

Post-Conference draft: Comments welcome

INTERJURISDICTIONAL ISSUES IN THE DESIGN OF A VAT

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This version: June 7 2009

This is a revised version of a paper prepared for the American Tax Policy Institute Conference on *Structuring a Federal VAT: Design & Coordination Issues*, Washington D.C., February 18-19, 2009

Acknowledgments: We thank Charles McLure, Jack Mintz, Stephen Smith and other conference participants for helpful discussions. Errors or omissions are our own. Views expressed here should not be attributed to the International Monetary Fund, its Executive Board, or its management.

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Introduction

Three sets of jurisdictional design issues arise in taxing commodities (a term we use here to embrace both goods and services) that are traded across borders, whether between nations or lower level jurisdictions within federal systems: who should determine the rate and base of the tax,¹ who should ultimately receive the revenue, and who should administer the tax? This Article considers some of the key aspects of these issues as they would be posed by a decision to adopt a federal-level VAT in the United States. To focus on the core design issues, however, we focus, for the most part, only on the first two questions, rates and revenue. Our discussion of administrative issues is limited to their broad implications for the kind of rate and revenue arrangements that may be feasible, with deeper issues as to the allocation of administrative responsibilities across levels of government left aside: administrative issues are discussed by Harley Duncan elsewhere in this volume.²

The Article starts by looking at the economics of the basic choice between the destination and origin principles for the taxation of commodities traded between jurisdictions. Section II then considers the implementation of the destination principle for trade between nation states (for which it is the international norm)—so relating directly to the design of a federal VAT—with a particular focus on the increasingly important challenges in the treatment of international services. Section III turns to interjurisdictional issues in state and local taxation, both under current arrangements and, more speculatively, in the context of adoption of some form of VAT by subnational governments. Section IV concludes.

I. Destination or Origin Principles for the VAT?

The core issue of economic principle in relation to the VAT, as with commodity taxes more generally, is commonly posed as the choice between destination and origin principles. There are, however, no universally accepted definitions of these terms—which can cause confusion, as will be seen. For present purposes, we use the term *destination principle* to mean any arrangement under which tax is ultimately levied only on the final consumption that incurs within some jurisdiction—which, depending on context, may be a nation, state/province, or locality—and *origin principle* to mean any arrangement under which tax is ultimately levied only on production. Thus defined, the key difference

¹ The choice of base can be thought of as an aspect of the rate decision: a decision that some commodity should be taxed on only a specific (per unit) basis, for instance, is a decision to constrain the ad valorem rate to zero.

² Harley Duncan, Administrative Issues from the Adoption of a Federal VAT in Addition to Existing Federal and State Taxes, ___ Tax L. Rev. ___ (___).

between the two³ is that imports must be brought into tax under the destination principle (so far as they contribute to consumption) and exports must ultimately be excluded; and conversely under the origin principle.

This working definition begs the question, taken up in the next section, of whether consumption, and where it occurs, can be observed—and even whether these are well-defined concepts. It is also silent on the critical questions, raised above and now pursued further, of who ultimately receives the revenue and who sets the tax rate.⁴

On the first of these, a number of federal countries have arrangements for the explicit sharing of the revenue raised by VATs levied at lower levels of government, as discussed by Victoria Perry elsewhere in this volume.⁵ More commonly, however, the revenue raised by commodity taxes accrues to the jurisdiction in which the consumption or production occurs. The standard way of implementing the destination principle for the VAT is by zero-rating⁶ exports and bringing imports fully into tax (with appropriate credit further down the production chain): the exporting (origin) jurisdiction then collects nothing, and the importing (destination) one everything. But this is not the only way in which the destination principle, as just described, can be implemented: one could also envisage, for instance, the exporting country charging tax on exports just as it does on all domestic sales, with the importing country allowing this as a credit against its own tax charge. This would be consistent with the destination principle as just described—given the “ultimately” in the definition—even though (in the absence of offsetting payments between the jurisdictions) not all revenue accrues to the country of import. In this sense (and here is the risk of confusion),⁷ origin-based taxation—interpreting this as meaning

³ Strictly, the two differ, as defined, even in a closed economy: investment goods could be taxed under the latter, for example, but not the former.

⁴ It is also silent on administrative questions and (a point of some importance for policy makers’ tax-setting incentives) on where the real economic incidence of the tax ultimately falls.

⁵ Victoria J. Perry, *International Experience in Implementing VATs in Federal Jurisdictions: A Summary*, ___ Tax L. Rev. ___ (___).

⁶ Meaning that firms do not charge VAT on their sales, but are entitled to credit or refund of the VAT paid on their inputs. ‘Exemption’ again means that no output VAT is charged, but in this case no credit or refund is given for input VAT paid.

⁷ The European Union, for instance, has a long-standing objective of establishing an origin-based VAT: Article 432 of the core VAT Directive 2006/112/EC provides that the arrangements it sets out “...for the taxation of trade between Member States are transitional” (see note 37 for a description of these arrangements) “and shall be replaced by definitive arrangements based in principle on the taxation in the Member State of origin of the supply of goods.” Quite what is meant by the reference to “origin” here remains unclear: the clearing house arrangements proposed by the European Commission in 1986, for instance, involved some charging of tax in the exporting country but was in effect a way of implementing the destination principle in the sense above.

simply that some tax is charged in the exporting jurisdiction—can perfectly well be part of a system for implementing the destination principle.

Who sets the tax rate is also critical, since—in combination with who gets the revenue—it shapes policy-makers’ incentives in tax-setting, and hence the tax rates that will emerge in equilibrium. And it is those tax rates that drive the price signals to which the real economy responds, and hence that determine the economic efficiency of the resulting allocation. Conditional on the tax rates that are set, who gets the revenue is a question of distribution, not efficiency.

It is important too to be clear, given its multi-stage nature, on what a VAT designed on the origin principle would look like. What is required for each jurisdiction to levy tax on the value created within its own borders, in principle, is for the exporting jurisdiction to tax exports like domestic sales and the importing jurisdiction to then give a credit against its own output VAT not for the tax that was actually paid in the exporting jurisdiction but rather for that which would have been paid had tax been levied at the importing jurisdiction’s own rate.⁸

The destination principle—and with revenue accruing to the country of import—is the norm in international trade, and sanctioned by WTO rules.⁹ The Commonwealth of Independent States operated some varieties of origin-principle taxation among themselves for some while, but no longer does so.¹⁰ Elements of origin-principle taxation are found, however, within some federations, whose experiences are reviewed elsewhere in this volume.¹¹

What though does economic theory say of the appropriate choice of principle? For once, as will now be seen, it gives a reasonably clear answer: though the case is not unambiguous, the destination principle is noticeably the more attractive.

⁸ Suppose for example that a good with producer price of \$100 is exported from a country with a VAT rate of 10 percent to another where the VAT rate is 25 percent: the appropriate credit is then $(\$110/1.25)0.25 = \22 . This ensures that the part of the value that is added in the country of export is taxed at 10 percent and sets the stage for taxing further value added beyond that at 25 percent. This is referred to as the “stage of processing method” by Gene Grossman, *Border Tax Adjustments: Do They Distort Trade?*, 10 *J. Int’l Econ.* 117 (1980), and as the “notional credit method” by Bernd Genser, Andreas Haufler & Peter Birch Sørensen, *Indirect Taxation in an Integrated Market: Is There a Way of Avoiding Trade Distortions Without Sacrificing National Autonomy?*, 10 *J. Econ. Integration* 178 (1995).

⁹ Footnote 1 of the Agreement on Subsidies and Countervailing Measures provides that “...the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy.”

¹⁰ This experience is described and evaluated by Katherine Baer, Victoria Summers & Emil Sunley, *A Destination VAT for CIS Trade*, 6 *MOCT-MOST Economic Policy in Transitional Economies* 87 (1996).

¹¹ Perry, note 5.

A. Equivalence Results—and their Limitations

There are circumstances in which the choice of principle is irrelevant, in the sense that both lead to the same real outcome. To see this, consider first a country that applies a destination-principle VAT at 10 percent to all consumption, and suppose, to begin, that it has balanced trade with the rest of the world and no net foreign assets. Then the real effects of shifting to an origin-principle VAT at the same uniform 10 percent rate can be undone by a 10 percent depreciation of the real exchange rate, brought about by some mixture of nominal devaluation and a reduction in the domestic price level.¹² The underlying reason for this equivalence is straightforward: trade being balanced, national consumption is equal to national consumption—so taxing either has exactly the same effect.

This result is in some respects quite general. For a country running a trade surplus, for example, shifting to the origin principle will mean a wider tax base and hence more revenue. This has no efficiency implication—as noted above, the effect could be offset by international transfers—but, more to the immediate point, equivalence will continue to hold in present value terms if trade must be balanced in the long run, as in many (though not all) trade models it must be. Nor does the result require that market behavior be perfectly competitive.¹³ But the conditions required are restrictive, nonetheless. A change of base may, for instance, impact old and young differently (the former currently consuming on the basis of earnings from past production, the latter still earning to finance future consumption), and real exchange movements will have income effects through the domestic value of net foreign assets.¹⁴ Moreover, and perhaps most fundamentally, the result requires that all commodities be taxed at the same proportionate rate. The prevalence of exemptions and multiple rates in practice makes this a condition that is rarely if ever satisfied. Although little is known of how significant this implied non-equivalence is likely to be in practice, the implication is that, even leaving practical considerations aside, the choice between destination and origin principles is one of economic substance.

B. Comparing Tax Principles When Equivalence Fails

¹² Suppose for instance that the United States initially imposes a 10 percent destination-principle tax, imports wine from Europe at €2 per bottle, exports cars at \$10,000 per car, and that the exchange rate is initially \$1=€1. Thus U.S. consumers pay \$2.20 for a bottle of wine, and EU consumers pay €10,000 for an American car. Suppose now that the United States switches to an origin basis at a (tax-exclusive) rate of 10 percent, and that the dollar devalues to \$1.1=€1. Wine, now bearing no tax in the United States, again costs the consumer \$2.20; and American car manufacturers receive a tax-inclusive price of \$11,000, which, after tax, leaves them with \$10,000, just as before. The same effect could be achieved at an unchanged nominal exchange rate if the domestic price of US cars were to fall to \$9,091.

¹³ The most general equivalence results are in Ben Lockwood, David de Meza & Gareth Myles, *When Are Destination and Origin Regimes Equivalent?*, 1 *Int'l Tax & Pub. Fin.* 5 (1994).

¹⁴ Lans Bovenberg, *Destination and Origin-based Taxation under International Capital Mobility*, 1 *Int'l Tax & Pub. Fin.* 247 (1994).

