use Tax Agreement (SSUTA) and the Agreement meets certain standards contained in the Act. There are two areas in which these bills go beyond the simplifications required under the SSUTA; they require states to provide "reasonable" vendor compensation to all sellers and to apply certain of the SSUTA simplifications to a range of taxes and fees other than sales and use taxes on telecommunications services. Hearings on the remote sales legislation were held in the 110th Congress, but no action was taken. Similar legislation is expected to be reintroduced in the 111th Congress.

<sup>33</sup> The Agreement has been amended on several occasions since then. The complete Agreement is available at the Streamlined Sales Tax Governing Board Web site, <http://www.streamlinedsalestax.org/>.

<sup>34</sup> The fact that more states have not conformed to the SSUTA should not be interpreted as a rejection of the Agreement, but rather, in my mind, adoption of a "wait and see" attitude. Most of the financial incentives for a state to become a member of the Agreement are prospective in nature, i.e., the additional revenues the state would gain at such point as Congress authorizes member states to require remote sellers to collect tax on sales into the state. There is one monetary incentive to full membership even without Congressional action. The SSUTA provides that upon becoming a member, a state is required to provide a one year amnesty period during which it agrees not to hold sellers that come forward and voluntarily register for collection of tax liable for past taxes if the seller should have been registered, but was not. The SSUTA further provides that a seller that proposes to volunteer to register and collect in any state must also register and collect in all full member states. Thus, to the extent that sellers want to take advantage of the amnesty in any one state, collections may be improved in other states.

<sup>35</sup> For a listing of full member and associate member states, see <http://www.streamlinedsalestax.org/govbrdstates.htm>.

The SSUTA is administered by a Governing Board comprised of representatives of each full member state with advisory participation from non-member states and the business community. The Board has both state legislators as well as representatives of the executive branch of state government, primarily state tax administrators, on it. The Governing Board is responsible for approving all amendments to the SSUTA, reviewing member state conformity to the Agreement, hearing disputes regarding compliance with the Agreement and the like.

Key provisions of the SSUTA include:<sup>36</sup>

- All local sales and use taxes must be administered and collected by the state;<sup>37</sup>
- The tax base for local sales and use taxes must be the same as the state tax base;<sup>38</sup>
- A state must have only one state sales tax rate, except that a second rate (which rate may be zero) may be imposed on food, prescription drugs and electricity;<sup>39</sup>
- A local jurisdiction that imposes a sales and use tax may have only a single tax rate. In some states, multiple layers of local governments may impose tax a single transaction.<sup>40</sup>
- States must establish a centralized registration system that allows a seller to register in all member states;<sup>41</sup>
- States must use uniform definitions for a number of common features of sales taxes (e.g., sales price, lease, rental) as well as various products such as food and food ingredients (including various subcategories), clothing, telecommunications services (including various subcategories), various categories and types of software, certain digital products and the like.<sup>42</sup>
- Each state must maintain a taxability matrix that defines the manner in which that state treats all defined items (i.e., whether it taxes or exempts them);<sup>43</sup>
- States are prohibited from limiting the amount of tax on a transaction (cap) or providing that only a portion of the purchase price of a product is exempt (threshold);<sup>44</sup>

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<sup>36</sup> For a complete review of the SSUTA and its provisions, see WALTER HELLERSTEIN & JOHN A. SWAIN, *STREAMLINED SALES AND USE TAX* 2d ed. (Warren, Gorham & Lamont, 2005).

<sup>37</sup> *STREAMLINED SALES AND USE TAX AGREEMENT* (“SSUTA”) § 301 (as amended through Feb. 26, 2009).

<sup>38</sup> SSUTA § 302.

<sup>39</sup> SSUTA § 308.

<sup>40</sup> SSUTA § 308B.

<sup>41</sup> SSUTA § 401.

<sup>42</sup> SSUTA § 327.

<sup>43</sup> SSUTA § 328.

<sup>44</sup> SSUTA § 323.

- States must adopt uniform rules in a number of areas such as sourcing transactions to a jurisdiction for tax purposes (with some options to states), the handling of due dates for remittances when the normal date falls on a bank holiday, sales tax holidays (limited to defined products), drop shipments, rounding tax on transactions;<sup>45</sup>
- Those states that allow local governments to impose sales and use taxes must provide a data base of local government boundaries as well as a data base that provides the correct tax rate for any physical address in the state;<sup>46</sup>
- States may not hold sellers to a “good faith” standard in accepting exemption certificates. States must absolve a seller from any tax that may be due if the seller accepts an invalid exemption certificate provided the state offers the type of exemption claimed. If a purchaser appropriately uses an exemption certificate, the state must pursue collection of the tax from the buyer, not the seller;<sup>47</sup>
- States must offer all sellers the option to file a simplified electronic tax return, and they must adopt uniform rules governing the process of making electronic tax remittances;<sup>48</sup> and
- States must adopt procedures for certifying software providers as accurately computing tax due under the agreement and appropriately filing required returns with the state. States must also agree to absolve sellers that use such certified software providers for their tax compliance responsibilities from additional liability that may arise for errors that may be subsequently identified if the seller is using the software properly.<sup>49</sup>

The Streamlined effort and the SSUTA provide quite a clear window into the manner in which states view simplifying the sales and use tax as well as how they view harmonizing and making their taxes more uniform with one another. From the outset, there were two principal design constraints imposed on the efforts of the SSTP. To a considerable degree, these constraints reflect the principal features of state and local sales taxes and the strong, state preferences of elected officials who first gave impetus to the effort through the National Governors Association and National Conference of State Legislatures as well as the experience that had been obtained in trying to secure passage of legislation authorizing states to require remote sellers to collect.

The first design constraint was that states would remain free to establish their individual tax base, and the SSUTA would not include a uniform tax base across the states. Instead, SSTP has tried to address the complexity created by varying exemptions

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<sup>45</sup> SSUTA §§ 310, 313, 315, 319, 322, 324.

<sup>46</sup> SSUTA § 307.

<sup>47</sup> SSUTA § 317.

<sup>48</sup> SSUTA §§ 318, 319.

<sup>49</sup> SSUTA §§ 501, 502.

and bases in several ways: (a) developing uniform definitions for certain commonly exempted items and other elements of the tax base and requiring states to employ those definitions; (b) requiring states to make available a “taxability matrix” displaying how certain items that have been captured in uniform definitions are treated for tax purposes; and (c) absolving sellers from additional liability for improperly used exemption certificates in most instances. Under such an arrangement, a member state may choose to exempt purchases of food, but to tax candy or ‘prepared food’ (e.g., restaurant meals, carry-out food, etc.); the state would be required, however, to use the approved definitions for those items so that there is consistency from state to state. State legislators, in particular, advised against trying to establish a common tax base. Even efforts to develop uniform definitions have created difficulties for some states by causing certain items to fall into a taxable or exempt category that differed from their prior treatment. They have also lead to rather tortured definitions as states attempted to the extent possible to develop definitions that enable them to replicate their current tax base. Take, for example, the definition of “prepared food” which after establishing principles for what constitutes prepared food, goes on to provide that a state may at its option deviate from the definition and not include certain bakery items (that would otherwise fall within the definition of prepared food) under certain conditions – a move necessary to avoid disrupting the pre-existing tax scheme in certain member states. Likewise, the definition of “clothing” contains a subcategory of “fur clothing” to accommodate some states that exempted clothing generally, but taxed certain types of fur clothing.<sup>50</sup>

The second design constraint backdropping the Streamlined effort is that the resulting system must accommodate local option sales taxes in which states may authorize a wide range of local units to impose a sales and use tax and to allow those localities latitude in establishing their tax rate. Accommodating local option taxes was considered necessary to securing local government support and involvement in the effort and any resulting federal legislation on the remote seller issue. Certain iterations of the remote seller legislation introduced prior to 2000 had provided that states would be required to establish a statewide “average” local sales tax that would be applied to all interstate sales; states would then have been responsible for allocating the revenue among localities in the state.<sup>51</sup> Local governments objected to these provisions because they feared the average rate would result in some localities receiving less than their full due of revenue; they also objected to the formulaic allocation aspects of the proposal as opposed to receiving the tax on sales taking place in their jurisdiction. Finally, local governments expressed concern that in times of fiscal stress, states might choose not to return the revenues to the localities. Instead of replacing local option taxes, the SSUTA contains a number of provisions that simplify the administration of them, including requiring the local tax base to conform to the state base, mandating that all local taxes in member states be collected and administered by the state, requiring states to provide sellers with data

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<sup>50</sup> Efforts such as this have caused some to disparage the SSUTA as not representing significant simplification or sufficient simplification to require remote sellers to collect tax. See H.R. Subcomm. on Commer. and Admin. Law, Comm. on the Judiciary, *The Wrong Path to Tax Reform: How Parochial State Interests Undermined the Streamlined Sales Tax*, 110th Cong. (Dec. 6, 2007) (testimony of George Isaacson, Direct Marketing Assoc.).

<sup>51</sup> See, e.g., H.R. XXXXXXX, XXXX Cong. [forthcoming]

bases that identify local jurisdiction boundaries and enable sellers to determine the appropriate tax rate for any physical address in the state, and requiring certain lead times for the implementation of local tax rate and boundary changes.

In short, the SSUTA contains a number of detailed and in many cases significant simplification measures that should reduce the complexity of state and local sales and use taxes for multistate sellers. The simplifications cannot, however, in most cases be considered fundamental from the standpoint of harmonizing state tax bases with one another and in moving from independent administration by each state. Instead, most features of the SSUTA are aimed at preserving and simplifying, rather than replacing, two of the most complicating features of the current system – varying state tax bases and nearly innumerable local option taxes. Charles McLure has summed up the situation quite fully and succinctly:

If the Streamlined Sales and Use Tax Agreement (SSUTA) is widely adopted and is implemented in a common form, it will greatly simplify compliance. It deserves to be enacted. But, even if enacted, SSUTA will leave compliance substantially more complicated than is necessary or sensible.<sup>52</sup>

### **Intergovernmental Cooperation in Tax Administration<sup>53</sup>**

***Federal-state exchanges of information.*** The cornerstone of cooperative tax administration in the United States is an active exchange of information between federal and state tax authorities to support enforcement of the personal and corporation income tax. Federal law (I.R.C. Section 6103) authorizes the U.S. Internal Revenue Service (IRS) to provide federal tax return information to state tax agencies, provided it is used solely for tax administration purposes and is properly safeguarded against unauthorized disclosure or release.<sup>54</sup> All states have entered into an exchange of information agreement with the IRS through which they routinely receive an abundance of income tax information. Information exchanged includes copies of all federal audits or other adjustments to a taxpayer's return, identification of taxpayers filing a federal income tax return with an address in the receiving state, extracts of items of income and expense reported on the federal tax return, information reports filed by third-party payers (e.g., banks, brokerage firms, and employers) with respect to taxpayers in a particular state, address and location information for taxpayers and information on the financial assets of taxpayers that can serve to aid in debt collection.

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<sup>52</sup> Charles E. McLure, Jr., *Understanding the Nuttiness of State Tax Policy: When States Have Both Too Much Sovereignty and Not Enough*, 58 NAT'L TAX J. 565, 571 (2005).

<sup>53</sup> This section relies extensively on earlier work by the author and Charles McLure. See Harley T. Duncan & Charles E. McLure, Jr., *Tax Administration in the United States of America: A Decentralized System*, 51 BULL. FOR INT'L FISCAL DOCUMENTATION, Feb. 1997, at 74-85.

<sup>54</sup> State tax statutes likewise authorize the exchange of return information with other states and with the federal government under appropriate safeguards.

State income taxes are based to a considerable degree on the federal income tax.<sup>55</sup> Consequently, federal tax return information is quite valuable to state administrators and is often used to assess additional state tax directly. For example, one of the most effective information exchanges is an IRS program that matches third-party reports of income to entries on taxpayer returns. The IRS assesses additional federal tax where income has been omitted and provides information on the adjustment to the state tax authority in which the taxpayer resides. The state customarily issues an automated assessment of additional state tax, unless the income is exempted by the state. States also compare the exchanged data with state files to insure consistency in amounts reported to federal and state tax authorities and to identify potentially non-filing taxpayers. With the massive amounts of information involved, all information is exchanged on electronic media. States and the IRS are now in the process of migrating to secure electronic delivery of the information. Federal data and federal audit reports are the predominant means of independently auditing state individual income tax returns in many states.