In navigating through the choice between the origin and destination principles, one must consider their critically different efficiency properties:

- The destination principle leaves business inputs untaxed in all jurisdictions, and in doing so preserves—assuming competitive market behavior—*production efficiency*: it does not directly interfere with firms’ production decisions, by, for instance, causing them to use domestically rather than foreign-produced inputs solely because they are less heavily taxed. Since imports and exports are taxed identically, the destination principle means that producers of tradable goods in different jurisdictions face the same after-tax prices (expressed in some common currency) when selling into any particular jurisdiction; and, in equating their marginal costs of production to those prices, producers will be led to equate their marginal costs among themselves. Failure of this condition would mean a production inefficiency, since global output could be increased (and hence someone’s welfare increased) by shifting production from jurisdictions in which the marginal cost is high to that in which it is low.
- The origin principle, in contrast, achieves *consumption efficiency*: since consumers pay the same price for any commodity whichever jurisdiction they reside in, they will attach the same relative values to those commodities. If that were not the case, overall welfare could be increased by shifting the consumption of commodities from jurisdictions in which, at the margin, they are relatively little valued by final consumers to those in which they are relatively highly valued.
- It is easily seen too that, unless all commodities are taxed at the same rate (in which case the comparison between them is largely vacuous, as noted above), the destination principle violates consumption efficiency, and the origin principle violates production efficiency.¹⁵

Suppose then, temporarily suspending disbelief, that tax rates in each jurisdiction were set cooperatively between them (or by some central authority) and that revenues could be shared freely among them. Which tax principle would one then expect to be chosen? In these circumstances, the production efficiency theorem of Diamond and Mirrlees¹⁶ applies: assuming competitive behavior (and some further conditions),¹⁷ any

¹⁵ Note too that, as anticipated above, neither form of efficiency constrains the allocation of tax revenue across jurisdictions.

¹⁶ Peter Diamond & James A. Mirrlees, Optimal Taxation and Public Production I: Production Efficiency, 61 Amer. Econ. Rev. 8 (1971); Peter Diamond & James A. Mirrlees, Optimal Taxation and Public Production II: Tax Rules, 61 Amer. Econ. Rev. 261 (1971).

¹⁷ The theorem requires, in particular, that any pure profits can be taxed at up to 100 percent; otherwise input taxation may be a useful way of pursuing distributional objectives. Quite what this might mean from a policy standpoint is unclear, however, so that production efficiency remains a central benchmark. The discussion here also assumes away production-related externalities (such as from carbon emissions); these can in principle be dealt with by targeted corrective taxes.

Pareto-efficient tax structure¹⁸ will be characterized by production efficiency—and hence by adoption of the destination principle. The underlying reasoning is straightforward. Suppose an element of the origin principle is in place, with some production decisions consequently being distorted: a tax on some input, for example, may be leading firms to use other inputs instead even though, in the absence of the tax, doing so would be more costly. Then, valued at the tax-exclusive prices that are relevant from the social rather than private perspective, firms' production methods are unduly costly: aggregate output is lower than it could be. Eliminating that input tax would increase output, and, by reconfiguring the taxes on final consumption, the government can ensure that some of that additional output is captured in tax revenue while still leaving enough left over for consumers to benefit too. In a setting of full cooperation between the jurisdictions, the destination principle would thus unambiguously be preferred over the origin.

There are caveats to this conclusion, as always. Most fundamentally, if revenue cannot be explicitly transferred between jurisdictions—as certainly seems the more plausible assumption in an international context, and historically too across states within the United States—then the Diamond-Mirrlees theorem simply does not apply, and production inefficiency may be an acceptable price to pay as an indirect way of transferring revenue between jurisdictions.¹⁹ In principle, Pareto-efficient taxation may thus require an element of the origin principle. Imperfect competition can also overturn the result, as the origin principle can then provide a way of improving production efficiency: inefficient production in some country that is able to survive behind some degree of monopoly power could in principle be dealt with by taxing its inputs at differentially high rates.²⁰ In both of these cases, however, use of the origin principle is not the best-targeted response to the underlying policy problem: direct interjurisdictional revenue transfers would enable production efficiency to be retained, and anti-trust policy could resolve the underlying production inefficiency without distorting prices faced by consumers. A strong case for use of the destination principle thus remains.

It is more likely, however, that jurisdictions will not set their taxes cooperatively, but rather with an eye to their own interests. They will have an incentive to use their indirect tax structures as imperfect surrogates for the tariffs they would like to impose but (we assume here) for some reason cannot. This means seeking to move the terms of trade in their favor, and/or to extract rents from foreign enterprises, by restricting both the domestic demand for their imports and the supply of their exports. By acting in this way, jurisdictions would have adverse effects on each other. Experience in the EU suggests that this can indeed be a significant problem. The UK, for instance, has been required on

¹⁸ Meaning one such that no tax change can be found that would make one person better off without making someone else worse off.

¹⁹ Michael Keen & David Wildasin, Pareto-Efficient International Taxation, 94 *Amer. Econ. Rev.* 259 (2004).

²⁰ Michael Keen & Sajal Lahiri, The Comparison between Destination and Origin Principles under Imperfect Competition, 45 *J. Int'l Econ.* 323 (1998).

these grounds to lower the (destination principle) rate applied to beer relative to that on (mainly imported) wine. The question then is whether these adverse fiscal externalities are likely to be systematically less marked under one principle than the other. The answer is no: there are examples in which the noncooperative outcome is worse under the destination principle than the origin, and examples in which the opposite is true.²¹ The issue may, in any event, be less likely to arise under the VAT, since implementation considerations give governments a strong incentive to minimize the degree of differentiation across commodities likely to be needed to capture the most obvious opportunities for this kind of gamesmanship. The presumption in favor of the destination principle is thus somewhat weakened, but survives.

There is another and more practical difficulty with an origin-principle VAT along the lines described above. This is that it creates an incentive for enterprises to establish transfer prices for their intermediate transactions so as to have value added appear to arise in low-VAT jurisdictions. No such incentive arises under the destination principle, since intermediate prices have no impact on tax ultimately payable. Extending to the VAT the range of transfer pricing problems that have caused such difficulties for corporate taxation is evidently best avoided if possible, providing a substantial practical consideration to reinforce the general theoretical preference for the destination principle.

II. Implementing the Destination Principle

Once one has settled on the destination principle as the basic design feature for interjurisdictional trade, the inquiry turns to how that principle should be implemented. Our discussion of implementation issues focuses principally on *international* trade in goods and services, although we also address issues that will arise at the subnational level under some basic assumptions regarding the U.S. subnational response to the adoption of a national VAT.

A. The Destination Principle as a Proxy for the Location of Consumption

It is important to be clear what is meant by “consumption” (though as will be seen it remains a somewhat slippery concept). As economists understand and use the term, only people consume. Businesses buy and use capital goods, office supplies and the like—but they do not consume them in this sense. Indeed, even to talk about business consumption is something of an oxymoron.²² Crucially, it is consumption in the economists’ sense that underlies both the expression of and the rationale for the

²¹ Ben Lockwood, *Commodity Tax Competition under Destination and Origin Principles*, 52 *J. Pub. Econ.* 141 (1993).

²² Indeed, one of us explicitly made this point in discussing the fundamental flaws in the U.S. retail tax, which includes substantial business purchases in its base: “[F]rom a normative standpoint, the very notion of ‘business consumption’ is an oxymoron. Since the sales tax base is designed to be a tax on personal consumption, ‘business consumption’ by definition lies outside its scope.” Jerome R. Hellerstein & Walter Hellerstein, *State and Local Taxation* 697 (8th ed. 2005).

destination principle set out above. That principle is therefore entirely silent on which jurisdiction should tax business-to-business (B2B) transactions, which needs to be resolved by administrative concerns. The use of the term “place of consumption” in connection with the imposition of VAT on business purchases, for example, is simply a crude way of describing a particular rule for determining the jurisdiction in which the place of taxation should be identified for business purchases (and especially to distinguish it from another rule, in which taxation occurs where the sales in question originate). The decision as to where to impose tax might reasonably be guided by some “best guess” as to the jurisdiction in which, somewhere further down the production chain, consumption by people will occur (as in relation to transactions connected to immovable property, for instance). But the considerations that should guide decisions on place of taxation for border-crossing B2B transactions must ultimately be pragmatic. What is needed is a sensible and practicable rule that facilitates implementation of the destination principle—the taxation of final consumption by real people.

It is also important to recognize that in many (if not most) cases consumption is not directly observable. What we can hope to observe is spending, and where it takes place, and take that as a proxy for consumption and where it occurs. Even in the context of cross-border trade in goods,²³ where typically there is no controversy over identifying the destination of the sale, the location of the purchaser can be no more than a proxy for the location of consumption. Thus, a purchaser may take delivery in the United States of an automobile that he has ordered from abroad, and subsequently drive it across Canada where he will be “consuming” at least some of its value, but no one would seriously suggest that a VAT should seek to tax such consumption where it actually occurs. In the context of services, the role of the destination principle as a proxy for the location of consumption – as distinguished from an effort to identify where consumption actually occurs – is even more pronounced, because controversy can arise over the appropriate concept of “destination” with respect to the sale of services.²⁴

The fundamental point is that the destination principle is a rule of tax administration that seeks to approximate the location of consumption in a sensible and administrable fashion, not a theoretical ideal that seeks to identify the location where consumption actually occurs. As Rebecca Millar has pointed out (relying on Sijbren Cnossen’s description of a VAT as a tax on “consumption expenditures” rather than a tax on consumption itself),^{25, 26} the place of taxation under a VAT should not depend on

²³ See Section II(B).

²⁴ See Section II(C).

²⁵ Sijbren Cnossen, VAT Treatment of Immoveable Property, in *Tax Law Design and Drafting*, Vol. I, 232 (Victor Thuronyi, ed., 1996).

²⁶ This is related to a further potential pitfall in the use of the term “consumption.” The consumption of some commodities may not in itself directly generate consumer well-being. Some have argued, for instance, that financial services are inputs to the production of household well-being, not direct sources of well-being themselves, and on that ground should not be subject to VAT. But the same could be said of

where actual consumption takes place.²⁷ Instead, recognizing the transactional nature of a VAT, and the fact that it is a tax on consumption expenditures at the time and place where they are incurred,

place of taxation rules focus almost exclusively on using proxies to predict the expected place of consumption. The concept of consumption underlying a modern VAT can thus be understood by examining the proxies used for determining the place of consumption for particular types of supply.²⁸

Understanding this point at the outset allows us to pursue the question of how the destination principle should be implemented from the pragmatic perspective that we are trying to accomplish something that is good enough for government work, which, after all, is what taxation is all about, rather than satisfying a theoretical norm of identifying where consumption actually occurs.

B. Cross-Border Trade in Goods

Implementing the destination principle with respect to cross-border trade in goods is relatively straightforward, at least in theory. When the seller of goods is in one jurisdiction and the purchaser is in another, the goods generally are taxed where they are delivered. To accomplish this goal, exported goods are commonly zero-rated²⁹—as described above³⁰—and imported goods are taxed at the border.³¹ For the most part, border controls provide an effective mechanism for assuring collection of VATs on cross-border supplies of goods at their destination.³² In addition, the destination principle is often implemented in the B2B context, by “reverse charge” mechanisms pursuant to which registered business purchasers, who are subject to control and audit by taxing

almost anything: there is no sure way of knowing what those final objects of well-being are. It is the use of commodities by final consumers that is, in principle, the appropriate object of the VAT.

²⁷ Rebecca Millar, *Jurisdictional Reach of VAT*, in *VAT in Africa* 175 (Richard Krever, ed., 2008).

²⁸ *Id.* at 180.

²⁹ Liam Ebrill, Michael Keen, Jean-Paul Bodin & Victoria Summers, *The Modern VAT* 184 (2001). Under the EU VAT, for example, if a taxable supply is zero-rated, the supplier need not collect VAT on the sale of the supply, and the supply is effectively relieved of VAT altogether at origin, because the supplier can obtain a credit or refund for the payment of any VAT on inputs related to its acquisition or production.

³⁰ See note 6 and accompanying text.

³¹ See Walter Hellerstein, *Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective*, 38 *Ga. L. Rev.* 1, 28 (2003).

³² Organisation for Economic Cooperation and Development, *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* 124 (2001) [hereafter OECD, *Ottawa Framework Conditions*].

authorities at destination, self-assess the VAT.³³ This is currently the case for trade in goods between Member States in the EU, for instance: goods are zero-rated in the exporting Member State, and importing registered traders then account for import VAT not at the border but in their first periodic return, at which point they both charge themselves tax and claim any credit due against sales.

This is not to suggest that the destination principle as applied to goods creates no difficulties. Zero rating of exports can lead to fraud,³⁴ causing a loss of revenue when goods that are purportedly exported are in fact sold locally and traders claim input tax refunds on the purported exports.³⁵ If border controls are not air tight, and sometimes even if they are, individual consumers can avoid the destination principle through cross-border shopping, particularly with respect to high value, easily transported goods, which they illegally (or legally) bring back across the border.³⁶ And, in circumstances in which there are effectively no borders – or, at least, no fiscal frontiers – between different taxing units, as between the EU Member States since 1993,³⁷ between the U.S. states (and local jurisdictions), and between Canadian provinces, one needs to develop other mechanisms for assuring collection of VATs (and other consumption taxes) on goods at destination, or (in effect) to allow substantial amounts of cross-border trade to go untaxed, at least in the

³³ Id. at 30.

³⁴ Ebrill, et al., note 29, at 184.

³⁵ International VAT Association, *Combating Fraud in the EU: The Way Forward* (2007).

³⁶ Ebrill, et al., note 29, at 184 (“It has been estimated, for instance, that in 1986 about one-quarter of all spirits drunk in the Republic of Ireland were bought in Northern Ireland.”); cf. SEC (2007) 170/2, Commission Staff Working Document Accompanying the Proposal for a Council Directive Amending Directive 2003/96/EC as Regards the Adjustment of Special Tax Arrangements for Gas Oil Used as Motor Fuel for Commercial Purposes and the Coordination of Taxation of Unleaded Petrol and Gas Oil Used as Motor Fuel, Impact Assessment 7-8 (“Whereas the consumption of diesel per capita is less than 750 litres in other Member States, it amounts to more than 4200 litres in Luxembourg, a Member State with a diesel excise duty rate lower than all of its neighbors”).

³⁷ In 1993, the original EU VAT system was modified to move the system more in the direction of a single internal market by abolishing existing collection and fiscal controls at the border and replacing them with administrative controls at the enterprise level. Council Directive 91/680/EEC of 16 December 1991 supplementing the common system of value added tax and amending Directive 77/338/EEC with a view to the abolition of fiscal frontiers. The current (“transitional”) system is based on taxpayer identification, administrative records of the enterprises, and automated exchange of information between tax authorities of Member States. Richard Doernberg, Luc Hinnekens, Walter Hellerstein & Jinyan Li, *Electronic Commerce and Multijurisdictional Taxation* 94-105 (2001). The so-called “definitive system,” which as noted earlier would impose a VAT at origin and which assumes a substantial degree of harmonization of rates (if not an EU-wide VAT) as well as the revenue sharing, id. at 105-07, has never been (and may never be) introduced. Hence the “transitional” system continues to apply. For a more detailed discussion of these issues, see Sijbren Cnossen, *Taxing Consumption in Common Markets and Federations: Lessons from European Experience*, ___ *Tax L. Rev.* ___ (___).

business-to-consumer (B2C) context.³⁸ Possible mechanisms of the former kind are discussed in section III.B below.

Despite these difficulties, the widely accepted, if imperfect mechanisms for implementing the destination principle with respect to cross-border trade in goods are generally workable and appear to be appropriate for the design of a U.S. VAT at the national level.

C. Cross-Border Trade in Services

Implementing the destination principle is more complicated with respect to the taxation of cross-border trade in services than with respect to cross-border trade in goods.³⁹ Part of the problem is simply historical. Until fairly recently, cross-border trade

³⁸ Indeed, in the United States, one of the gaping holes in the destination-based retail sales tax is created by the rule, reflecting implied constitutional restraints supporting a national common market, that a vendor without physical presence in a state cannot be required to collect a sales or “use” tax on sales destined to consumers in those states. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Accordingly, many B2C Internet and mail-order sales from non-physically present remote vendors effectively go untaxed in the US states, at a considerable cost to state treasuries. See Donald Bruce, William F. Fox & LeAnn Luna, *State and Local Revenue Losses From E-Commerce*, 52 *State Tax Notes* 537, 545-46 (2009) (citing estimates of uncollected tax revenue from just the e-commerce share of remote sales for 2007 through 2012, rising from \$7.2 billion (or 2.4% of tax collections) to \$11.4 billion (or 3.8% of tax collections). (This is less of a problem in the B2B context because of self-assessment mechanisms, resale exemptions, and audits.) By contrast, in the EU, under the distance-selling rule, when a vendor in one Member State makes sales of goods to nontaxable persons in other Member States, and those sales exceed a specified euro threshold, the vendor is required to register for VAT in the destination state and to charge the destination state’s VAT on its sales. See Doernberg, et al., note 37, at 109-11. In Canada, if the provincial Goods and Services Tax (GST) is harmonized with the federal GST, the federal government collects the entire tax (including the provincial tax) on the interprovincial sale and remits the appropriate provincial tax to the destination province. See generally Richard M. Bird & Pierre-Pascal Gendron, *Sales Taxes in Canada: The GST-HST-QST-RST “System,”* ___ *Tax L. Rev.* ___ (____). If the provincial GST is not harmonized with the federal GST, then no provincial GST is collected on B2C interprovincial imports, except to the extent that consumers comply with self-assessment mechanisms. As for interprovincial retail sales taxes (RSTs) on B2C transactions, “provincial sales taxes rely on provisions similar to and probably no more effective than the so-called use tax common in the United States.” Richard M. Bird, *Is a State VAT the Answer? What’s the Question?*, 45 *State Tax Notes* 809, 821 (2007). With respect to international imports, the Canada Border Services Agency has made arrangements with most provinces to collect provincial sales taxes (regardless of whether they are imposed in GST or RST form) on imports for final consumption, *ibid.*, but only if the final consumer is a resident of the province at the international port of entry. *Id.* By contrast, with respect to B2B transactions, “commercial imports made by registered importers are not subject to any provincial tax on import from other provinces or from abroad. Tax on those imports is deferred at import and collected on the next taxable transaction.” *Id.* Because there is no national consumption tax in the United States, cooperation between customs officials and subnational state taxing authorities is generally limited to information sharing, which unsurprisingly does not lead to effective enforcement of subnational sales or use taxation on international cross-border shopping.

³⁹ This Article distinguishes between trade in “goods” and trade in “services” as if this embraces the entire universe of trade. While this dichotomy may make sense to those in the EU, which defines a “supply of services” as “any transaction which does not constitute a supply of goods,” Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, art. 24(1) (O.J. L. 347, 11.12.2006, p. 1) [hereinafter EU VAT Directive], other jurisdictions distinguish between trade in goods, services, and *intangibles*. Indeed, in the context of income taxation, the distinction between income from services and

in services attracted relatively little attention because most services were consumed where they were performed.⁴⁰ Consequently, there was not much cross-border trade with respect to which a “destination” needed to be identified. The general rule in many jurisdictions – that services should be taxed where the service provider is established⁴¹ – although technically an origin-based rule, in fact functioned satisfactorily as a destination-based rule, because the supplier’s location was also the customer’s location, and customer location may be viewed as a reasonable proxy for the “destination” of services.

This state of affairs changed dramatically with the enormous growth in cross-border trade in services, driven by forces of globalization and facilitated by technological innovation. With the increasing “disconnect” between performance and consumption of services in a territorial sense,⁴² the traditional rule for determining the place of taxation of services by reference to the service provider’s establishment becomes problematic. The problem was exacerbated by the growth of multinational corporations, which render services in myriad locations through complicated legal structures. But the problem of designing an appropriate regime for taxing cross-border trade services is more than the matter of recognizing that many contemporary services are in fact performed in one jurisdiction and consumed in another and simply adopting a destination rule for the place of taxation of services akin to the rule for the place of taxation of goods.

The more fundamental problem is that the enormous growth in services involving suppliers in one jurisdiction and customers in another often involves services that are intangible in nature, making it more difficult both to determine the appropriate jurisdiction of “destination” and to enforce the tax on the basis of that determination.

income from intangibles is well established. Despite the fact that trade in services and intangibles is treated differently under some VAT regimes, for purposes of this Article it makes more sense to elide the two categories, because the distinction has no significant bearing on the ensuing discussion and the reference to intangibles would introduce an unnecessary complication. It may also be worth observing that taxing jurisdictions do not all draw the line between goods and services in the same way. Rebecca Millar, *Cross-Border Services: A Survey of the Issues*, in *GST in Retrospect and Prospect* 317, 318-21 (Richard Krever & David White, eds., 2007).