States also use the results of federal corporation tax audits for enforcement. Since the computation of state tax generally begins with federal taxable income, states rely extensively on federal examination activities for verification of the tax base and the proper treatment of various transactions, particularly those involving international operations. State agencies devote their audit activities primarily to verifying the apportionment of income across states, examining the taxpayer's treatment of certain types of transactions, and determining the membership of the unitary group if the state employs combined reporting.

Historically, the flow of information was largely from the federal government to the states. In recent years, however, states have begun providing more information to federal tax administrators, and the IRS has begun more systematically using the information it receives. States have begun providing certain audit reports to the IRS. Also, under the State Reverse File Matching Initiative, states are extracting various items of return information from their individual income tax files and providing them to the IRS, so it can match them against the IRS Master File. The effort helps identify people who may have filed at the state level but not at the federal and allows the IRS to compare certain items of income and expense that are reported on the state return to those entries on the federal return.

States also use data from the U.S. Customs Service on imported goods to identify goods to which the retail sales and use tax may apply or to identify potential taxpayers that may not be registered.

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<sup>55</sup> Of the 41 states and D.C. that levy a broad-based personal income tax, all but five, by law, begin the state computation with a particular amount of income as determined on the federal tax return – either Adjusted Gross Income or Federal Taxable Income. They then make adjustments to exclude income they cannot tax or choose not to tax or to include income not included in the federal return. They also rely extensively on the Internal Revenue Code for defining itemized deductions in states that allow them. There is a somewhat greater degree of conformity with the federal corporation income tax base with nearly every state beginning state tax computations with federal taxable income. For further discussion, see Harley T. Duncan & Ronald Alt, *State Conformity to Federal Income Tax Provisions*, STATE GOV'T NEWS (Council of State Gov'ts), Mar. 2003.

***Debt Offset Programs.*** Since 2000, states have been participating in the federal Tax Refund Offset Program where a certified delinquent state income tax debt is offset against a federal tax refund. This produces about \$250 million per year for the states, and nearly all income tax states participate in the program.<sup>56</sup> Likewise, the IRS participates in state offset programs through the State Income Tax Levy Program (SITLP)) in about 30 states, and this produces upwards of \$100 million per year for the IRS.<sup>57</sup> In addition, two states are now piloting a program with the federal government in which the federal tax debt files are matched to all vendor payments made by states in order to recover tax delinquencies. In the same vein, several states – Delaware, Maryland, New Jersey and Connecticut – have begun a program for reciprocal offset of refunds for taxpayers in these states, i.e., a New Jersey taxpayer’s refund is subject to offset an income tax debt owed by the taxpayer to Delaware.

***Cooperative/Joint Return Filing.*** States and the IRS have made significant strides in developing cooperative approaches to the electronic filing of income tax returns. Each of the 42 states (including D.C.) with an individual income tax has a program for electronic filing of the returns. All but three of these states participate in the FedState E-file program in which a taxpayer (using a participating tax preparer or approved third party software) may file his/her federal and state tax return in a single electronic transmission. The return is transmitted to the IRS which performs limited validity checks and then makes the state return information available to the states.<sup>58</sup> Electronic filing is generally seen as improving tax compliance by eliminating mathematical and data entry errors and improving overall service to taxpayers. In 2008, about 60 percent of all state income tax returns were filed electronically, the vast majority through the cooperative FedState program.<sup>59</sup>

Cooperative electronic filing efforts are also being extended to areas beyond the individual income tax. As the IRS has moved into electronic filing of corporation income and other types of returns, states have worked closely with the Service to fashion counterpart state-level programs. By 2009, over one-half of the states will implement Fed-State electronic filing programs for corporation income tax. Likewise, a number of

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<sup>56</sup> FIN. MGMT. SERV., U.S. DEP’T OF TREASURY, COMPARISON OF STATE AGENCIES AND DISTRICT OF COLUMBIA NET COLLECTIONS FROM THE TREASURY OFFSET PROGRAM IN CALENDAR YEARS 2007 AND 2008. Data through October 2008 indicate state collections in excess of \$380 million; this figure is larger than has been the case in the past few years because the economic stimulus checks sent to taxpayers in early 2008 were subject to offset.

<sup>57</sup> Information obtained from IRS officials via email.

<sup>58</sup>Beyond the point at which the electronic return is received by the state tax agency, administration proceeds separately, with each level responsible for any further contact it might have with the taxpayer. A federal law enacted in 1976 authorized the federal government to administer state income taxes for states that agreed to adopt the federal income tax base (among other conditions). No state has availed itself of this opportunity, and the provision was repealed in 1992 as an unused and unnecessary piece of federal law. **[I need to find citations to laws or IRC sections.]**

<sup>59</sup>Information obtained from the Federation of Tax Administrators.

states will be developing similar programs for the electronic filing of partnership returns over the next few years.<sup>60</sup>

**Other Taxes.** There are relatively few instances in which the states and the federal government conduct joint audits of individual taxpayers. An important exception occurs in the motor fuel excise tax area, where joint audits are conducted if earlier investigative work by either the federal or state tax authority has revealed evidence of criminal tax evasion.

There is also little in the way of cooperative efforts between state and federal agencies in the administration of excise taxes on alcoholic beverages or tobacco products, except for occasional working arrangements between individual agencies at the local level. Federal law, however, does require that manufacturers of tobacco products and alcoholic beverages provide reports to state tax authorities on all products shipped to wholesalers in the state. This is a great aid in insuring that tax is paid on all products entering the distribution chain in a particular state.

**Interstate Coordination Mechanisms.** In addition to the Streamlined Sales Tax Agreement, there are several multistate organizations of state tax officials and authorities that contribute to coordination, cooperation and collaboration in state tax administration. Generally speaking, these organizations are aimed at one or more of the following objectives: (a) improving state tax compliance through information sharing; (b) improving the uniformity of state tax laws and practices to increase compliance and reduce complexity for taxpayers; and (c) conducting administrative operations on a combined basis to reduce administrative costs and the complexity of operating in multiple states. Like the SSUTA, they are indicative of the manner in which states tend to address issues of complexity, compliance burden, uniformity and the like.<sup>61</sup>

**Multistate Tax Commission.**<sup>62</sup> The Multistate Tax Commission (MTC) is an organization of 20 full-member states which serves as the administrative agency for the Uniform Division of Income for Tax Purposes Act (UDITPA) and the Multistate Tax Compact.<sup>63</sup> The MTC was formed in 1967 as a means of coordinating state activities in

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<sup>60</sup> For further information, see information prepared by the Federation of Tax Administrators at <http://www.statemef.com/>.

<sup>61</sup> For a further review of issues involving tax coordination in various settings, see Charles E. McLure, Jr., *Legislative, Judicial, Soft Law, and Cooperative Approaches to Harmonizing Corporate Income Taxes in the US and the EU*, 14 COLUM. J. OF EUR. L. 377 (2008).

<sup>62</sup> For a complete analysis of the Commission, see W. Bartley Hildreth et. al., *Interstate Tax Uniformity and the Multistate Tax Commission*, 58 NAT'L TAX J. 575 (2005).

<sup>63</sup> UDITPA is a model uniform law developed by the National Conference of Commissioners on Uniform State Laws (NCCUSL) as a means of coordinating the division of a corporation's income among states in which it does business. It has been adopted by 22 states and the laws of 12 other states are in substantial compliance with UDITPA. There are many deviations from UDITPA, even in laws of states that have adopted it, the most glaring being the greater (or sole) weight accorded to sales in apportioning income of multistate corporations. NCCUSL consists of leading state legislators and other state legal experts. Its mission is to review areas of state policy and governance which would benefit from a uniform state

the taxation of businesses operating in multiple states and bringing greater uniformity to state taxation of such businesses. The Multistate Tax Compact and MTC were formed largely in response to a series of hearings and studies by the U.S. Congress regarding the taxation of interstate commerce and purported complexities and inequities facing multistate businesses.<sup>64</sup> To forestall federal legislation preempting state taxation of interstate commerce, the states formed the Compact to bring greater uniformity and equity to state taxation of multistate businesses. In addition to the 20 full-member states, which are required to have adopted UDITPA and the Multistate Tax Compact, seven states are Sovereignty Members, 21 states are Associate Members or work with the MTC on various projects. Sovereignty and Associate members do not participate directly in governance of the MTC and have not enacted the provisions of the Multistate Tax Compact.

The Multistate Tax Commission operates several programs:

- A joint audit program for member states wherein MTC staff conducts sales tax or corporate income tax audits on behalf of multiple states at the same time. Upon completion of the audit, individual states are responsible for finalizing assessments and dealing with the taxpayer on all matters and any appeals. The joint audit program supplements, but does not replace, audit programs of the individual states. States participating in joint audits accept the results at their option.
- An active process of working with states and taxpayer groups to develop uniform approaches to the taxation of multistate businesses. Proposals for uniformity cover a wide range of issues, but are commonly focused on developing consistent approaches to the apportionment and allocation of income, defining the jurisdictional reach of state authority to tax, and developing tax approaches to new and emerging technologies and industries. All recommendations are advisory to state tax authorities and legislatures.
- A “nexus discovery” program for about 40 states aimed at identifying taxpayers that should be, but are not, registered for tax purposes in one or more states.
- A “voluntary disclosure” program which assists businesses involved in multistate commerce to voluntarily resolve potential state sales/use tax and/or income/franchise tax liabilities where nexus is the central issue.

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approach and to recommend legislation which would implement the preferred approach. The group is currently assessing whether to undertake a project to review and revise UDITPA

<sup>64</sup> See generally the proceedings of the Special Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary pursuant to Public Law 86-272 (generally known as the “Willis Commission” hearings after its chairman, Rep. Edwin E. Willis, D-La). The Subcommittee operated from 1962-1966.

**International Fuel Tax Agreement.**<sup>65</sup> Since the mid-1990s, states have been required by federal law to join the International Fuel Tax Agreement (IFTA), as a means of reducing the administrative burden on interstate motor carriers through joint administration of the interstate motor fuel use tax. All states (and a number of Canadian provinces) are now members of IFTA, which provides a mechanism for apportioning the motor fuel excise tax liability of an interstate or multijurisdictional motor carrier among the states in which it operates.<sup>66</sup> Under the Agreement, the carrier files only a single tax return with the state in which it is domiciled or based, together with information on its operations (purchases, mileage, etc.) in all jurisdictions for the reporting period. The “base state” provides information to other jurisdictions, reconciling the tax owed by the carrier in all jurisdictions, and otherwise providing for the administration of the tax with other jurisdictions on behalf of the carrier. The base state also audits carriers on behalf of all other jurisdictions. In short, the interstate carrier deals only with the tax authority in its base state, which is responsible for all contacts on behalf of the carrier with other jurisdictions.

An organization known as IFTA, Inc. provides the staffing and governing structure for IFTA which is governed by a board of state officials. Through IFTA, Inc. the governing board oversees state actions, insures state compliance with the Agreement and operates several programs including training and information to assist in the operation of IFTA. The governing board is also responsible for adopting rules to implement the Agreement and changes to the Agreement.

New York State has taken the joint administration of IFTA one step further. It has developed a data processing facility which provides tax return and remittance processing services for about 15 IFTA jurisdictions, including two Canadian provinces. The processing center captures all data from returns filed with it and handles all financial transactions among the states involved as well as with other IFTA jurisdictions. The states are individually responsible for registering and auditing carriers and dealing with delinquent carriers.

IFTA began as a voluntary cooperative effort among a relatively small number of states--three at the outset. However, because of the perceived benefits, the interstate trucking industry pushed hard for further participation and was eventually successful in securing enactment of a federal law requiring states to participate in IFTA if they wished

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<sup>65</sup> For a complete discussion, see Charles E. McLure, Jr., Robert C. Pitcher & Lonette L. Turner, *Taxation of Commercial Motor Fuel in the US and Canada: The International Fuel Tax Agreement*, 61 BULL. FOR INT’L TAXATION 541 (2007). See also Dwight Denison & Rex L. Facer II, *Interstate Tax Coordination: Lessons from the International Fuel Tax Agreement*, 58 NAT’L TAX J. 591 (2005).

<sup>66</sup>In the United States, a carrier pays tax at the time fuel is purchased or “at the pump,” but is then responsible for apportioning the tax paid on its entire fleet on the basis of miles traveled in each jurisdiction. Before the adoption of IFTA, a carrier was responsible for filing quarterly returns in each jurisdiction in which it operated, detailing its mileage, purchases and consumption and any tax or refund owed. Congress, at the behest of the trucking industry, which desired simplification of compliance, essentially mandated state participation in the IFTA.

to continue imposing the apportioned fuel use tax beyond September 30, 1996.<sup>67</sup> While some states initially resisted enactment of the requirement, all complied with its provisions by the deadline.

### **Conclusion**

In sum, state and local governments make extensive use of broad-based consumption taxes in the United States. While the typical sales tax deviates substantially from the norm of an ideal consumption tax, they are firmly entrenched in the U.S. fiscal system and generate considerable revenue. Over time, states have undertaken various efforts to simplify and reduce the complexity of various taxes, to reduce the burden imposed on the private sector in complying with the various taxes, and to make taxes more uniform from state to state. From these efforts, three conclusions seem relevant to this inquiry: (a) Control of the tax base by state officials is a jealously guarded prerogative; (b) Local use of the sales tax is an equally important matter and is seen favorably by many state officials as well as local authorities; and (c) State efforts to develop joint or unified administrative mechanisms have been quite limited. Federal and state cooperation in tax administration is limited primarily to electronic return filing and an active data exchange.

## **Section II**

### **If the Federal Government Adopts a Credit-Invoice VAT, What Options Are Open to the States?**

This section describes how various state consumption taxes would operate in the context of a federal VAT and the benefits and shortcomings that would arise under each permutation. By explaining how each alternative would operate in practice, this section sets the stage for discussing the numerous political, administrative, and legal accommodations that would be required to allow state consumption taxes to be administered adequately in light of the supposed federal VAT.

Four distinct state responses to a federal enactment of a VAT are considered. Two are based on a premise that states would adopt their own VAT, and the other involves retention of a retail sales tax (RST) at the state level.

Regardless of the model ultimately adopted, the federal consumption tax introduces opportunities for improving state administration of the counterpart state and local taxes – whether administered as a VAT or RST. Equally as important, the existence of the federal VAT provides political “cover” for addressing certain of the policy shortcomings in current RSTs, thereby reducing tax-driven economic distortion and improving compliance and promoting administrative simplicity.

### **State Value Added Tax**

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<sup>67</sup> See Intermodal Surface Transportation Efficiency Act of 1991, Pub. L. No. 102-240, 105 Stat. 1914.

A state VAT should work similarly to the mechanism existing in the member states of common markets – the European Union, for example. All domestic sales by registered sellers would be subject to VAT levied at the statutory rate. Registered sellers, in calculating their state tax, would be allowed a credit for VAT paid to their suppliers. Registered sellers importing goods or services from other states or internationally would be subject to a reverse charging mechanism so that, upon the acquisition of imported supplies, they would report an output tax which would be offset completely by an input credit. Exports from one state to another state or internationally would be zero rated, so that all input credits would be offset against VAT on in-state sales and refunded to the extent they exceed the tax on such sales.

Sales to individual households and consumers (B2C sales) by registered traders in the state of the purchaser would be subject to VAT at the state-specified rate. Presumably, registered traders making interstate sales and shipments into a state where they currently have a legal requirement to collect tax under the *Quill* rule<sup>68</sup> could also be required to collect VAT in the destination state as they are required to collect RST today. That still leaves a significant volume of sales to households on which tax is not collected with the attendant distortions, etc.<sup>69</sup> Improving the collection of VAT or RST on remote sales where the seller is not required to collect will require modification of the *Quill* rule or some other mechanism.

One possible mechanism to improve compliance would be to require that cross-border sales between registered taxpayers be reported by the exporting seller to the state tax authority in the origin state – which, in turn, could report the sales to a central data clearinghouse -- or to the federal government. The data would then be accessible by authorities in the importing state to assist in monitoring the flow of goods in the state and to aid in the collection of tax. If the data reporting requirement was extended to the reporting of B2C transactions (perhaps only for sellers above a certain threshold) it would aid in collection of tax directly from consumers if the seller were not required to collect the tax.

The above description fails to specify how a sub-national VAT would function at a local level. In 33 states, local governments have the authority to fix (within a stipulated range) local sales taxes.<sup>70</sup> A local VAT, with attendant border adjustments, is simply unfathomable. A revenue sharing solution based on objective data (population or, where it exists, consumption or other economic data) would be viable if local governments could be persuaded by the prospect of more stable and broad-based source of revenues to forego their rate-setting authority.

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<sup>68</sup> See discussion of *Quill v. North Dakota* *supra* notes 16 and 32.

<sup>69</sup> For a review of the volume of remote Internet sales on which tax is not collected, see DONALD BRUCE, WILLIAM F. FOX & LEANN LUNA, STATE AND LOCAL GOVERNMENT SALES TAX REVENUE LOSSES FROM ELECTRONIC COMMERCE (Apr. 13, 2009).

<sup>70</sup> See discussion *supra* note 1.

Alternatively, Professor McLure's paper in this volume describes a local-level "integrated sales tax" (IST) in which all sales to registered traders are zero-rated that he believes could be made to work in the conjunction with a state VAT or a state IST (that he describes fully and that is examined to some extent below) to handle local taxes. Failing either of these options, the VAT seemingly cannot be made to work on a local government level. This shortcoming (along with exposure to refund fraud) is one of two nearly insuperable obstacles to implementation of a state level VAT in the traditional credit-invoice form.

Assuming states solve the local tax problem, it is likely that any state adopting a VAT will gravitate to, but not completely reach, one of two polar approaches. (1) States will conform their VAT base to the federal analog; or (2) They will try to replicate the current retail sales tax base, nonetheless taxing value added during production or distribution. Though it is unlikely that either polar extreme will *per se* be workable, it is nonetheless useful to examine the options schematically using these two points as an analytic tool.

**Conformed State VAT.** A state VAT base conforming to the national VAT would clearly be the simplest – both for the taxing authority and for the taxpayer. For this reason, it is the approach most likely to promote a high level of compliance. In a conformed VAT, states would adopt the federal registration information (including the VAT taxpayer ID) and would "piggyback" on the federal system much the way they do with regard to personal or corporate income tax by adopting a similar tax base but enacting their own tax rates.<sup>71</sup> As with personal and corporate income tax, the administrative gains for the state tax authority and for taxpayers could plausibly justify the loss of state autonomy from conforming to the federal tax base – and could even allow the federal government to administer state VATs.

The features of system in which state fully conformed to a federal VAT include:

- A single registration of all federal and state VAT payers would permit all VAT registrants to be identical in the database of both federal and all states in which they do business. Taxpayers could thus register one time with the federal government<sup>72</sup> and at the same time designate the states in which they were required or desired to register for state VAT collection. Alternatively, states could require prior federal registration, thus borrowing the federal ID number as their own. Either alternative would facilitate a number of administrative processes:

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<sup>71</sup> As noted *supra* Section 1 and discussion at note 55), while states conform their starting points for income tax purposes to the federal tax, there a number of deviations from strict adherence to the federal base.

<sup>72</sup> This paper assumes that the Internal Revenue Service would be the agency charged with administering the hypothesized federal VAT. It could, however, be administered by a new federal VAT administration authority.

- With the congruence of federal and state taxable entities, federal designation and monitoring of exempt entities would be fully effective for state tax compliance.
- Mutual sharing of information relating to tax compliance would be enhanced by uniformity. Federal reporting by federal VAT number would conform to state registration files, avoiding ambiguous or erroneous identification of the taxpayer on federal information that might be received such as audit reports, information on interstate shipments, etc.
- Conformity of registration would facilitate the creation and utility of a database to report interstate transactions. The reporting mechanism is needed so that the importing state can administer and enforce a deferred payment mechanism, strongly indicated in the absence of border controls and by the fact that the incoming goods or services received by a registered trader arrive unburdened by consumption tax.
- State and federal VATs will each produce significant numbers of claims and very large quantities of refunded input credits, given the vast volume of interstate trade in the U.S. economy. Each refund liability represents a possible asset against which an offset could be made to discharge tax arrears if a taxpayer is claiming excess input credits. In addition, given adequate legal authority, refunds by one taxing authority could be garnished in favor of any state with a fully enforceable claim against the refund-seeking taxpayer (typically, a state exporter). The ability to offset refunds to discharge liabilities to other jurisdictions would be facilitated by common ID numbers; in fact, automated setoffs would be rather difficult without common VAT numbers between federal and state governments and among different states.
- By virtue of identical tax bases, all federal taxable transactions would be state taxable transactions and *vice versa* (though the tax rates would be determined by each jurisdiction). Common tax bases would facilitate enforcement cooperation and monitoring of compliance as well as permit division of labor and reducing the taxpayers' burden of furnishing the same information to multiple taxing authorities.
- Identical tax bases will promote the ability of states to use federal audits as a prime source of identification of risks of state tax non-compliance. Some risks would be mutually applicable (over-invoicing of inputs, under-invoicing of sales, non-recording of cash sales, etc.) while others would not -- for example, fraudulent refunds based on fabricated exports from one state to another.
- The European Union rules generally require that a seller making more than a specific level of sales to individuals and households in a member state register

with that state and collect and pay VAT on sales into that state.<sup>73</sup> For sales under the threshold, the tax may be paid to the origin or the destination state. If the United States is to adopt a sales volume distance or remote selling rule, it would be desirable, though not required, that the thresholds for distance selling should be uniform across all VAT states. In any case, the definition of ‘distance selling’ should be uniform or at least the ground rules laid out; otherwise, sellers could face conflicting requirements as to whether the tax needs to be paid to the origin or the destination state.

As noted earlier, distance or remote sales to individuals and households present special issues in the United States because of the volume of such sales and the current law rules. Since Congress would need to authorize distance selling registration in the destination state (overruling *Quill Corp. v. North Dakota* 504 U.S. 298 (1992)), Congress could probably at the same time specify the definition of, and registration threshold for, distance sales. The remote sales legislation considered in the 110th Congress (H.R. 3396 and S. 34) had an effective ‘distance selling’ threshold in that sellers with less than \$5 million in national remote sales would not be subject to the expanded nexus standard.<sup>74</sup>

- It appears that the definition of what constitutes a sale to a registered trader should depend on the trader being VAT-registered in the destination state. Otherwise, in the case of deliveries to a business that is registered federally but not in the destination state, the firm would not be required to account for the imports (by not being subject to reverse charging) and it would nonetheless be able to sell, without tax, goods purchased free of VAT.
- Conformity would require that all states and the federal government agree on how to determine the destination of supplies. States adopting the Streamlined Sales and Use Tax Agreement have approved a hierarchical decision-tree approach that could be expanded (especially with regard to services) and universally adopted.<sup>75</sup>
- Conformity would facilitate federal collection of state VAT at the U.S. border, reducing confusion over the identity of the taxpayer and the taxability of the goods in question. State VAT rates that vary depending on the nature of the goods would undercut the federal government’s ability to collect state VAT at the U.S.

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<sup>73</sup> “The general rule [in the EU] is that it is the VAT rate of the supplier which applies (‘origin’ principle). However, if the level of sales in any one Member State exceed a certain threshold (either €35,000 or €100,000 depending on the Member State), then the supplier must register for VAT and charge VAT at the rate applicable in that Member State (‘destination’ principle).” European Union Taxation and Customs Union Web site, *Mail Order and Distance Purchasing*, [http://ec.europa.eu/taxation\\_customs/taxation/vat/consumers/mail\\_order\\_distance/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/vat/consumers/mail_order_distance/index_en.htm).