⁴⁰ Organisation for Economic Cooperation and Development, Report: The Application of Consumption Taxes to the Trade in International Services and Intangibles, CTPA/CFA (2004)34, p. 4 [hereinafter OECD, Consumption Tax Report].

⁴¹ See, e.g., EU VAT Directive, note 39, art. 43 [through December 31, 2009] (deeming the place of supply of services, with some notable exceptions, to be “the place where the supplier has established his business or has a fixed establishment from which the service is supplied, or, in the absence of such a place of business or fixed establishment, the place where he has his permanent address or usually resides”). As explained briefly below and in more detail elsewhere in this volume, see Cnossen, note 37, these rules changed in important respects on Jan. 1, 2010 with regard to B2B supplies of services and will change with regard to certain B2C supplies of services on Jan. 1, 2015.

⁴² Indeed, even the place of performance may be uncertain, as when the warranty of a U.S. resident’s computer is fulfilled by a technician in Bangalore who takes electronic control of her laptop and resolves the problem through key strokes performed 8,000 miles away,

Such intangible services, which may be somewhat circularly defined as services “where the place of consumption may be uncertain,”⁴³ or, perhaps a bit more precisely, as “services and intangible property that are capable of delivery from a remote location,”⁴⁴ include services such as “consultancy, accountancy, legal and other ‘intellectual’ services; banking and financial transactions; advertising; transfers of copyright; provision of information; data processing; broadcasting; and telecommunications.”⁴⁵ The challenge, then, for VAT design is how to identify – or provide mechanisms for identifying – the “destination” of services when, in contrast to cross-border trade in goods, the destination cannot be readily identified by reference to physical flows.

1. *Tangible Services*

Before addressing implementation of the destination principle with respect to intangible services, we first consider its implementation with respect to “tangible” services, which may be defined (again somewhat circularly) as services “where the place of consumption can be readily identified.”⁴⁶ These include services relating to land and buildings, to goods, and to physical performance. Perhaps a more meaningful definition of “tangible services” would be those with respect to which sensible *proxies* for consumption can be identified by reference to the location of the performance of the services, or their link to the location of property, rather than the location of the customer.⁴⁷ The point is simply that when services have a strong connection to an identifiable physical location where consumption may be reasonably deemed to occur—and where that deemed location is not susceptible to easy modification in response to tax

⁴³ OECD, Ottawa Framework Conditions, note 32, at 24.

⁴⁴ Organisation of Economic Cooperation and Development, Committee on Fiscal Affairs, Consumption Taxation of Cross-Border Services and Intangible Property in the Context of E-Commerce (2001), reproduced in OECD, Ottawa Framework Conditions, note 32, at 44 [hereafter OECD, E-Commerce Guidelines]. For ease of exposition, we will continue to refer to these simply as “intangible services,” even though the phrase embraces intangible property as well.

⁴⁵ OECD, Ottawa Framework Conditions, note 32, at 24.

⁴⁶ *Id.*

⁴⁷ Indeed, the definitional proposition that “the place of consumption” of tangible services “can be readily identified” presumably is based on a combination of two assumptions. First, such services often will not involve cross-border trade at all, because both the supplier and the customer are in the same location, where the service is consumed (e.g., restaurant services). Second, even if such services do involve performance in one jurisdiction and consumption in another, e.g., if a movie star has her hair coiffed in London in preparation for an appearance at the Cannes film festival, where she may actually “consume” the hairdressing service, the choice of a practical place of taxation is unproblematic, whatever theoretical difficulties the choice may raise. Nevertheless, tangible services can in fact raise thorny cross-border tax issues. Analyzing the example of services provided by a real estate agent in Country A to both a buyer resident in Country A and a seller resident in Country B concerning the sale of land in Country B, Rebecca Millar demonstrates that different countries would in fact approach the transaction in different ways. Millar, *Cross-Border Services*, note 39, at 337-47. In short, the consumption of such tangible services (at least as defined above) is not always “readily identifiable” to all observers.

considerations—most VAT regimes look to those locations as suitable proxies for the place of consumption of the services in question⁴⁸ rather than to some overarching place-of-taxation rule like customer location.⁴⁹

The OECD, for example, in elaborating upon the types of services that would fall within its definition of tangible services, and therefore would be subject to taxation based on a proxy tailored to the characteristics of the services in question (rather to some overarching principle like customer location), identified “services which are not capable of direct delivery from a remote location” (e.g., hotel accommodation and vehicle rental); “circumstances where the place of consumption may be readily ascertained, as is the case where a service is performed in the physical presence of both the service provider and the customer” (e.g., hairdressing); and circumstances “when the place of consumption can more appropriately be determined by reference to a particular criterion” (e.g., services related to particular immovable property or goods).⁵⁰ Rebecca Millar likewise observed in her excellent survey of cross-border taxation of services under VATs⁵¹ that proxies other than the customer’s or recipient’s location – the “natural” choice as the primary proxy for the place of taxation of services – are typically employed in VAT regimes when the physical location of the service, or the property with respect to which the service is provided, makes that location a more practical choice for the place of taxation than the customer’s or recipient’s location. She identifies the most common proxies, apart from the location of the recipient or consumer, as:

- the location or residence of the supplier, or a location where the supplier carries on an enterprise;
- the location of the goods;
- the location of immovable property;
- the location where the supply is performed;
- the place of effective use and enjoyment.⁵²

Millar also points out that VAT regimes differ in the way that they combine the proxies, the order of their application, and the priority given to each proxy.

⁴⁸ Id. at 322.

⁴⁹ We consider such a rule below in connection with intangible services.

⁵⁰ OECD, Ottawa Framework Conditions, note 32, at 45. The OECD’s working groups charged with developing VAT/GST guidelines ultimately adopted an overarching “main rule,” to wit, customer location, for determining the appropriate place of taxation for *all* cross-border trade in services, and these working bodies are currently engaged in explicating the main rule and its applications. See Section II(C)(2).. At the same time, they are developing guidelines for “exceptions” to the main rule with respect to services that, for the most part, the OECD once described as “tangible.”

⁵¹ Millar, Cross-Border Services, note 39.

⁵² Id. at 322-23.

A U.S. VAT would presumably adopt place of taxation rules for “tangible” services analogous to those identified above, whether adopted as free standing rules or as exceptions to some overarching place-of-taxation rule like customer location. We do not here recommend any specific rules or, indeed, attempt to draw the line between “tangible” and “intangible” services, assuming that such a line should be drawn at all.⁵³ What we do recommend is that whatever rules the U.S. may adopt for tangible services be consistent with emerging international norms so as to avoid both double taxation and unintended nontaxation. Useful guidance for this undertaking will emerge from the VAT/GST Guidelines that the OECD’s Committee on Fiscal Affairs is currently developing and which we now describe in more detail in connection with intangible services.⁵⁴

2. *Intangible Services: Initial Efforts at Destination-Based Approaches to Taxation of Cross-Border Trade in Intangible Services*

The OECD’s Committee on Fiscal Affairs, and its technical advisory groups, have been in the forefront of efforts to develop conceptual and practical guidance for the application of consumption taxes to international trade in services. These efforts were spawned by concerns over the impact of electronic commerce on international cross-border taxation, both direct and indirect, which culminated in a 1998 conference in Ottawa and the OECD Committee on Fiscal Affairs’ seminal report, *Electronic Commerce: Taxation Framework Conditions*.⁵⁵ Among other things, this report delineated the overarching principles that should inform the development of principles to govern VATs and other consumption taxes in the electronic age, including embrace of the destination principle,⁵⁶ and recommendation of the use of the reverse charge or similar self-assessment mechanisms when businesses within a country acquire services and intangible services from suppliers outside the country.⁵⁷ The first concrete guidelines based on these principles were issued in 2001,⁵⁸ and they are instructive in providing

⁵³ See note 47.

⁵⁴ Organisation for Economic Cooperation and Development, *International VAT/GST Guidelines* (February 2006) [hereafter OECD, VAT/GST Guidelines]. See OECD, *Consumption Tax Report*, note 40. At this writing, there are no publicly available documents reflecting the OECD’s current work on the place of taxation of tangible services, or what it characterizes as “exceptions to the main rule,” but such documentation is likely to be available in the near future.

⁵⁵ OECD, *Ottawa Framework Conditions*, note 32, at 10. The report is set out in *id.* at 228-34.

⁵⁶ “Rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place . . .” *Id.* at 231.

⁵⁷ *Id.*

⁵⁸ OECD, *E-Commerce Guidelines*, note 44.

guidance with respect to the design of a U.S. VAT with respect to cross-border trade in intangible services.⁵⁹

a. Business-to Business (B2B) Transactions

In delineating the operational rules for taxing cross-border supplies of intangible services at the place of consumption, which we take as roughly equivalent to the concept of destination as the appropriate proxy, the OECD guidelines treat B2B and B2C transactions differently, in recognition of the different practical considerations that bear on the application of these rules in the two contexts. Although both the B2B and B2C rules look generally to the place where the recipient is located as the basic proxy for determining the place of consumption and, thus, the place of taxation,⁶⁰ the difficulty of enforcing the VAT with respect to cross-border B2C supplies of intangible services at the recipient's location, as explained further below, has led to somewhat different approaches in the two contexts.

With regard to B2B transactions, the guidelines' basic proxy for determining where consumption (and hence taxation) occurs is "the jurisdiction in which the recipient has located its business presence."⁶¹ "Business presence" is further defined "in principle" as "the establishment ... of the recipient to which the supply is made." The guidelines nevertheless recognize that "[i]n certain circumstances, countries may ... use a different criterion to determine the actual place of consumption," when application of the basic proxy "would lead to a distortion of competition or avoidance of tax."⁶² In accordance with the Ottawa Framework Conditions, the guidelines also recommend the application of a self-assessment or reverse charge mechanism (when consistent with overall design of the national consumption tax system) in circumstances when the supplying business is not registered or required to be registered for consumption tax in the country of the recipient business.⁶³

⁵⁹ The guidelines explicitly excluded "tangible" services from their application. See notes 46-52 and accompanying text.

⁶⁰ It is worth recalling, as we pointed out in Section II(A), that the notion of "business consumption" is something of an oxymoron from a normative standpoint, because the VAT is designed to be a tax on personal consumption, and where a business "consumes" a supply has no necessary role to play in determining where a supply should be taxed. Nevertheless, as we also observed, the pragmatic considerations that should inform the determination of the appropriate place of taxation for cross-border B2B supplies are administrable rules that facilitate implementation of the destination principle—the taxation of final consumption by real people. The principle that business purchases should be taxed at the recipient's location falls comfortably within this pragmatic rationale. This point should be kept in mind through the following discussion of "business consumption," although we will not repeat it.