<sup>74</sup> The legislation did not require collection of the origin state tax by sellers below the threshold, but it presumably could.

<sup>75</sup> SSUTA §§ 309-316. For a complete description, see HELLERSTEIN & SWAIN, *supra* note 36, at 6-1 to 6-34.

border and add complexity for multistate retailers. To address this, the SSUTA provides only limited latitude for multiple consumption tax rates.<sup>76</sup> Consideration might also be given to mapping state tax rates to the Harmonized Tariff Schedule.<sup>77</sup>

- Near conformity could enable a state VAT return that reconciles to the federal VAT return, as state income tax returns do to their federal counterpart. On the other hand, the VAT form may ultimately require such large adjustments that the reconciliation lacks utility. Among the adjustments would be: variations in the tax base, adjustments for differential tax rates; and, in the case of multistate firms, adjustment of sales and input credits to those occurring in-state, among many others. A “piggy-backed” return would require a separate line reconciling each of the discrepancies between the state and federal VAT bases. The greater the number of deviations, the more cumbersome (and unrealistic) the piggy-backed return becomes.
- Political reservations will arise about taxation of sales (food, pharmaceuticals, etc.) currently exempt under an RST.

Despite the advantages of complete conformity in both the identity of taxpayers or of the shape of the tax base, various circumstances militate against that level of conformity ever being achieved.

In order for registration conformity to exist, the registration threshold and other registration criteria would need to be the same for both federal and state taxation, but this outcome is difficult to achieve because of the following, which is expanded on in Section III:

- The federal government and state governments will very likely not establish identical registration thresholds. Among the variables that enter into establishing registration thresholds are the level of revenue materiality as seen by the respective governments, administrative capacity to monitor a given number of VAT taxpayers, and sensitivity to competitive advantage/disadvantage between registered and non-registered sellers. It would be surprising if each of the small and large state governments would resolve all these variables and come to one standard registration threshold. It would be even more surprising if all states and the federal government resolved the same vectors and in turn arrived at the same threshold.

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<sup>76</sup> SSUTA § 308. States are limited to a single sales tax rate except they may have a separate rate on food, electricity and prescription drugs.

<sup>77</sup> U.S. INT’L TRADE COMM., HARMONIZED TARIFF SCHEDULE OF THE UNITED STATES (2009), *available at* <http://hotdocs.usitc.gov/docs/tata/hts/bychapter/0900htsa.pdf>. This approach was considered by the National Tax Association Project on Electronic Commerce but dropped because it was seen as administratively infeasible due to the volume of codes, some imprecision in the codes and concerns about the ability of sellers to accommodate such a regime. For a discussion of the National Tax Association Project, see HELLERSTEIN & SWAIN, *supra* note 36, at 2-3 to 2-9.

- Aside from required registration, different taxing jurisdictions will need to allow voluntary registration as determined by taxpayer circumstances within their borders.
- Tax authorities will want to de-register VAT taxpayers that have gone out of business in their jurisdictions or that have abused their privilege as registrants. The same registrant may still be operating in good standing in another jurisdiction.
- Even if there were universal adoption of a standard turnover threshold that triggered registration, federal calculation of that threshold should presumably not involve turnover of only a single firm. Rather, it would likely take into consideration the aggregate turnover of a family of related firms, not all of which will necessarily do business in every state in which one of them does business. If the related entities all received the same federal VAT number, then all related entities would be registered in any state where any of the members of the group conducted business. Under this scheme, states would lose the ability to disaggregate legal entities and thus to register only those firms engaged in business in the taxing state. If, on the other hand, the federal government issued separate VAT numbers to each of the related firms but required their consolidation to determine whether registration for all of them was required, then states would need to apply the same rule for there to be registration conformity. In the former case, application of state rules to extra-territorial events is implicit; in the latter case, extra-territoriality is explicit. In either case, application of the federal rule at the state level is constitutionally suspect. Since taxation of extraterritorial values may raise issues under the Due Process Clause, federal legislation may not cure the infirmity, should it exist.<sup>78</sup>

It seems fair to conclude that a common registration base, even with common ID numbers, will be difficult to achieve. Thus, unless some federal administrative accommodation to state interests is forthcoming, vendors will not be able to rely only on a federal ID number to determine whether a sale to another state with a VAT is B2B or B2C. Administrative responses to this issue are discussed later in this paper.

***Evaluating the Pros and Cons concerning a Conformed VAT.*** Adoption of a conformed VAT would affect the variables set out in the beginning of this paper in the following respects. Some of the effects would be considered an advance over the existing RST, while other effects are decidedly negative. We evaluate against the policy and compliance shortcomings outlined for existing RSTs earlier.

**Capture by the destination state of tax on incoming supplies.** The VAT offers opportunities for importing states to receive information about incoming supplies (whether B2B, B2C, or both), but the outcome would not be easy to put into place

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<sup>78</sup> See *Butler Bros. v. McColgan*, 315 U.S. 501 (1942).

because the two sources of the information – the federal government and the exporting state – have no incentive to keep track of or report the information.<sup>79</sup>

If states were to apply something similar to the scheme in place in the EU,<sup>80</sup> the seller could be required to report data (including the state to which the supplies are to be delivered) to the state from which export occurred, and the data could then be supplied to a clearinghouse and subsequently to the importing state. The data could then be used to control the importer's deferred payment and the collection/payment of VAT on subsequent sales. Exporting states would not benefit from the information that they supply to the clearinghouse, but they would benefit from the information supplied by other states. Thus, without a system of sanctions – mandated by legislation or interstate agreement -- for a state's failure to maintain the currency of the database, one could expect its utility to be limited. Its usefulness would also be limited by the fact that the VAT database by definition would contain data only from VAT states since states with RSTs have no interest in tracking exports.

If the database approach alone were to be applied to B2C sales, several matters are evident: (1) recovery of the VAT would depend on the existence of a "use tax" collected from consumers in the importing state, requiring extensive intervention to collect; (2) the number of taxpayers the taxing authority would need to monitor, and from whom to receive tax returns, becomes much larger and requires more human contact in the form of taxpayer education, auditing, etc.; and (3) the tax due in the case of each customer is small relative to the tax due from each seller. Accordingly, state tax authorities, with limited resources, will be inclined to overlook non-compliance on the part of each individual consumer.

Consequently, The EU does not require similar reporting for B2C deliveries. Instead, its distance selling rules for B2C sales require the seller to report sales and pay tax to the destination state when sales exceed a certain threshold. Distance sales below the threshold are reported to the origin state, or to the destination state – at the taxpayer's election.

Since, at best, the VIES-clone would capture sales only from VAT states, a better alternative would be receipt of the same information from the federal government. However, to achieve this result, the government must receive and record data from

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<sup>79</sup> There may even be a negative incentive – in that the most faithfully reporting states might be viewed as the least desirable places in which to locate a multistate business. Michael Keen & Jenny E. Ligthart, *Information Sharing and International Taxation: A Primer*, 13 INT'L TAX AND PUB. FIN. 81 (2006). This argues for a database available to all participants with incentives to keep data current – perhaps even on a real-time basis.

<sup>80</sup> The EU clearinghouse system is called VAT Information Exchange System ("VIES"). VIES does not encompass B2C sales or supplies of service. REPORT FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT ON THE USE OF ADMINISTRATIVE COOPERATION ARRANGEMENTS IN THE FIGHT AGAINST VAT FRAUD, COM(2004) 260 final (Apr. 16, 2004). In addition, EU member states not only share information. They have an obligation to establish competent authorities that are obligated to follow-up on inquiries on behalf of the other member state as if it were its own inquiry. Council Regulation (EC) No 1798/2003, *Administrative Cooperation in the Field of Value Added Tax* (2003).

reports reflecting the destination of supplies and take steps to assure the accuracy of data. As with the exporting state, however, the federal government receives little benefit in recording and assuring accuracy of data reflecting the destination state.

On the brighter side, with regard to supplies with foreign origin, the federal Customs and Border Protection would be able to collect both federal and state VAT at the border, provided the state and the federal government identified taxpayers uniformly; the supplies were taxable by both the federal and state governments; and there were clear rules for determining the destination state.

**Gray areas regarding exempt products.** A completely harmonized tax – subject to development of federal interpretative regulations, case law, and the like – applicable to all goods and services, in which taxpayers are susceptible to audit by federal or state authorities would go a great distance to advance state consumption tax compliance. But taxation of food and necessities, even if subject to federal tax, will not likely be well received.

**Vagueness and abuse of exempt entities.** It is impossible to know what entities would become exempt under future VATs, but abuse would be reduced by being exposed to enforcement by both state and federal authorities in any event. Vagueness in applicability of exempt status to specific entities would be greatly reduced by federal determination as to exemption under a procedure similar to I.R.C. § 503.

Taxing of the products supplied by exempt entities is a more significant issue. States adopting the same treatment as the federal government<sup>81</sup> (as suggested by Professor Schenk's paper in this volume dealing with non-profit organizations and governments) would be an advance over the current sales tax treatment.

**Under-reporting of taxed transactions.** Under the conformed VAT there is, in one sense, no administrative advance versus RST against under-reporting of tax, other than exposure of the evader to two sets of tax enforcers. Cash sales can go unaccounted and unregistered businesses can, as under the RST, make sales without applying the tax. The VAT of course limits the harm (except for refund fraud) to incremental increases in value while in the hands of the tax-evading seller. Failure to pay over VAT on the part of one vendor short-changes the government only to the extent of the value added by that vendor. It should be noted, however, the value added by sellers of services (who often can, without a storefront needed to attract customers or a facility to house inventory, operate discreetly without registration more easily than sellers of goods) can be substantial.

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<sup>81</sup> Federal legislation should provide that states may tax sales by the federal government to the extent the sales compete with sales by taxable providers. Without statutory authority, it is unlikely that states would be able to require the federal government to collect tax. (The federal government should also be able to tax sales by sub-national governments and in fact, governments at all levels should not regard themselves as exempt from VAT registration.) Similar legislation exists to allow state governments to require the federal government to enter into agreements to withhold state income tax on salaries paid to federal employees. 5 U.S.C. §§ 5517 and 5520.

Nevertheless, under-reporting under the VAT can take on forms beyond those available to RST evaders: overstatement of input credits (often supported by fake invoices), missing trader fraud, pre-planned insolvencies, etc. The most serious threat from adoption of a VAT is the prospect of massive refund fraud.<sup>82, 83</sup> Consideration of implementation (and design) of a VAT, in particular where the volume of cross-border transactions is as enormous<sup>84</sup> as would be the case with state VATs, needs to take that threat into account. States would be susceptible to fraud not only in the case of international sales (which would be subject to federal audit), but on the enormous volume of interstate commerce.

The opportunity for refunds of taxes never paid into the government offers dishonest individuals a blank check. Even countries with strong tax administrations having many years of VAT experience and established informational and enforcement infrastructures are challenged by ingenious schemes of fraudsters seeking to obtain refunds of taxes never paid into the treasury. No state will initially have the competence, experience, or information needed to give assurance against a significant drain arising from unwarranted refunds. It is unlikely that any but a few states even in the intermediate term will be able to accept the high degree of exposure to the risk of significant VAT refund fraud.

To the extent they do accept the risk, there is the danger that the states (like many countries)<sup>85</sup> will over-allocate audit resources to avoid illicit refunds and under-allocate

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<sup>82</sup> Even legitimate refunds will be a significant percentage of gross VAT receipts. In Canada and the EU, for example, 50 percent and nearly 40 percent, respectively, of VAT revenues are refunded. The states of the United States could be expected to have the same experience. “Everything else equal, the level of VAT refunds is likely to be *higher* in countries with more open and faster-growing economies (i.e. where there are higher export and investment shares in total economic activity), as well as in countries with modern tax systems and administration that apply self-assessment procedures and respect taxpayers’ rights, including minimizing tax compliance costs.” Graham Harrison & Russell Krelove, *VAT Refunds: A Review of Country Experience*, IMF Working Paper (2005).

<sup>83</sup> States often require that all items of expenditure (including aggregate tax refunds) be appropriated. Thus, the task of revenue estimating becomes more complicated and more important. Gross sales to consumers need to be estimated as well as the amount of exports in interstate commerce and other causes of excess input credits. If the estimate is linked with the budget process and a balanced-budget requirement, budget havoc can ensue when, as the year progresses, refunds turn out to be significantly understated.

<sup>84</sup> There appear to be no good data regarding the magnitude of interstate commerce. This is confirmed in email from Prof. Geoffrey J.D. Hewings (January 12 and 13, 2009) who had cited the high rate of growth of interstate commerce in Geoffrey J.D. Hewings and John B. Parr, *The Changing Structure of Trade and Interdependence in a Mature Economy: The US Midwest*, Regional Economics Applications Laboratory Discussion Paper No. 07-T-09 (2007), available at <http://www.real.uiuc.edu/d-paper/07/07-T-9.pdf>. However, the so-called interstate commerce numbers were extrapolated from transport surveys that themselves do not distinguish interstate from intrastate transport. Even if the transport data were to reflect interstate commerce, they do not include trade in services or sales of digital “goods” that do not need to be physically transported.

<sup>85</sup> Harrison and Krelove, *supra* note 82, at 7.

resources needed to assure compliance with positive VAT reporting and remittance requirements.<sup>86</sup>

**Diversion of Dual-Use Products into Taxable Uses.** Since credits are given for inputs received by registered firms, diversion to private use does represent a threat. However, exposure to both state and federal audit attention may act as a deterrent.

**Compliance Burden on Interstate Sellers.** Conformed federal and state VATs would ease the burden on multistate businesses otherwise trying to comply with diverse consumption tax exemption schemes and multiple rates in various taxing jurisdictions. On the other hand, the recordkeeping and reporting burden under a VAT is significantly greater than under a RST. In short, RST only requires reporting and documenting sales, while VAT requires, in addition, reporting of, and documenting, inputs and requires additional detailed reporting on exports. Small businesses (many of which can be eliminated from liability through the registration threshold) may need to be supported (e.g., with a non-refundable credit phased out over a short period of time) to acquire the bookkeeping infrastructure for compliance, as was done when Canada introduced the VAT.

As noted in Section 1, about half the sales tax states compensate retailers for collecting the sales tax. Loss of the collection allowance with the implementation of the VAT would make compliance seem all the more burdensome on existing retailers.<sup>87</sup>

### **Integrated Sales Tax**

Professor McLure has in this volume proposed the concept of an “integrated sales tax” (IST) to address some of the concerns identified above regarding a state-level VAT (particularly the volume of refunds and the potential for refund fraud) and at the same time move states and localities in the direction of a consumption tax that is more aligned with sound tax policy principles. Under an IST, all sales (whether intrastate, interstate or international) to registered traders would be zero-rated, and a VAT at rates established by state and local governments would be applied to sales to individuals and households with a destination in the state. Presumably, states could establish their own tax bases under the IST, but McLure would clearly prefer that the base be concurrent with the federal VAT base. [He also hopes fervently that the federal base will closely approximate all individual consumption with only modest adjustments for technical, policy or political reasons.] Through an IST, it is possible that states and localities can adopt a tax that has somewhat the “look and feel” of a sales tax (no refunds, input credits, etc.) and at the

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<sup>86</sup> The logic that motivates this result is clear. First, whether a refund was valid or fraudulent will often become known after it is issued. Therefore, both the head of the tax administration and the head of audit can be personally faulted and disciplined for approving claims shown after the fact to have been fraudulent. On the other hand, undetected underreporting in the case of taxpayers who are not audited cannot be attributed – simply because it is undetected -- to the leadership or to audit staff. Second, the risk of failing to realize a target is less in the case of refusing or delaying refunds (since the refund claimed is a known number) versus the speculative amount that might be gained from auditing returns for underreporting.

<sup>87</sup> See *supra* note 30.

same time achieves some political economy gains, principally by removing tax from business inputs and applying tax more even-handedly across household consumption.

Aside from improving economic efficiency by not taxing business inputs and taxing a larger share of household consumption, a state-level IST could have the following positive results:

- Since all sales to registered traders are zero-rated, exports do not result in refunds, thus avoiding one of the fatal flaws of a state-level VAT. The zero-rating approach also seems preferable to a VIVAT or CVAT mechanism, each of which would require establishing a clearinghouse or other mechanism to reconcile and distribute payments among jurisdictions to insure implementation of destination-based taxation.
- Under an IST, the state tax base could differ from that of the federal VAT, thus making it potentially more acceptable to state policymakers. Deviations from the federal base, however, will increase the burden on sellers and will also likely mean that the base does not reach the full extent of all household consumption.
- The IST as proposed by McLure should be able to accommodate the submission of reports on the origin and destination of zero-rated sales to aid in enforcement of tax on sales to consumers and in compliance by unregistered businesses.
- The return on which the IST is reported can be used to report the local IST implemented as a zero-rate VIVAT, as described by Prof. McLure.

Among the issues to be considered in implementing an IST are:

- Leaving aside political questions involved in conforming to a federal consumption tax, the principal issue facing state policymakers will be one of revenue. That is, does the revenue gained by applying the IST to a broader range of individual consumption than is now the case with the RST offset the reduced revenue that results from zero-rating all sales to registered traders. Given that purchases by businesses now account for over 40 percent of sales tax receipts,<sup>88</sup> the state IST base will necessarily have to capture a significantly greater proportion of individual consumption to avoid a reduction in revenues relative to the current RST. Policymakers will also need to deal with the political perception that the zero-rating is relieving a tax on businesses and shifting it to individuals and households.
- From an administrative standpoint, the greatest issue in implementing an IST at the state level it would seem is ensuring compliance with the tax. The zero-rating feature of the IST means that all goods entering the state via sales to a registered trader will bear no tax, and the state will have only one chance to collect the tax – on the final sale to the individual consumer. This is in contrast to current RSTs where tax is collected on a number of intermediate inputs. It is also in contrast to

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<sup>88</sup> See Phillips, Cline and Neubig, *supra* note 22.

a conventional VAT where there is fractional collection of the ultimate tax based on the value added at successive stages of the production process. This compliance risk puts a premium on insuring proper registration of all traders, having an adequate audit program to insure proper collection and remittance of the tax, and an aggressive investigation program to identify and deter fraudulent traders. This paper also proposes that the federal government work with states to establish a data base for the reporting of zero-rated sales to aid in enforcement of the IST if it is implemented (or possibly RSTs if they are maintained.)

- As with a state VAT (and current RSTs), remote or distance selling remains an issue. The IST could be implemented so as to follow the EU model as far as taxation of distance selling; sales to out-of-state consumers below a threshold would be taxed in the origin state while sales above the threshold would be remitted by the seller to the destination state. The principle could work whether the destination state imposed an IST or a RST. To achieve this end, Congress would need to overrule *Quill v. North Dakota*.
- With zero-rating of all sales to registered traders, one question to be addressed is whether sales to federally registered traders that are not registered in the taxing state – because, for example, they are below the turnover threshold for registration in that state – should be zero-rated. If they are zero-rated, then these sellers would buy without state IST and yet be able to sell without applying IST. As a result, it seems that state registration should be the relevant criterion for zero-rating.
- The IST offers the opportunity for registered traders to misuse their ability to make zero-rated purchases for business purposes and to convert such purchases to personal use. The opportunity clearly exists in dual use goods – computers, vehicles, furniture – but also for digital services or services plausibly provided to firms that would benefit the owner (financial advice, tax consultation, etc.)
- To the extent the IST provides for registration only of sellers above a certain threshold, it departs from the nearly universal application of the RST which is applicable even to small traders.
- If states require detailed reports of zero-rated sales and purchases by registered businesses, the compliance burden increases substantially.<sup>89</sup>

In sum, the IST embodies some of the advantages and disadvantages of the harmonized VAT, but importantly avoids the two fatal (at least in the short-term) flaws of a state-level VAT: refund fraud and the difficulty the tax creates for local governments' imposition of their own consumption taxes. To the extent, however, that it allows states

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<sup>89</sup> Sales tax returns require reporting *total* sales for which the seller received an exemption certificate. See, e.g., Wisconsin's Sales and Use Tax Return, Form ST-12, available at <http://www.dor.state.wi.us/forms/sales/s-012f.pdf>. Exemption certificates themselves can, of course, be inspected during audit.

to deviate from the federal tax base and to the extent states take advantage of that flexibility, it falls short in moving the state tax base in the direction of the ideal consumption tax, and is less likely to offer significant improvements in compliance and administration as compared to the current situation.<sup>90</sup> Given the degree to which current state tax bases differ from one another and the extent to which states have preserved their authority over the tax base even as they have attempted to simplify sales tax administration through the Streamlined Sales Tax Project, we should expect that even if they adopt an IST, states will have sharply different tax bases from one another and from the federal VAT.

### **Retail Sales Tax**

Aside from the “crowding out” of flexibility of raising revenue through consumption taxes, there is no reason why a federal VAT is inconsistent with a state-level RST. Their co-existence in several Canadian provinces proves their compatibility.<sup>91</sup>

Moreover, the overlay of a federal VAT and the additional information likely to be possessed by the federal government could bring about improvements to the operation of state RSTs, all related to existence of federal enforcement and informational infrastructure. At the very least the federal taxing (and customs) authority will: receive (and may share) return information that could include the identity of suppliers and customers; audit consumption tax returns (detecting unreported receipts, matching payments of one taxpayer with receipts by another, etc); and collect VAT at the border.<sup>92</sup>

It is also possible that the existence of a federal VAT could provide a model and some impetus for states that decide to maintain a RST to modify the base of the RST so that it begins to more closely align with the ideals of a consumption tax by exempting business inputs and taxing more individual and household consumption. That is, to the extent that administration of the federal VAT demonstrates that tax compliance can be achieved without taxation of business inputs and that federal information can aid in state RST compliance, states may move toward removing the RST from a greater range of business inputs. Similarly, as greater experience is gained in the taxation of services consumed by individuals (and consumers become more used to such taxation), it may aid states in moving their RST base in that direction.

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<sup>90</sup> Fox and Luna, *supra* note 11, at 878.

<sup>91</sup> The Canada VAT experience has been analyzed in any number of articles. *See, e.g.*, Richard M. Bird, *Is a State VAT the Answer? What's the Question?*, 45 STATE TAX NOTES 809 (Sept. 24, 2007); Richard M. Bird, *Coordinating Federal and Provincial Sales Taxes: Lessons from the Canadian Experience*, 69 NAT'L TAX J. 889 (2006); Richard M. Bird and Pierre-Pascal Gendron, *Dual VATs and Cross-Border Trade: Two Problems, One Solution?*, 5 INT'L TAX AND PUB. FIN. 429 (1998); Charles E. McLure, Jr., *Harmonizing the RSTs and GST: Lessons for Canada from the Canadian Experience*, 45 TAX NOTES INT'L 439 (Feb. 5, 2007); Charles E. McLure, Jr., *Coordinating State Sales Taxes with a Federal VAT: Opportunities, Risks, and Challenges*, 38 STATE TAX NOTES 35 (Spec. Suppl. Oct. 3, 2005); Richard M. Bird, *Taxing Sales Twice: International Experience with Multilevel Sales Taxes*, 38 STATE TAX NOTES 49 (Spec. Suppl. Oct. 3, 2005).

<sup>92</sup> Administrative measures to take advantage of the federal consumption tax overlay for the status quo RST as well as other state responses are described in the next section of this paper.