⁶¹ OECD, E-Commerce Guidelines, note 44, at 45.

⁶² *Id.* at 45.

⁶³ *Id.* at 46.

b. Business-to-Consumer (B2C) Transactions

For B2C transactions, the OECD guidelines' basic proxy for determining where consumption (and taxation) of cross-border supplies of intangibles occurs is "the jurisdiction in which the recipient has their usual residence."⁶⁴ This is analogous to the "business presence" rule for B2B transactions. The guidelines explicitly recognize that the rule it adopted was *not* designed to determine where consumption actually occurred, but was a convenient proxy for such a determination that was dictated by administrative concerns.⁶⁵

The principal problem with this rule, as the guidelines also recognize, is effective enforcement, at least when the jurisdiction where the recipient has his or her usual residence is not one in which the supplier is registered or, under existing jurisdiction-to-tax rules, can be compelled to register.⁶⁶ In contrast to B2B transactions, where absence of effective power to require the remote vendor to collect the consumption tax can be addressed by shifting that requirement to the customer, who will ordinarily be registered in "the jurisdiction in which the recipient has located its business presence,"⁶⁷ in the B2C context, when there is no power in the jurisdiction of the private recipient's usual residence to compel the supplier to collect the tax, relying on private consumers to remit tax on their purchases is notoriously ineffective and, where it is effective, amounts essentially to a "tax on honesty."⁶⁸ To address this problem, the guidelines suggest a variety of short-term, medium-term, and long-term options, including simplified registration systems, technology-based solutions, and enhanced international administrative cooperation.

Developments in the EU with regard to the place of taxation of intangible services mirror the OECD's differential approach to B2B and B2C transactions. As explained more fully by Sijbren Cnossen elsewhere in this volume,⁶⁹ as of 2010 the EU generally embraced a customer-location rule for the place of taxation with respect to B2B supplies of intangible services, but, in light of enforcement concerns, retained a supplier-based rule with respect to the place of taxation for B2C supplies of such services. Nevertheless, recognizing the force of the general principle that B2C services should, as a normative matter, be taxed at the consumer's location, effective 2015 the EU adopted a customer-

⁶⁴ Id.

⁶⁵ Id. at 45 n.5 ("implementing this Guideline will not always result in taxation in the actual place of consumption.... However ...to apply a pure place of consumption test would lead to a significant compliance burden for vendors").

⁶⁶ Id. at 47. See generally Hellerstein, *Jurisdiction to Tax*, note 31, at 51-70.

⁶⁷ OECD, *E-Commerce Guidelines*, note 44, at 44.

⁶⁸ Hellerstein, *Jurisdiction to Tax*, note 31, at 23.

⁶⁹ Cnossen, note 37; see also note 39 (describing revised EU VAT Directive).

location rule for B2C supplies of many intangible services (telecommunications, radio and television, and electronically supplied services).⁷⁰

c. The Need for More Comprehensive Guidance

Notwithstanding the significance of the OECD's initial steps in articulating guidelines for taxing services at the place of consumption (destination), it was plain from the outset that they represented only the beginning of the process of addressing the issues involved. First, the guidelines themselves were explicitly confined to intangible services supplied in the context of e-commerce, leaving unaddressed the supply of services (tangible and intangible) in other contexts. Second, particularly in the context of B2C transactions, perhaps more questions were raised than resolved by settling on a rule that taxed final consumption in the jurisdiction of the recipient's usual residence, because of enforcement concerns. Finally, even within the B2B context, where enforcement of a rule taxing consumption where it occurs may raise fewer enforcement issues, the guidelines left numerous questions unanswered. For example, while taxing consumption at the establishment of the recipient "to which the supply is made" will presumably lead to taxation at the place of consumption (destination), the location of a recipient's establishment to which a supply of global services is made is hardly self-defining. Moreover, the exception for a different criterion better reflecting "the actual place of consumption" when the main proxy leads to "distortion of competition or avoidance of tax" without further refinement leaves more uncertainty regarding the scope of the main rule and the exception than may be desirable for tax compliance and administration purposes.

Recognizing that the problem of providing guidance for consumption taxation of international trade in intangible services in the e-commerce context was simply one facet of the broader problem of consumption taxation of international trade in services generally, the OECD's Committee on Fiscal Affairs undertook the task of providing broad guidance through the development of International VAT/GST Guidelines.⁷¹ This task is a work in progress that at this writing is – and, for the immediate future, will continue to be – the focus of considerable efforts of the OECD's Committee on Fiscal Affairs.

2. *OECD's International VAT/GST Guidelines: Implementing the Destination Principle*

The initial version of the OECD's International VAT/GST Guidelines, promulgated in early 2006, incorporates the results of the OECD's earlier work and

⁷⁰ EU VAT Directive, note 39, art. 58 (eff. Jan. 1, 2015).

⁷¹ OECD, VAT/GST Guidelines, note 54.

provides a roadmap for future work.⁷² More importantly for purposes of our inquiry, work on implementation of the destination place-of-taxation principle in the B2B context is now well under way. In late 2007, the OECD's Committee on Fiscal Affairs issued an initial paper for public consultation on "Emerging Concepts on Place of Taxation."⁷³ The purpose of the paper was not to propose specific VAT/GST Guidelines as such.⁷⁴ Rather its purpose was to explore the application of the fundamental principles, which the OECD had adopted in its earlier work, to a fairly simple set of hypothetical examples in an effort to assure that there was broad consensus as to how these principles would apply in practice. In short, the goal was a means of informing the OECD's Committee on Fiscal Affairs as it seeks to find ways of minimizing double taxation and avoiding unintentional nontaxation, particularly as applied to complex business models.⁷⁵

In implementing the principle that consumption should be taxed where consumption occurs, which is now characterized as the "destination principle,"⁷⁶ the consultation paper adopts as its basic proxy the rule that "the place of consumption should be deemed to be the jurisdiction where the customer is located ('Main Rule')."⁷⁷ After making a number of simplifying assumptions,⁷⁸ the paper then elaborates on the Main Rule that the place of taxation should be based on customer location by declaring:

The identity and the jurisdiction where the customer to which the supply is made is located will then normally be supported by the relevant business agreement, as it is expected that business agreements generally reflect the underlying

⁷² Although the precise status of the Guidelines is as yet undetermined, like most OECD guidance, they will be agreed by all OECD member countries without being binding on them, and will suggest principles that member countries, in the absence of reservations, are expected to follow.

⁷³ Organisation for Economic Cooperation and Development, *Applying VAT/GST to Cross-Border Trade in Services and Intangibles, Emerging Concepts for Defining Place of Taxation (Invitation for Comments)* (January 2008) 2 [hereafter OECD, B2B Place of Taxation Consultation Paper]. The work is being carried forward in part by a TAG.

⁷⁴ OECD, B2B Place of Taxation Consultation Paper, note 73, explanatory cover note.

⁷⁵ Id.

⁷⁶ Organisation for Economic Cooperation and Development, *Applying VAT/GST to Cross-Border Trade in Services and Intangibles, Emerging Concepts for Defining Place of Taxation – Outcome of the First Consultation Document* (June 2008), par. 5 (comments to consultation document "agreed on the 'destination principle' adopted by the CFA [Committee on Fiscal Affairs] (taxation should occur in the jurisdiction of consumption)").

⁷⁷ OECD, B2B Place of Taxation Consultation Paper, note 73, par. 4.

⁷⁸ The paper recognizes that "in order to ensure common understanding and agreement there are limitations on complexity that need to be observed at this stage." Id., par. 6. These conditions include the following: only B2B supplies are considered; all examples reflect legitimate and bona fide economic substance; and all transactions are between separate legal entities. Id.

transactions and financial flows. Only in specified or exceptional circumstances should the place of taxation vary from the main rule.⁷⁹

“Business agreement” is further defined as “any agreement, regardless of form, between persons acting in a business capacity that underlies the provision of a supply. (In most cases, documentation will reflect the existence of the business agreement).”⁸⁰

In short, the principal focus from a practical standpoint for determining the location of the customer to which the supply is made – and hence the “destination” jurisdiction of consumption and taxation – will normally be the business agreement. The examples in the paper proceed to illustrate how various business agreements determine the customer to whom the supply is made and, consequently, the appropriate place of taxation. These agreements include agreements not only between unrelated suppliers and customers, but also agreements (whether explicit or implicit) between affiliates of the respective unrelated suppliers and customers, who may be involved in the provision or receipt of the supply. As noted,⁸¹ one of the key simplifying assumptions is that all of the agreements in question – even those between related entities – are supported by legitimate and bona fide economic substance.⁸²

The basic conclusion that the business agreement will ordinarily be the focus for determining the customer location to which the supply is made – though admittedly preliminary, conditioned on a number of simplifying assumptions, and subject to variance in “specified” and “exceptional” circumstances – is extremely significant. It suggests that, at end of the day, the determination of where consumption (and thus taxation) of B2B services occurs will look to the bona fide agreements among the parties and not to other possible indicia of where consumption occurs, such as the physical flows of services between suppliers and customers.

For example, suppose that a consulting firm in Country A enters into an agreement to provide advice to a retailer in Country B, but arranges with its subsidiary in Country B (which is more familiar with market conditions there) to render the advice to the retailer.⁸³ The contractual services and physical flows may be represented as follows:

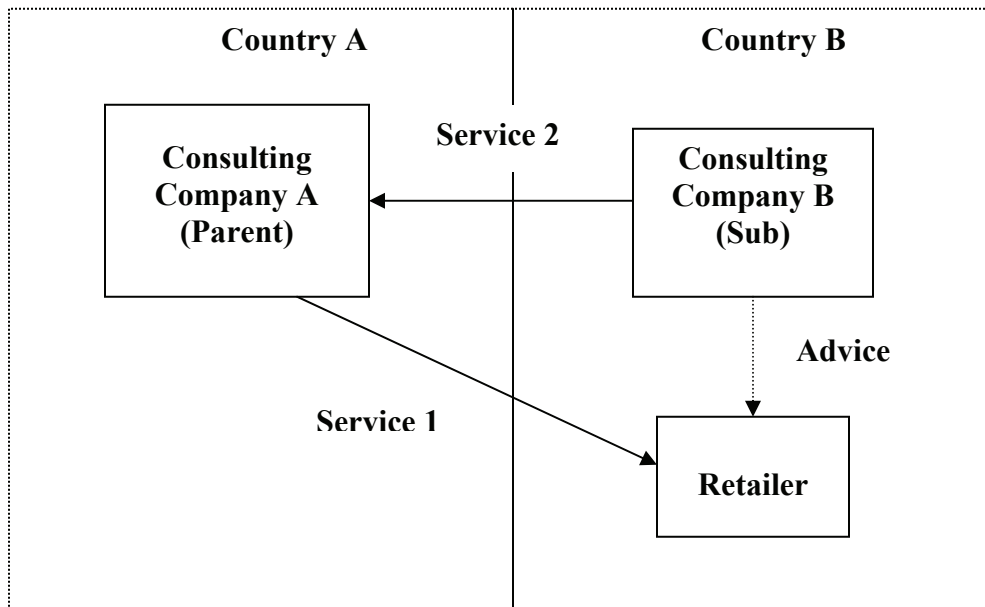
⁷⁹ Id., par. 9.

⁸⁰ Id., n. 3.

⁸¹ See note 78.

⁸² Recognizing that additional issues would be raised if the simplifying assumptions were relaxed, e.g., fraud and avoidance, the consultation paper noted that “[t]hese issues will be considered later once the fundamental principles that emerge from the simple models and examples have been understood and agreed.” OECD, B2B Place of Taxation Consultation Paper, note 73, par. 7.

⁸³ This example roughly tracks the example in OECD, B2B Place of Taxation Consultation Paper, note 73, pars. 23-24.



There are two separate business agreements, each leading to the supply of services for a consideration. Consulting Company A is the supplier and the retailer is the customer under one of the agreements (Service 1) and Consulting Company B is the supplier and Consulting Company A is the customer under the other agreement (Service 2). The place of taxation will be decided for each supply individually. In accordance with the Main Rule, the place of taxation for Service 1 will be Country B, because Country B is where the customer (the retailer) is located. The place of taxation for Service 2 will be Country A, because Country A is where the customer (Consulting Company A) is located. The place of taxation is thus determined by the business agreements, and not by reference to where or to whom the services are physically rendered.⁸⁴

Although this is only the first step in a long journey towards mature International VAT/GST Guidelines, it is an important one that may provide a template for addressing more complex issues, such as a multinational corporation's purchase (through a centralized purchasing company) of global auditing services provided by an international accounting firm. In other words, if we can determine the place of consumption (by carefully analyzing the relevant business agreement at issue) for simple examples involving international trade in services, as the consultation paper suggests we can, perhaps we can also do the same thing for more complex arrangements, which,

⁸⁴ Although reliance on the business agreements to determine the place of taxation can lead to abuses if the agreements do not reflect economic substance or are manipulated to minimize tax liabilities, the OECD paper implicitly recognizes this point through the simplifying assumption for the initial stage of its work, namely, that all examples reflect legitimate and bona fide economic substance. See notes 78 and 82.

ultimately, can be “deconstructed” into a series of business agreements that permit us to identify the customer to whom the supply is being made and its location.

Significantly, the initial response to the OECD’s approach has been quite supportive. As the OECD observed “all the comments received agreed on the ‘destination principle’ ... and on the proxy as a main rule for cross-border business-to-business transactions in services and intangibles.”⁸⁵ Moreover, “[t]here was also agreement on the principle that each transaction should be treated independently.”⁸⁶

In designing the rules for cross-border trade in services under a U.S. VAT, drafters would be well advised to pay attention to the guidance emerging out of the OECD. Not only will it reflect the collective wisdom of many with long experience in working with VATs, it will – because of the OECD’s consensus-based decision making – also reflect views of many of our most significant trading partners on the recommended design features of 21st century VATs in an effort to minimize double taxation and avoid unintentional nontaxation, while keeping in mind administrative concerns.

III. Subnational Issues

The analysis in the preceding section focused entirely on design issues associated with a national VAT regime. We said nothing about how this regime might interact with the existing (or some hypothesized) subnational regime. In his Article in this volume on coordination of a federal VAT with state and local RSTs or VATs, Charles McLure has identified the key issues that must be addressed in this respect and has offered a number of recommendations as to how those issues should be resolved.⁸⁷ The discussion here complements the discussion there, providing context for and elaborating upon the issues addressed by McLure insofar as they concern interjurisdictional design issues.

In the first subsection, our discussion will operate under the assumption, which reflects practical reality, that even with the adoption of a federal VAT, states and localities will retain their RSTs rather than adopting state and local VATs. Thus we initially focus on the existing universe of state and local RSTs and how they might be modified in light of the existence of a federal VAT. Subsection B considers broad options for designing the interjurisdictional aspects of state-level VATs and coordinating them with a federal VAT.

⁸⁵ Organisation for Economic Cooperation and Development, *Consumption Tax Trends 2008* 35 (2008).

⁸⁶ *Id.*

⁸⁷ Charles E. McLure, Jr., *How to Coordinate State and Local Sales Taxes with a Federal Value Added Tax*, ___ *Tax L. Rev.* ___ (____).

A. The American RST and the Destination Principle

If the destination principle is going to be implemented at the state and local level under subnational RSTs in coordination with a federal VAT, it may be instructive to consider the existing landscape of subnational RST rules regarding cross-border sales if only to understand the challenges, and the extent of the changes that will need to be made, under a coordinated consumption tax regime. While McLure alludes to some of these rules, and their interaction with a national VAT, we describe them here in a bit more detail.

1. Goods

The American RST by and large embraces the destination principle in its application to the sale of goods, at least at the *state* level.⁸⁸ “Imports” shipped from outside the state to purchasers within the state are generally subject to sales or use tax in the state of destination,⁸⁹ and “exports” shipped from within the state to purchasers outside the state are generally exempt from sales or use tax in the state of origin.⁹⁰

While broadly reflected in the rules and practice governing the RST, the destination principle is nevertheless subject to some significant refinements and exceptions. First, the legal standard governing the place of taxation of tangible personal property is typically stated in terms of the place of “delivery”⁹¹ or place of transfer of title or possession, a standard that may not always describe the state of destination.⁹² Thus when goods are purchased in over-the-counter transactions by nonresident shoppers, the

⁸⁸ This generalization does not apply to the sale of services. See Section III(A)(2).

⁸⁹ If the sale occurs within the state, the sales tax will apply; if the sale occurs outside the state or in interstate commerce, the use tax will apply. See generally 2 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ch. 16 (3d ed. 1998 & Cum. Supp. 2009). Sales and use taxes are functionally equivalent and complementary, i.e., the use tax applies only when the sales tax is inapplicable. Even though the sales or use tax is legally due in the destination state, the states’ ability to require out-of-state vendors to collect the tax depends on whether the vendor has a constitutionally sufficient nexus with the state, which the U.S. Supreme Court in *Quill* defined as physical presence. See note 38; see generally 2 Hellerstein & Hellerstein ch. 19.

⁹⁰ John Due & John Mikesell, *Sales Taxation: State and Local Structure and Administration* 271 (2d ed. 1994). We use the term “imports” and “exports” in this context to signify goods shipped from or to other states or countries. The U.S. Supreme Court has confined the meaning of the term “Imports” and “Exports” in the Import-Export Clause of the Constitution, which bars “Imposts” or “Duties” on “Imports” or “Exports,” U.S. Const. art. I, § 10, cl. 2, to foreign imports and exports. See 1 Hellerstein & Hellerstein, note 89, ¶ 5.01.

⁹¹ See, e.g., *State v. Dorhout*, 513 N.W.2d 390, 393 (S.D. 1993) (“In determining whether a taxable event occurred in South Dakota for sales tax purposes, the question is: where was the sale consummated by delivery?”).

⁹² See 2 Hellerstein & Hellerstein, note 89, ¶ 18.02[2].

state in which the goods are delivered will almost invariably impose a sales tax on the transaction, even though it may not be the ultimate destination for the goods nor the state in which they are actually consumed. Furthermore, while the use tax in principle serves to reinforce the sales tax to create a destination-based consumption tax,⁹³ the states' inability to enforce the tax with respect to physically remote vendors⁹⁴ means that many consumer expenditures escape taxation on a destination basis. The substantial taxation of business purchases under the sales and use tax⁹⁵ likewise tends to undermine the character of the sales and use tax as a destination-based tax, at least if the tax is evaluated in light of personal consumption expenditures.

a. Implications for Coordination of Destination Principle

As the preceding discussion suggests, and as McLure has observed, two significant changes would have to be made with respect to the treatment of goods under the existing RST to effectuate the destination principle and the alignment of the ultimate burden of the national VAT and the state RST.

i. *Remote Vendor Collection*

First, there would have to be a more robust enforcement mechanism for B2C sales than exists under current U.S. constitutional standards, which often preclude the destination state from requiring remote vendors to collect the tax.⁹⁶ This could be accomplished by the stroke of a congressional pen in the form a sensible distance selling rule. However, abolition of the present rule in the absence of substantial simplification of the state and local use tax “system” would impose the very compliance burdens on remote vendors that led the U.S. Supreme Court to articulate the existing constitutional restraints on mandatory remote vendor collection.

In fact, legislation has been introduced into Congress – but has not yet been enacted –authorizing individual states, under specified conditions, to require collection of sales and use taxes with respect to sales by remote sellers, notwithstanding their lack of physical presence in the state (otherwise constitutionally required under the *Quill*

⁹³ See *id.* ¶ 16.01[2].

⁹⁴ See note 38.

⁹⁵ See John Mikesell, Thomas Neubig, Robert J. Cline & Andrew Phillips, Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services, 35 State Tax Notes 457 (2005); Raymond J. Ring, Jr., Consumers' Share and Producers' Share of the General Sales Tax, 52 Nat'l Tax J 79 (1999); Raymond J. Ring, Jr., The Proportion of Consumers' and Producers' Goods in the General Sales Tax, 42 Nat'l Tax J. 167, 175 (1989).