If states maintain their current (or modified) RSTs, the compliance burden faced by sellers will necessarily be increased. They will be required to deal with one more (federal) consumption tax administrator and one more set of rules. It is possible, over time, that the creation of a federal administrative apparatus dealing with consumption tax may provide a vehicle for some greater simplification and uniformity of RSTs at the state level. If states began to use federal definitions of various products and services or other parts of the administrative apparatus attending the federal consumption tax, the burden on sellers could be relieved to some extent – not unlike the manner in which burden is reduced and compliance increased by state conformity to the federal income tax. In the short-term, however, sellers should expect that they will be dealing with an additional federal consumption tax administration as well as the existing state and local administrations.

### **Section III**

#### **Administrative and Statutory Mechanisms to Facilitate State Consumption Tax Administration**

Constant attention from the very beginning to state tax implications will be essential in drafting legislation to implement a federal VAT, even where it is widely conceded that states would, if at all, implement their own VATs or ISTs<sup>93</sup> only at some unspecified future time. Congress will be unlikely in the future gratuitously to consider statutory support for an expansion of state tax bases since doing so will be perceived as Members of Congress having ratified a “tax increase,” without the corresponding advantage of Congress having control over the use of the revenues whose receipt they facilitated. Similarly, no state will likely consider enacting a VAT on the assumption that it or a handful of similarly minded states could at some future time convince Congress to facilitate state VAT administration. The groundwork for state VATs should be laid at the outset, or it will likely never be laid.

The premise is thus that legislation that creates a federal VAT must also enable and facilitate state VATs. This section then concentrates on the administrative and statutory steps that will be necessary or desirable in order optimally to implement a state VAT. These steps would, as noted, often improve administration of RSTs as well.

#### **Informational Infrastructure**

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<sup>93</sup> In this section, the term “VAT” should also be read to include the Integrated Sales Tax (IST) proposed by McLure in this volume and reviewed above. Specific references are often made to the mechanisms necessary to facilitate state adoption of an IST because it is my position that if states are to impose a VAT-like tax, it will need to be in the form of an IST (or some similar modification of a conventional VAT) because of the volume of refunds and the potential for refund fraud that exists in a conventional VAT. Particular attention is not necessarily paid to the steps that would be necessary to implement a credit-invoice VAT at the state or local level because it is not considered feasible. McLure comes to the same conclusion in this volume.

**Federal return information.** The statutory centerpiece of federal and state cooperation is I.R.C. § 6103(d)<sup>94</sup>, authorizing the IRS to disclose certain federal tax return information to state taxing authorities. Under current law, the IRS may disclose tax return information (including the identity of the taxpayer) to state governments only with respect to taxes imposed under certain enumerated chapters of the Internal Revenue Code. Assuming a new VAT chapter is added to the IRC, § 6103 would need to be amended to allow disclosure of VAT return information to the states.<sup>95</sup>

In addition, consideration should be given to amending the statute to enable the IRS to disclose certain tax information to certain private sector entities. It would be helpful to VAT compliance and administration for parties engaged in trade between two registered traders to be able to verify the validity of the VAT registration of the other party as a means of combating fraud.<sup>96</sup> State laws may also need to be amended to allow sharing of VAT or RST information with the federal government.<sup>97</sup>

If states move to a VAT or IST system in which all sales among registered traders are zero-rated (i.e., no tax will have been applied and collected prior to the final retail sale), the need for information to assist in ensuring proper compliance will be paramount. Information that can be made available to states to assist in monitoring the flow of goods into and within the state will be of critical importance in ensuring that sellers are properly registered and that the appropriate tax is collected and remitted on the final sale. Likewise, other information from federal VAT records and returns will be important in state audit and compliance programs. Such an information flow would also be valuable to states that maintain a RST.

The federal VAT administration agency should, however, be in possession of information that could assist states. Thus, the federal government, in theory, could bridge at least some of the information gap. This is true, however, only to the extent the IRS captures and makes available data on individual transactions and that this data contains the origin and destination states of supply. While the IRS may determine to require

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<sup>94</sup> To engage in the exchange, the state must enter into an Implementing Agreement with the IRS and annually identify the exchanges in which it proposes to participate. The state must commit to using the information only for tax administration purposes and to safeguard the information in accord with the requirements of the IRS. The Service also conducts periodic reviews of state facilities and safeguarding procedures to assure their adequacy.

<sup>95</sup> As noted earlier, this paper assumes a federal VAT would be administered by the Internal Revenue Service. If the VAT is administered by another federal entity, that entity would need the authority outlined here in the context of the IRS.

<sup>96</sup> The IRS currently provides some information to lending institutions, but the taxpayer must first affirmatively agree to the disclosure. Some states, however, have established applications that allow sellers to verify the sales tax registration number of another seller for purposes of verifying eligibility for a sale for resale exemption. See, for example, the “Verify a Permit/License” application at <<https://efile.boe.ca.gov/boewebservices/verification.jsp?action=SALES>>.

<sup>97</sup> For example, North Dakota law permits disclosure to the IRS of only income tax return information. N. DAK. CENT. CODE, § 57-38-57 (3).

reporting (hopefully, electronically<sup>98</sup>) transaction data so as to match taxes paid on outputs with input credits, this is likely to be required, captured and analyzed, if at all, only for large transactions or sets of transactions. While federal VAT administration will not benefit immensely from capturing the state of origin and destination on these transactions, it is only with the origin and destination information that the data is of value to state VAT administration.<sup>99</sup> Last, access to the information will likely be too slow to be initially useful in deterring specific carousel fraud schemes while in operation.

That said, if federal government does capture state-specific information on origin and destination of supplies, and devises an effective way of matching input credits with the taxes paid by suppliers in a transaction-specific way, the data would go a long way toward filling the information gap in the case of both VAT and RST. In the case of VAT, the IRS could report the nature of the supply, the destination state, and whether the customer was VAT-registered. In the case of the RST, this information will distinguish taxable from non-taxable supplies.

***Information sharing implementation.*** The IRS could, in the same manner as it currently shares extracts of income tax data, produce periodic reports on magnetic media of sales indicating the origin and destination states and international imports and exports to and from those states and whether the sales were subject to tax or zero-rated. These utility of the reports For tax compliance will be directly related to the degree of coincidence between the federal and state tax bases. For example, the reports would combine sales of goods and services, which would limit the usefulness to states imposing a RST that was not imposed on services. The very usefulness of this information and the additional revenue to be derived therefrom might motivate states to move their tax base in the direction of the federal base.<sup>100</sup>

***State Sponsored Information Initiatives.*** If the IRS database on transactions is either deficient or its data is slow to be made available, states may want to consider creating their own database. Something in the nature of the European Union VIES system (though expanded)<sup>101</sup> would be a good starting point, though inferior to a robust federal reporting system. Under the VIES model, exporters need to report B2B transaction data – i.e., the nature of the supplies, value of the transaction as well as the customer and the destination.<sup>102</sup> The process would be valuable for detecting certain types of non-

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<sup>98</sup> Most filers of more than 250 income tax information returns are required to file the returns electronically. IRS Publication 3609, *Filing Information Returns Electronically* (2007). It would even be more desirable if transaction data were required to be captured in real-time. This might be made more feasible if a Trusted Third Party/Certified Service Provider were employed by all VAT states.

<sup>99</sup> And thus the origin and destination state need to be specified on the approved VAT invoice.

<sup>100</sup> This system would not be unlike the current exchange of information between the U.S. Customs and Border Protection and a number of states in which states receive quarterly extracts of certain goods shipped into the state from international locations.

<sup>101</sup> VIES does not include supplies of services or B2C transactions.

<sup>102</sup> The extent of reporting for exports implied by a state VIES clone would exceed the amount of reporting required for in-state transactions – if for no other reason than the VIES clone would require identification

compliance. The system would allow the taxing authority in the importing state – constrained by its own resource limitations -- to follow the supplies and, in theory, to assure that tax is paid, though the data would likely not be available in time to find a quickly disappearing fraudulent trader. In addition, the state database would be of only limited utility relative to a federal database with state-specific destination information.<sup>103</sup> Specifically, the state database would reflect exports only from VAT states, but not exports from RST states into VAT states.

Creating the Interstate – VIES system would not be the first time states have established tax return databases in aid of tax compliance.<sup>104</sup> Still, to the extent a number of states enact a VAT, creation and administration of the database would be a large undertaking. The logistics will take money and management attention. There would be sources of revenues created by the enactment of VATs, however, that can be invested in promoting better compliance, and state tax administrations are accustomed to paying dues to organizations that provide services to aid in administration (and enforcement) of state tax laws.<sup>105</sup> A federal VAT will likely produce very substantial numbers and dollar magnitudes of refunds. Should these refunds be offset in favor of state income tax debts, they would represent a new source of revenue that for the most part would never have been realized without the VAT. A portion of those refund offsets could be dedicated to fund the creation and maintenance of the database – or to fund any charges the IRS might exact for furnishing data from its own database.<sup>106</sup> Presently, under I.R.C. § 6402(e), federal refunds of “named persons” – presumably refunds of individual income tax -- can be offset in favor of state income tax debts. For the states to be able optimally to offset federal refunds, § 6402 (or regulations) would need amendment to allow offset of corporations’ refunds to satisfy any state tax debt.

There are yet other ways of bridging the information gap arising from cross-border sales. One way would be for a trusted third party<sup>107</sup> to assume responsibility for

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of the customer; in-state transactions would not. Thus, federal legislation should ratify establishing of the reporting requirements so that the requirement is not subject to contest under the Commerce clause of the U.S. Constitution.

<sup>103</sup> VIES data are supplied to Member States on request. There have been suggestions that the database be opened up, subject to privacy controls, so that a Member State can routinely access data on its own initiative. Lisa M Nadal, *European VAT Fraud Growing at Alarming Rate, Association Says*, TAX NOTES INTERNATIONAL 150, 151 (April 9, 2007).

<sup>104</sup> See the discussion of IFTA and the New York Regional Processing Center in Section I. In addition, New York State has developed and sponsored a multistate data base to aid in the identification of tax shelter participants.

<sup>105</sup> See discussion of the International Fuel Tax Agreement and the Multistate Tax Commission in Section I.

<sup>106</sup> Similarly, state VAT refunds could be offset in favor of the federal government.

<sup>107</sup> Richard Ainsworth has suggested that, in addition, certified software and certified service providers (CSPs) can be used. These certified service providers would provide information to the buyer regarding the tax it is to pay to the CSP. Failure to pay tax using a certified system or to the CSP would result in inability to claim input credit. Since the CSP assumes all liability for tax due from its clients it will use the

paying VATs in all states – consolidating in one party all information on input and output VAT. Unless all parties to a series of transactions acted in concert – that is, never paying VAT at all to suppliers --, at some point VAT would be paid into the state treasury. This method seems to have some but not all the disadvantages<sup>108</sup> of the Bulgarian “special VAT accounts” into which, until January 2007, VAT needed to be paid. At the very least, the Trusted Third Party would prevent the evader from disappearing with the VAT; at the same time, however, legitimate businesses may be deprived of working capital.

Between the federal or state-sponsored databases, the federal alternative would be far more effective as it would provide information based not only on data from states enacting a VAT but instead would accumulate data from all states. The federal database could be funded in the same manner – federal offsets against state refunds -- or the IRS could charge states for participation in the database program per reported transaction or through a subscription based on an equitable formula.

### **Registration**

The core requirement of a tax administration database is that the user of the database can access data of a taxpayer whose identity is defined unambiguously by the user and the database. Registration is the process by which taxpayers are uniquely identified. Thus, registration is the key functional area of tax administration insofar as integrity and sharing of information is concerned. In the case of income tax, federal taxpayer identification numbers identify taxpayers in state systems as well and thus are the foundation on which information is shared. An analogous procedure would be needed in the case of a VAT.

***Initial registration on implementation of a VAT.*** With the enactment of a federal VAT, the federal government would have an enormous initial registration challenge. State sales (and gross receipts) tax data, along with federal income and employment tax data, can be used to design and target the registration campaign. To aid in the federal registration campaign, states should be expected to share their data on taxpayer identity and turnover.<sup>109</sup>

The enormity of the registration challenge would, by itself, motivate states to delay adoption of a VAT to allow the federal campaign to have become successful at registering the great bulk of VAT taxpayers. State registration – particularly registration

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mechanisms of the private marketplace to assure that the tax is collected. Richard T. Ainsworth, *Carousel Fraud in the EU: A Digital VAT Solution*, 42 TAX NOTES INTERNATIONAL 443 (May 1, 2006).

<sup>108</sup> In short, traders lose the use of working capital while funds sit in the special accounts and, ultimately, schemes that are even more ingenious were invented that reduced the accounts’ effectiveness in fighting fraud. Konstantin Pashev, *Fighting VAT Fraud: The Bulgarian Experience*, Center for the Study of Democracy Working Paper (2006), available at <http://mpr.ub.uni-muenchen.de/998/>. The U.K. House of Lords recently issued a report in which it suggests setting up something similar to the Bulgarian (now no longer in use) “special account” system. Charles Gnaedinger, *U.K. House of Lords Calls for New Approaches in VAT Fraud Fight*, 46 TAX NOTES INT’L 1190 (June 18, 2007).

<sup>109</sup> As illustrated by North Dakota, not all states have statutory authority to share sales tax data with the federal government. See *supra* note 97.

consistent with the federal process -- becomes immeasurably easier once the IRS has established and implemented federal VAT registration. As described below, states designing a registration campaign to implement VAT should be able to use the federal ID number as well its own and federal records to issue state VAT IDs on its own initiative. The same records can then be used to target additional firms whose duty to register remains in doubt.

***Issuance of a VAT number.*** Registration for VAT will result in issuance of a VAT taxpayer identification number. Consideration could be given to incorporation of the Employer Identification Number into a VAT ID (though doing so would require amendment to IRC § 6103, since VAT IDs are made available generally by the tax administration), but a new number would need to be given to those who do business as sole proprietors (and others) who are permitted to use Social Security Numbers as Taxpayer Identification Numbers.<sup>110</sup>

As noted above, there are likely to be businesses required to register with the federal government, but which are not required to register by any particular state. Among such instances would be families of related firms whose turnover is consolidated for purposes<sup>111</sup> of required federal registration, but whose sales within any particular state are too small to require state registration; or, firms that are de-registered (or that are refused registration) by a state but which continue to be registered for federal VAT purposes.<sup>112</sup>

Similarly, and likely to be much more numerous, are those cases where: (a) the firm is required to register in a given state, but because of a higher registration threshold, is not required to register federally; or (b) where firms desiring to engage in interstate commerce will wish to register voluntarily with states in which they do business so as to be able to engage in zero-rated purchases and sales.

Registrations among jurisdictions may also lose sync where one jurisdiction wishes to decline to register taxpayers in the case of a registration application that contains misrepresentations or to de-register a taxpayer based on tax misdeeds. Another jurisdiction would likely not automatically decline to register or de-register a taxpayer simply because another jurisdiction has made a decision to do so, particularly if the infraction does not pertain to the second jurisdiction. For example, if a taxpayer has failed

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<sup>110</sup> For reasons of privacy and protection against identity theft, the government has endeavored to restrict public disclosure of Social Security Numbers. U.S. Gov't Acct. Off., *Social Security Numbers: Federal and State Laws Restrict use of SSNs, yet Gaps Remain*, GAO Report No. GAO-05-1016T (2005). THE PRESIDENT'S IDENTITY TASK FORCE, COMBATING IDENTITY THEFT: A STRATEGIC PLAN (2007).

<sup>111</sup> Unless related entities are considered together, firms would divide themselves up into separate legal entities and compete unfairly with those required to charge VAT. Tax driven fragmentation seems more attractive in the case of service industries, where taxable sales are more likely greatly to exceed inputs -- as contrasted with businesses merely selling marked-up inventory.

<sup>112</sup> To implement a consolidated approach to registration, the IRS could therefore issue one VAT ID to the entire group or it could issue separate IDs. This would make the state's use of the federal ID very difficult. In implementing its own threshold, the state would not wish to take account of turnover not involving the taxing state, much less that of firms not even conducting business within the state.

to collect state VAT, but has complied with the federal VAT, the federal government might not be required automatically to de-register the taxpayer. Likewise, a third state that has nothing to do with the complained of incident would not be expected automatically to follow suit.

To enjoy the same unambiguous identification as with income tax, something similar is required; namely, the state and federal VAT IDs must be either identical or readily translatable one to the other. One approach that could work is the following: State tax agencies might condition issuance of its state VAT number on a taxpayer having received a federal VAT number. But, many of those who would become voluntary state registrants would not register for the federal VAT. The federal government under this scenario would need to issue VAT numbers to businesses that will not be required to file federal VAT returns. The IRS files could then contain a field indicating the taxpayer is registered only for state taxes and is not required to file a federal return.

This approach would not permit states to infer from the fact of federal registration which firms should register in a given state (other than perhaps the state indicated as its mailing address on the federal form) and the scenario would require multiple registrations – federal and each state in which it would conduct taxable or zero-rated sales. While an alternative approach would be for the federal government to capture and report registration information for each state in which the firm would conduct sales and to forward the information to the states in question, this approach would be complicated by state registration thresholds, exempt or zero-rated sales, and in the case of sales tax, differing tax bases. In addition, the scenario is problematic because federal VAT implementation would undoubtedly be completed before states enact their own VATs.

Ultimately, the purpose of translating state VAT numbers into federal VAT ID numbers, and *vice versa*, is to facilitate exchange of information that will improve ease of voluntary compliance and effective enforcement in all affected jurisdictions. The information exchange will be no less valuable in the case of administering a RST. Thus, to facilitate exchange of consumption tax information, RST states may wish to consider adopting the federal VAT ID, even in the case of sales tax registration. This should be straightforward in that both the states and the federal government have crosswalk data linking the VAT ID to the Employer Identification or the Social Security numbers and thus states could automate the issuance of a new RST ID number. Even if the IRS were to issue a single VAT ID to a family of related firms that the state nonetheless considers to be separate, the state could append a suffix to the ID, identifying each component firm separately.

**Registration Visits.** Ideally, VAT registration should entail selected site visits by the state and federal tax administrations. Registration visits would represent a major change in the way tax administrations do business and a resource challenge for both federal and state tax administrations. In both cases, registration today is largely a matter of providing registration forms, entry of data when the forms are submitted and maintaining and generating computer records reflecting the population of registrants. These visits ideally would accomplish a number of objectives, including: (1) inform the

business, immediately upon start-up, of its tax obligations; (2) judge from an on-site view the likely turnover of the business and its potential for exporting -- to other states, as well as to other nations -- as an aid to detecting inflated invoices, diversion of zero-rated supplies into personal use, or refund claims emanating from newly registered businesses; (3) determine in a cursory fashion whether the business has adequate bookkeeping resources and accounting controls so as to assess the need for audit early in VAT implementation or for concerted taxpayer education; and (4) warn of the consequences of failure to meet legal obligations.<sup>113</sup>

States with their own VAT would target their own on-site visits to those businesses receiving less federal attention (for example, by virtue of falling below the federal registration threshold), but which are still required to register with the state in question. Information gathered on the registration site visits would need to be shared with among the federal and state tax administrations, particularly if registration was denied or revoked based on a site visit.

***Revocation of registration.*** The ability of states and the federal government to revoke VAT registration can be a powerful tool to achieve any number of compliance objectives. Absence of VAT registration means a business will not be able to claim VAT input credits or make zero-rated purchases and sales. Any of the following (if confirmed after due process notice and hearing) could conceivably occasion revocation of VAT registration: acts of VAT fraud or activities in support of fraud (solicitation, assisting in commission of fraud<sup>114</sup> etc.), knowingly making a false application for registration, knowingly submitting a false claim for a refund, having a tax debt (not only VAT) that, under state law, justifies the tax authorities closing the business, etc.

It might be appropriate that state revocation involving VAT fraud could be considered cause for revocation of federal registration.

### **Compliance Activities**

The VAT offers many of the enforcement challenges of the RST -- under-invoicing; under-reporting of cash transactions; and sales conducted by unregistered sellers. When a federal rate is overlaid on the state rate -- whether under a VAT or RST -- and the incentive to evade is increased (perhaps substantially), the challenge becomes all the greater. Adoption of a VAT places additional daunting challenges on enforcing compliance. At the federal level, the major issues seem to be use of false input credits, disappearing links in the chain of distribution, and falsification of exports-- all exacerbated by a system of refunds that offers dishonest taxpayers employing any of these gambits a blank check. For states that move to an IST with the zero-rating of all purchases by registered traders, the only point of tax collection will be on the final sale to the individual consumer. The primary compliance challenge will be assuring that the

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<sup>113</sup> Several states, including South Dakota, New York and California, conduct these sorts of compliance visits at the present time.

<sup>114</sup> All the following could be included: furnishing false invoices so that another would reduce its own VAT liability, being a knowing member of a carousel fraud scheme, etc.,

traders are registered and appropriately charging and collecting tax on sales to unregistered traders and households.

There are administrative mechanisms that may aid in enforcing compliance with a VAT – especially refund fraud -- but their effectiveness is likely to be limited.

- Judicious federal matching of input credits and VAT on sales could result in improved compliance and detection of non-compliance.<sup>115</sup> However, when the IRS detects non-compliance, it would likely be concerned with the overall audit adjustment for federal VAT purposes and often would not refine the non-compliance as to exactly which transactions were not correctly reported – and thus which destination states were affected. Consequently, federal detection of non-compliance based on credit matching, even if effective, might be difficult to translate to breach of any particular state’s VAT requirements.
- Customs and Border Protection could collect state as well as federal VAT on imported goods, if those goods were being sold to an individual or unregistered trader in the case of a state IST. This would be feasible only if there were either substantial coincidence between state and federal consumption bases. Coincidence could be achieved under either the state Conformed VAT or Conformed RST variants. Alternatively, CBP collection may also be premised on a less likely coincidence between the state tax base and definitions in the Harmonized Tariff Schedule.<sup>116</sup>
- Under current state sales and use taxes, a primary compliance challenge for states is collecting use tax on interstate sales to individuals and households where the seller does not have a legal obligation to collect use tax on sales in the destination state. Under the IST envisioned by McLure (and considered the most feasible state VAT option), the compliance issues and risks for states is compounded because all sales to registered traders will be zero-rated and the only point of collection will be on the final sale to the consumer. The remote selling rule of *Quill* will need to be modified to require that all registered traders with sales above some threshold be required to collect on interstate sales (or in some other manner) if this substantial compliance issue and risk is to be mitigated. As an incentive to states to move to an IST, the benefits of modifying the *Quill* rule could be limited to only those states that adopt an IST with a base identical or substantially similar to the federal base.<sup>117</sup>

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<sup>115</sup> However, worldwide experience has not shown large scale cross-matching to be very successful. LIAM EBRILL ET. AL., THE MODERN VAT 153 (I.M.F. 2001); Harrison and Krelove, *supra* note 82, at 27.

<sup>116</sup> Congress should explicitly authorize the collection of state taxes at the U.S. border so as to eliminate any question as to whether the disadvantage in loss of the time value of the tax paid violates the Import-Export Clause (U.S. CONST. art. I, § 10) or the Commerce Clause (U.S. CONST. art. 1, § 8, cl. 3). There will also be a need to insure tax collection on interstate sales directly to individuals and households so that international trade is not treated differentially.