⁹⁶ With regard to B2B sales, this problem is less acute because in many instances the sales will be exempt sales for resale, and, even when the business is taxable, “direct pay” or self-assessment mechanisms and the ability to audit registered businesses reduces the enforcement gap.

decision⁹⁷), if the state has adopted the provisions of the Streamlined Sales and Use Tax Agreement (SSUTA).⁹⁸ SSUTA is a collective effort of the states to streamline, simplify, and, to a certain degree, harmonize their sales and use taxes. Specifically, the proposed legislation declares that it is the “sense of Congress” that SSUTA – to the extent that it meets congressionally prescribed simplification requirements (which generally track those embodied in SSUTA) –

provides sufficient simplification and uniformity to warrant Federal authorization to Member States that are parties to the Agreement to require remote sellers, subject to the conditions provided in this Act, to collect and remit the sales and use taxes of such Member States and of local taxing jurisdictions of such Member States.⁹⁹

The proposed legislation declares that “[t]he Congress consents to the ... Streamlined Sales and Use Tax Agreement.”¹⁰⁰ This explicit consent, coupled with the “sense of Congress” language quoted above reflecting Congress’s intent in granting such consent, removes any Commerce Clause barrier to the requirement of any member state that remote vendors collect taxes on sales to local consumers.¹⁰¹ If the states satisfy SSUTA’s requirements, Congress would authorize mandatory collection by remote sellers, but with additional conditions and limitations beyond those required by SSUTA. These include, among other things, an exception for “small” sellers (i.e., those with less than \$5 million of nationwide remote sales), reasonable seller compensation (including compensation that covers all tax-processing costs of remote sellers), and federal court review of controversies arising under SSUTA. Again, it is important to keep in mind that this is *proposed* legislation, and states that have conformed their tax bases under SSUTA have, for the moment at least, done so on a voluntary basis.

ii. Taxation of Business Inputs

The second change in existing state RSTs required to effectuate implementation of the destination principle (and facilitate coordination with the federal VAT) would be a broader exemption of business inputs than exists under the current RST. Although a well-designed RST would be a single-stage levy on household expenditures (just as a well-

⁹⁷ See note 38.

⁹⁸ See, e.g., H.R. 3396 (“The Sales Tax Fairness and Simplification Act”), 110th Cong., 1st Sess. (2007), on which the ensuing discussion is based. SSUTA is discussed in more detail below. See Section III(A)(3).

⁹⁹ H.R. 3396, § 3(a).

¹⁰⁰ *Id.* § 2.

¹⁰¹ It is plain that Congress has the requisite authority to make SSUTA mandatory by exercising its affirmative power to regulate commerce among the states. See Charles E. McLure, Jr. & Walter Hellerstein, *Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals*, 31 *State Tax Notes* 721 (2004); see generally 1 Hellerstein & Hellerstein, note 98, ¶ 4.23.

designed VAT is a multiple-stage levy on household expenditures), and would exclude business inputs from the tax base, the states' RSTs deviate substantially from this norm. According to a number of studies, roughly 40 percent of state sales tax revenues are attributable to business purchases.¹⁰² A tax that treats business purchases as taxable sales, and does not allow a full exemption or credit for the tax burden imposed on business, will be imposed on an origin rather than a destination basis.

Although this problem, too, could be resolved by the stroke of a congressional pen, the political and revenue implications of congressional reconfiguration of the RST base are much more complex than the relatively transparent trade-off of greater simplification and harmonization in return for authority to impose a distance selling rule embodied in the proposed Streamlined legislation described above. As McLure points out, the enormous reduction in the RST base and the higher RST rates that would be required to achieve revenue neutrality if business inputs were removed from the state RST suggest that this thorn in the side of a destination-based RST would be particularly difficult to extract.¹⁰³

2. *Services*

Implementing the destination principle for cross-border trade in services under state RSTs in coordination with a national VAT presents a number of additional issues beyond those that we have described above with respect to goods.¹⁰⁴ To understand these issues, one must first have some appreciation of how states treat services under their RSTs.

a. *Taxation of Services Under State RSTs*

For the most part, the taxation of cross-border trade in services under state RSTs does not raise problems from a technical design standpoint for the simple reason that state RSTs generally do not extend to services.¹⁰⁵ Although most states have traditionally taxed some services (e.g., public utility services and hotel services), and a few states (e.g., Hawaii and New Mexico) have always taxed a broad range of services,¹⁰⁶ the states

¹⁰² See note 95.

¹⁰³ McLure, note 87.

¹⁰⁴ The issues we have identified with respect to goods, however, would likewise apply with respect to taxable services, namely, the problem of requiring remote vendors to collect the tax on B2C sales and the problem of taxing the inputs of businesses whose sales are subject to tax.

¹⁰⁵ See 2 Hellerstein & Hellerstein, note 89 ¶ 12.05. Needless to say, the failure of state RSTs to tax household services is a fundamental design flaw in the state RSTs at least judged by the normative standards for a good consumption tax. However, for purposes of our initial discussion, we shall consider the RST we have, not the RST we would like to have.

¹⁰⁶ There may be some question whether the broad-based gross receipts taxes in Hawaii and New Mexico are more properly characterized as retail sales taxes or as business gross receipts (turnover) taxes. See

have historically limited the sales tax base to tangible personal property and selected services. The original explanation for the limited scope of the sales tax base lies partly in the desire to create a simple and easily administrable tax and partly in the perception that a tax on services would have constituted a tax on labor. Once so limited, however, political resistance to additional taxes helped confine the sales tax principally to sales of tangible personal property, at least until relatively recently.

Despite the states' historical reluctance to extend the sales tax to services, economic and fiscal pressures have been pushing them in that direction. The significant shift in economic activity toward the service sector has had the effect of eroding the sales tax base relative to total consumption expenditures.¹⁰⁷ As Harley Duncan has observed, “[t]he inexorable shift in consumer expenditures from the purchase of goods to the purchase of services continues to raise concerns about the long-term vitality of state retail sales taxes which traditionally are applied primarily to the sale of tangible personal property.”¹⁰⁸ In response to these developments in the American economy, there has been a gradual but piecemeal expansion of the sales tax base to selected services. These include (in addition to utility, admissions, and hotel and motel services that most states tax), services such as repair of tangible personal property; repair of real property; data processing services; information services; and cleaning services.¹⁰⁹ In general, however, the states have not extended the RST base to the services that would generate the greatest revenues – such as construction, professional services, and health care.¹¹⁰

Walter Hellerstein, Michael J. McIntyre, and Richard D. Pomp., *Commerce Clause Restraints on State Taxation After Jefferson Lines*, 51 *Tax L. Rev.* 47, 88-93 (1997) (characterizing New Mexico levy as retail sales tax and noting that “Hawaii’s tax regime is the most difficult to characterize”). The discussion in this paper is limited to RSTs (and to those portions of other levies that are designed to and intended to operate as RSTs) and does not apply to taxes that are explicitly designed as taxes on business activity, such as Washington’s business and occupation tax, *id.* at 89-90, and Ohio’s recently enacted Commercial Activities Tax. Ohio Rev. Code Ann. § 5751.02 (Westlaw 2009).

¹⁰⁷ Thus from 1960 to 1991, the share of personal consumption expenditures for services (excluding housing) increased from 26 percent to 42 percent. National Council of State Legislatures & National Governors’ Association, *Financing State Government in the 1990s* 34 (1993). During the same period, the share of personal consumption expenditures for tangible goods fell from 60 percent to 44 percent. *Ibid.* By 2002, expenditures for services had reached 59.1 percent of total consumer expenditures. William F. Fox, *The Ongoing Evolution of State Revenue Systems*, 88 *Marquette Law Review* 19, 41 (2004).

¹⁰⁸ Federation of Tax Administrators, *Sales Taxation of Services: An Update* i (1994).

¹⁰⁹ See Due & Mikesell, note 90, 92-97; Research Institute of America, *All States Tax Guide* ¶ 259-A (2008) (chart), available at www.checkpoint.riag.com; Commerce Clearing House, *Multistate Sales Tax Guide* ¶ 900-710 (2008) (chart), available in CCH Internet Tax Research Network, www.tax.cchgroup.com.

¹¹⁰ William F. Fox, *Importance of the Sales Tax in the 21st Century*, in *The Sales Tax in the 21st Century* 1, 3 (Matthew N. Murray & William F. Fox, eds., 1997). Moreover, the attempts of two states (Florida and Massachusetts) to expand the sales tax base broadly to include most services were repealed shortly after they were enacted. Samuel B. Bruskin & Kathleen K. Parker, *State Sales Taxes on Services: Massachusetts as a Case Study*, 45 *Tax Law.* 49 (1991); Walter Hellerstein, *Florida’s Sales Tax on Services*, 41 *Nat’l Tax J.* 1 (1988). One may argue that Florida reaped the bitter harvest of bad tax policy by not exempting business services, including advertising. A simpler (although not entirely inconsistent) explanation is that the tax could not survive the fierce opposition of those who buy ink by the barrel. *Id.*

b. Existing State RST Rules Regarding Cross-Border Trade in Services

Although the states generally do not tax services under their RSTs, when they do and the services are performed in one state but consumed in another, the sale of such services raises questions analogous to those raised by the cross-border trade in goods. However, in contrast to the RST rules regarding the appropriate place of taxation for cross-border sales of goods, which generally adhere to the destination principle, the RST rules regarding the appropriate place of taxation for cross-border sales of services are neither as consistent nor as well established as they are with respect to goods.

i. *Destination Principle*

In some instances, states follow the same destination principle that they employ in connection with sales of goods, taking the position that services should be taxed in the state in which they are delivered or enjoyed. They therefore exempt services “if the beneficial use of the service occurs entirely outside the state.”¹¹¹ Moreover, a number of states, by statute, regulation, or administrative pronouncement, follow the rule (analogous to the rule prevailing with regard to sales of tangible personal property) that information services, computer services, and other electronically deliverable services are taxable when the purchaser is located within the state and exempt when delivered to out-of-state purchasers.¹¹²

It is worth noting that these exemptions for “exported” services deal with only one half of the universe of cross-border trade in services – namely, services performed within the state but delivered or consumed outside the state. To deal with the other half of the relevant universe – services performed outside the state but delivered or consumed within the state – states must enact a use tax on services, for the same reason that they are required to apply a use tax to goods sold outside the state but delivered within the state.¹¹³

¹¹¹ See *In re State and Municipal Sales and Use Tax Liability of K.O. Lee Co.*, 489 N.W.2d 606, 610 (S.D. 1992). A New York tribunal, for example, drawing on the analogy to the retail sale of tangible personal property, held that because the sales tax is a consumption-based “destination” tax, the sale of information services delivered by electronic means should be allocated according to the number of the seller’s clients’ offices within and without New York State having access to the electronic reports. Paul R. Comeau, Advisory Opinion of New York Commissioner of Taxation and Finance, TSB-A-90(43)S, Sales Tax, August 20, 1990.

¹¹² See, e.g., D.C. Mun. Regs. tit. 9, §§ 475.8, 475.9 (Westlaw 2009) (taxing information services for use or consumption within the District and exempting information services “sold and delivered by the vendor to locations outside the District”); Pa. Rev. Pronouncement 60.13(b)(1) (1997) (sale of computer services subject to tax if predominant use of the service is in Pennsylvania; computer services delivered to a Pennsylvania location are presumed to be predominantly used in Pennsylvania); Tex. Tax Code Ann. §§ 151.010, 151.051, 151.101 (Westlaw 2009) (imposing tax on each “taxable item,” defined to include taxable services, sold or used in this state); Tex. Tax Code Ann. § 151.330(e) (Westlaw 2009) (exempting “[s]ervices performed for use outside this state”).