<sup>117</sup> The power of overturning *Quill* as a monetary incentive is diminishing as an increasing number of remote sellers register with the states and begin collecting tax. In large part, this movement is driven by a desire to integrate the retailing operations of Web sites, mail order and in-store facilities and provide an

- Division of labor would improve efficiency in conducting audits – especially of small and medium sized businesses. It appears that state audits would be more generally directly useful to the IRS than the reverse. Federal audits of large multistate businesses are unlikely to produce audit reports that reflect adjustments to the transaction detail and thus are not going to be directly useful to states. However, the IRS could establish a procedure whereby states could furnish a roster of all RST/VAT registrants, so that it could forward any audit report reflecting that taxpayer to any state in which the auditee was registered. State statutes could require that any taxpayer self-assess the state tax implied by a federal adjustment.<sup>118</sup>
- With the temptation introduced by refund of credits and the competitive advantage of not filing (and not registering to pay) a combination of federal and state consumption taxes, criminal tax activity will almost certainly increase substantially. And the crimes will take on more complexity as they become ones that are carried out by multi-participants acting in a conspiracy and are carried out using locations in more than one state. State tax intelligence divisions would need to increase resources and develop new skills.
- States will have very limited ability to investigate the activities of confederates whose out-of-state activities support VAT fraud – for example, carousel fraud -- inside the taxing state.<sup>119</sup> The state would not have easily executed extraterritorial subpoena power over persons or documents and would not have law enforcement authority outside its own borders. It might therefore be wise for Congress to enact a statute specifying a federal crime for participating in multistate tax (or, more limited, VAT) frauds against states, thus enabling the FBI (or IRS) to investigate and for the federal government to prosecute.<sup>120</sup> That said, one could not be confident that investigation and prosecution of this crime would receive high priority among the crimes that the federal authorities are charged with pursuing.

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integrated customer experience. Current estimates of the revenue impact of not collecting tax on remote Internet sales to households and businesses because of nexus issues is \$11-12 billion annually, of which about \$7 billion is due to sales to individuals. *See* Bruce, Fox and Luna, *supra* note 69, at 4-5.

<sup>118</sup> States typically require a taxpayer whose federal tax has been adjusted to file an amended return reflecting the federal adjustment. In the case of a VAT (or perhaps even a RST), states could require the taxpayer to take the initiative to make the determination as to which states' returns were understated and report the appropriate adjustments to those states. A penalty (typically quite substantial) for failure to file the amended return would be imposed on failure to fulfill this obligation.

<sup>119</sup> In contrast, European Council Regulation (EC) No 1798/2003 permits Member States' representatives to be present during tax inquiries in other Member States. It does not seem realistic in the United States for there to be a federal requirement that one state carry out tax investigations instigated by another state on a par with its own, much less that a representative of the requesting state be afforded presence during the investigation.

<sup>120</sup> On their face, Mail Fraud Statutes do not unambiguously cover VAT frauds where mail or electronic means were not used to promote the fraud; that is, where the taxpayers delivered the fraudulent documents in person. *See* 18 U.S.C. ch. 63.

- Federal audit activity would reduce some of the risk of non-compliance in connection with all consumption taxes, including existing RSTs – understating sales of registered sellers, untaxed sales by unregistered taxpayers, (use tax on) goods arriving from outside the United States. Sharing of audit and customs reports and use of audit adjustments would permit use of those reports as the sole basis for a corresponding state assessment and requirement to file an amended return.

In the final analysis, the compliance issues and approaches to a conventional credit-invoice federal VAT, on the one hand, and a state IST with universal zero-rating of sales to registered traders as posed by McLure, on the other, will differ substantially. The former will benefit from fractional collection of the tax at successive stages of production but require a focus on refund fraud-related issues. The latter, while not plagued with refund-related issues, will require a focus on ensuring proper collection and remittance by registered traders. Federal enforcement efforts can supplement, but cannot replace state enforcement efforts. Modification of the remote selling rule of Quill and development of a data base that allows monitoring of interstate sales of zero-rated goods and services are likely to be of greatest benefit to states.

### **Concluding Observations**

This paper has tried to address several questions relating to issues involved in coordinating a federal-level VAT with state and local consumption taxes. Those questions and the findings, observations and conclusions are summarized here.

### **What are the relevant institutional factors present in current state and local consumption tax environment?**

- State and local governments make extensive use of broad-based consumption taxes in the U.S while the federal government does not.
- The typical sales tax structure deviates substantially from the ideal consumption tax, particularly in its less-than-universal taxation of individual consumption, taxation of business inputs, and complexity burden for multistate sellers driven largely by the lack of uniformity across states.
- Three conclusions can be drawn from state efforts to simplify and make sales taxes more uniform: (a) Control of the tax base by state officials is a jealously guarded prerogative; (b) Local use of the sales tax is as jealously guarded and is seen favorably by many state officials as well as local authorities; and (c) State efforts to develop joint or unified administrative mechanisms have been limited.
- Federal and state cooperation in tax administration is limited primarily to an active data exchange program with the exception of the electronic return filing arena.

### **What conclusions can be drawn about the opportunities and challenges for implementing coordinated national and sub-national consumption taxes in the U.S?**

- Coordinating sub-national consumption taxes with a well-designed federal consumption tax would bring significant improvements to the structure and administration of state and local sales taxes.
- The biggest challenges in moving to a conformed, or harmonized, federal-state VAT are likely to be a strong desire by state officials to retain control of the tax base, the political issues in excluding business inputs and expanding the taxation of individual consumption (and the possible revenue consequences), and the thicket of local sales taxes.
- Experience elsewhere and various analyses indicate that there are any number of types of state and local consumption taxes that can co-exist with a federal VAT. Some arrangements are more desirable than others, and all could be improved by a well-designed federal VAT.
- Dealing with the issue of remote sellers not required to collect tax on interstate sales under current law will be important in trying to formulate an effective sub-national VAT. Enabling states to require collection of tax (either sales or VAT) on cross-border sales by remote sellers could be an incentive to encourage states to migrate to a VAT.
- Consideration should be given at the outset to the administrative and other arrangements that will be necessary and desirable in coordinating national and sub-national consumption taxes even if states are not expected to move immediately to a VAT. It will be difficult to develop such mechanisms once a federal VAT is implemented.

### **What stands in the way of state implementation of a VAT?**

- There will be an enormous volume of refund claims from interstate sellers under a conventional credit-invoice VAT. State VATs, under any circumstances, will be vulnerable to untenable levels of VAT refund fraud. As McLure concludes elsewhere in this volume, the complexity and risks involved make it unlikely and effectively infeasible for states to implement a traditional VAT.
- Implementing a VAT with refunds for interlocal sales is not possible. Other variations may work, but the cleanest, most administrable would be some form of revenue sharing.
- There will be operational risk in registering state VAT taxpayers before the IRS completes its registration process.
- States have limited experience in estimating net VAT revenues, especially where refunds need to be appropriated in the context of a balanced budget requirement.
- Similarly, there is limited experience and lack of capacity for criminal investigation in the context of VAT
- There is also a lack of experience in investigating and preventing schemes for evasion of state sales taxes involving multistate transactions and lack of

confidence in the federal government's ability and willingness to devote resources to accomplish the same.

- There will be a significant increase in taxpayer compliance burden as reflected in monthly reporting of inputs as well as sales and in compliance with reporting requirements regarding exports.
- The revenue consequences of foregoing the taxation of business inputs and imposing tax on individual service consumption will be a major consideration.

**Are there alternative formulations of a VAT or VAT-like tax that would be feasible and would improve state and local consumption taxes?**

- The Integrated Sales Tax (IST) proposed by McLure in this volume could potentially improve the operations of state and local consumption taxes and could improve significantly the policy underpinnings of those taxes. By zero-rating all sales to registered traders and modeling the state IST base on the federal VAT base, it would remove tax from business inputs and move to broader taxation of all consumption by individuals.
- The IST eliminates the need for the refund of input tax paid on exports and the imposition of a reverse charging scheme on interstate imports. As such, it removes an area of tremendous risk that would exist with a traditional VAT at the state level. It also appears to be administratively feasible at the local government level.
- The IST also has a comparative advantage over a VIVAT or CVAT (other formulations that have tried to address issues in coordinating VAT administration among members of a common market without border controls). The IST does not require the revenue redistribution and clearinghouse infrastructure required under the VIVAT and CVAT to achieve destination-based taxation.
- While the IST approach mitigates the risks and complexities involved with refunds, it creates a different kind of risk for adopting states. For states that move to an IST with the zero-rating of all purchases by registered traders, the only point of tax collection will be on the final sale to the individual consumer. There will not be the fractional collection at successive stages of production as in a VAT and there will not be tax on many business inputs (thus spreading risk) as in the current system. The states will thus face a significant compliance challenge of assuring that traders are registered and appropriately charging and collecting tax on sales to unregistered traders and households.

**What would contribute to reducing the major risks of implementing a state VAT or IST?**

- There must be a correspondence between state and federal VAT ID numbers – most probably by the IRS registering taxpayers who are not actually federal VAT taxpayers so that the VAT ID can be relied upon to identify a validly registered

trader and that information can be shared among tax administrations to aid in monitoring the flow of goods and aid in compliance.

- There should be a data base created to capture information on interstate sales so that states can have available such information to aid them in compliance activities. Such a data base would be beneficial in identifying persons that should be registered and collecting in the state as well as in selecting potential audit candidates. To populate the data base, federal VAT data and information must capture and report a taxpayer' sales, above a threshold, by state of origin and destination. In lieu of federal reporting, and as a distant second-best, state implementation of a VIES-like database, with sanctions against untimely update of data. In either case, real-time access should ideally be provided not unlike is now done when states have online access (with proper security and authorization) transcripts and information in the IRS Master file.
- The federal Customs and Border Protection Service should collect state VAT at the border on international sales to individual consumers.
- A Congressional overruling of *Quill v. North Dakota* and establishment of a workable remote selling rule that requires tax to be collected by sellers with significant distance sales is critical to both VAT implementation.
- There must be a federal commitment to criminal investigation and prosecution of multi-state frauds against state VAT and to working with states on tax investigations.
- Federal reports to reflect the state of origin and destination pertaining to audit adjustments, and a requirement that a federal audit adjustment trigger a self-assessed amended state VAT return would be beneficial to state administration.
- The ability to know if someone is validly registered for federal and state VAT will be of considerable importance to compliance. To aid states in insuring that only registered traders can receive goods without payment of tax, consideration should be given to requiring federal de-registration of a trader if a trader is convicted of state VAT fraud;;
- State implementation will need to lag federal until the federal implementation is complete and risks of non-compliance and implementation have been analyzed.
- Assistance must be put into place to assist the smallest (above threshold) taxpayers to achieve capacity to comply.

**What federal and state legislation or administrative practices should be adopted to support eventual adoption of state VATs?**

- Amendment of IRC § 6103 to allow disclosure of the federal ID number to the parties to a transaction and to share with states return information relative to the federal VAT provided state statutes permit reciprocal information sharing

regarding state consumption taxes. The return information should be shared routinely with states in which the taxpayer is registered as a consumption taxpayer.

- Establishment of a legal requirement to report data on interstate sales to the data base discussed above, along with sanctions and penalties for noncompliance.
- Federal statutory approval to foreclose Commerce Clause challenges (aside from those related to *Quill*) and ratify differential reporting requirements between in-state and out-of-state sales and collection of state VAT at the U.S. border.
- Requirement for federally approved VAT invoices to indicate origin and destination of delivery.
- Definition and specification of dollar threshold for registration for distant selling and modification of the *Quill* rule.
- Specification of a federal crime for offenses involving use of interstate commerce in effectuating state VAT fraud. Requiring report to Congress as to activities in investigating and prosecuting under this statute.
- Authority (and direction) of IRS to register businesses where the taxpayer will not be a federal VAT taxpayer.
- Permit reciprocal state and federal offsets of business tax refunds, including VAT refunds.
- Tight control of data security as states could receive more audit reports (based only on state VAT registration) that are not of use than are of use
- State statutes to require self-assessment following a federal audit.
- Federal government may consider demonstrable VAT fraud grounds for de-registering a taxpayer.

**Which of these measures will improve the administration of current RSTs and other taxes?**

- A limited overruling of *Quill* will allow states to require reporting and collection of sales tax under certain conditions (for example, sales into a state coincident with stipulated registration under distance selling provision) unless the benefits of the overruling are limited to states adopting a VAT.
- VAT data extracts by origin and destination state will be helpful in identifying taxpayers that should be registered with the state and developing audit protocols.
- Federal enforcement of a consumption tax could have a deterrent effect on noncompliance with state consumption taxes, and federal audit reports may also be helpful to state sales tax administrators.

- Federal collection of RST at international borders provided state RST reasonably conforms to the VAT base or to tariff schedules would be beneficial.