¹¹³ 2 Hellerstein & Hellerstein, note 89, ¶ 16.14.

Although some states do impose use taxes on services, the application of use taxes to services is much less systematic than is the application of use taxes to tangible personal property.¹¹⁴ Accordingly, even within the relatively narrow universe of taxable services, the states that apply the destination principle on “exported” services may fail to extend the principle to “imported” services.

ii. Origin Principle

Some states take the position that a sale of services takes place in – and is taxable by – the state in which the services are performed, even though the services are in effect “delivered” and consumed outside the state.¹¹⁵ Although a performance-based rule may be inconsistent with a consumption tax predicated on a destination basis,¹¹⁶ this position may recommend itself from an administrative perspective because the taxing authorities of the state in which services are performed always will have jurisdiction over the service provider and thus will be in a position to enforce collection of the sales tax.¹¹⁷

iii. Apportionment

There is yet a third variation on the rule of the place of taxation for cross-border trade in services. States sometimes take the position that a sale of services may be apportioned among the states in which they are used depending on the extent of use. In Texas, for example, if an information service is used to support a customer’s business that is conducted at locations within and without the state, the service is taxable only to the extent that it is used within Texas, and the taxpayer “may use any reasonable method for allocation which is supported by business records.”¹¹⁸ The District of Columbia regulations likewise provide for proration of the District tax on information services.¹¹⁹ Thus “[i]nformation services performed or delivered outside the District for use within other jurisdictions as well as for use within the District shall be subject to a prorated share

¹¹⁴ Id. ¶ 16.14[2].

¹¹⁵ See, e.g., *Airwork Service Division v. Director, Division of Taxation*, 2 N.J. Tax 329 (1981), *aff’d*, 4 N.J. Tax 532 (Super Ct., App. Div. 1982), *aff’d*, 478 A.2d 729 (N.J. 1984), *cert. denied*, 471 U.S. 1127 (1985) (sustaining tax on repair services performed in state on airplane engines delivered to customer outside the state); *Matter of Airlift International, Inc. v. State Tax Commission*, 382 N.Y.S.2d 572 (App. Div. 3d Dep’t 1976) (sustaining tax on repairs of airplanes used in interstate and international commerce).

¹¹⁶ In many instances, of course, there is no inconsistency, because the services are performed in the same state in which they are consumed.

¹¹⁷ These same concerns, of course, have informed the EU’s “slow motion” approach to embrace of the destination principle in the B2C context. See notes 69-70 and accompanying text.

¹¹⁸ 34 Tex. Admin. Code § 3.342(g) (Westlaw 2009).

¹¹⁹ D.C. Mun. Regs. tit. 9, § 475.8 (Westlaw 2009).

of the District use tax; provided that no sales tax was required to be paid on that prorated share to the other jurisdiction.”¹²⁰

3. *The Streamlined Sales and Use Tax*

The inconsistency in the states’ rules for taxing cross-border trade in services under their RSTs, coupled with the limited application of RSTs to services, exacerbates the problem of implementing the destination principle of RSTs with respect to services in coordination with a federal VAT that presumably would apply to most services purchased by households. While Congress possesses ample power to deal with this problem by forcing a uniform base and cross-border tax rules upon the states,¹²¹ which would be compatible with the federal VAT, such a “top down” solution is likely to encounter serious political resistance from the states. There is, however, one other development, to which we have briefly alluded above, that may provide some room for optimism on this score and warrants some attention.

Notwithstanding the states’ somewhat eclectic approach to taxing services as an historical matter, there is good reason to take at least a brief look at their approach to taxing services (as well as goods) in conjunction with their collective efforts over the past decade, under the auspices of the Streamlined Sales Tax Project (SSTP), to simplify and

¹²⁰ DC Mun. Regs. tit. 9, § 475.9 (Westlaw 2009). See also note 111 (describing New York ruling allocating sale of information services according to the number of the seller’s clients’ offices within and without the state). It worth noting that even within individual states, there are variations and inconsistencies with regard to the place of taxation of cross-border services. Thus, Arkansas generally imposes a tax on repair services performed within the state, Ark. Code Ann. § 26-52-301(3)(C)(i) (Westlaw 2009), including services performed on property for out-of-state customers. *Ragland v. Allen Transformer Co.*, 740 S.W.2d 133 (Ark. 1987), cert. denied, 486 U.S. 1007 (1988). However, it exempts repair services on (1) railroad cars, parts, and equipment “brought into the State of Arkansas solely and exclusively for the purpose of being repaired, refurbished, modified, or converted within this state,” Ark. Code Ann. § 26-52-301(3)(C)(iii) (Westlaw 2009); (2) “watches and clocks which are received by mail or common carrier from outside this state and which, after the service is performed, are returned by mail or common carrier or in the repairman’s own conveyance to points outside this state,” id. § 26-52-301(3)(C)(iv); and (3) “industrial metal rollers or platens that have a remanufactured, nonmetallic material covering on all or part of the roller or platen surface which are brought into the State of Arkansas solely and exclusively for the purpose of being repaired or remanufactured in this state and are then shipped back to the state of origin.” Id., § 26-52-301(3)(C)(v). Such variations within individual states plainly reflect the untidy reality of the political process rather than any principled distinction between the proper place of taxation for various categories of services.

¹²¹ Although one might contend that Congress’s power to require uniformity in state tax bases extends only to cross-border transactions, because the Commerce Clause grants Congress the power only to regulate commerce “among the Several States,” U.S. Const. art. I, § 8, it is well settled that the power granted to Congress to regulate interstate commerce is not limited to interstate transactions, but extends to intrastate transactions that affects Congress’s regulation of interstate commerce. *Shreveport Rate Case (Houston E. & W. Texas Ry. v. United States)*, 234 U.S. 342 (1914). Hence, there could be no serious constitutional objection to Congress requiring the states to adopt uniform tax bases for intrastate as well as interstate transactions, because of the burden that adoption of inconsistent “intrastate” and “interstate” tax bases would impose on interstate commerce, by requiring traders to distinguish between the two classes of transactions.

harmonize their sales and use tax regimes.¹²² The initial work was undertaken by the SSTP, whose participants included forty-four states and the District of Columbia – all the states with sales taxes except Colorado. The primary task of the SSTP was to draft the Streamlined Sales and Use Tax Agreement (SSUTA), which is the foundational document for the streamlined system and which became effective on October 1, 2005. At that point, the newly formed Governing Board of SSUTA member states assumed responsibility for the governance, administration, and continued development of SSUTA.

As of June 2009, nineteen states had fully conformed their sales taxes to SSUTA and become full members of its Governing Board, whereas an additional three associate member states were slated to be in compliance with SSUTA by July 1, 2009.¹²³ These states comprise roughly one-third of the population of the states with sales taxes (roughly equal to the combined populations of California, New York, and Texas). It is expected that other states soon will follow suit by conforming their sales tax laws to SSUTA and becoming part of the streamlined sales tax system. The pace of conformity would likely speed up considerably with the enactment of pending federal legislation, described briefly above,¹²⁴ that would authorize states adopting SSUTA to require remote vendors to require use tax collection by remote vendors.

Much of the Governing Board's work has focused on harmonizing the definitions of various product categories. It should be kept in mind that the goal of SSUTA is *not* to establish a uniform tax base among the various jurisdictions, but rather to establish a uniform set of definitions of categories of items that states can choose to tax or not tax as they see fit, as long as they tax (or exempt¹²⁵) the category, as uniformly defined. In addition, the Governing Board continues to develop the Streamlined Sales Tax Registration System (SSTR) to meet the requirements of SSUTA to implement a web-based system that will enable taxpayers to volunteer to register to participate in SSUTA. In this respect, it is important to keep in mind, in light of the lack of a congressional mandate underlying SSUTA, that while the states' voluntary harmonization of their product definitions under SSUTA applies to all sellers, no seller is required to register under SSUTA and thus commit itself to collecting taxes in all member states, including those in which it is not required to do so under federal constitutional principles. Nevertheless, states provide sellers with a significant incentive for registering under SSUTA, namely, protection from liability for failing properly to collect sales or use tax, if they use SSUTA-certified intermediaries or software for tax collection,¹²⁶ as well as

¹²² See generally Walter Hellerstein & John A. Swain, *Streamlined Sales and Use Tax* (2008).

¹²³ See *Streamlined Sales Tax, Governing Board States, State SST Status Map*, available at www.streamlinedsalestax.org (visited on June 1, 2009). Most of these states had relatively small populations.

¹²⁴ See notes 98-100 and accompanying text.

¹²⁵ In VAT terminology, one would use the term “zero-rate” rather than exempt. See note 6 (explicating the distinction between zero-rating and exemption under a VAT).

¹²⁶ SSUTA § 306; Hellerstein & Swain, note 122, ¶ 7.11[4][a].

elimination of the uncertainty that, at the end of the day, some court determines that the seller has constitutional nexus in one or more states where the taxpayer failed to collect sales or use tax.¹²⁷

a. SSUTA’s “Sourcing” Provisions for Sales of Products (including Services)

i. *Overview*

One of the central features of SSUTA – and the feature that is of interest here – is the set of uniform “sourcing” rules¹²⁸ for assigning the sales tax base to states on a uniform basis. Indeed, SSUTA identifies the provision of “[u]niform sourcing rules for all taxable transactions”¹²⁹ as one of the essential features of the streamlined system designed to “simplify and modernize sales and use tax administration.”¹³⁰ Although a detailed discussion of SSUTA’s sourcing rules is beyond the scope of this Article,¹³¹ a brief review of SSUTA’s approach to place-of-taxation issues is instructive as a template for what is likely to be the benchmark to which state RSTs increasingly adhere in the immediate future.

In implementing the requirement of “uniform sourcing rules,” SSUTA adopts a set of “general” sourcing rules for most transactions. These rules broadly embrace the destination principle, and they apply in a prioritized sequence depending on the circumstances surrounding the particular transaction (e.g., where the product is received) and the availability of information regarding the destination or the constructive destination of the sale (e.g., the purchaser’s address). These general provisions apply in principle “regardless of the characterization of a product as tangible personal property, a digital good, or a service.”¹³² Although it may be linguistically awkward to speak about digital downloads or services as “products,” the decision to treat the sale of all products according to a single set of sourcing rules will tend to avoid disputes over the classification of a sale to achieve a particular sourcing result. In practice, however,

¹²⁷ Of course, sellers can avoid this uncertainty under existing state tax regimes simply by registering with the state taxing authority.

¹²⁸ The term “sourcing rules” to describe the appropriate place of taxation of sales may seem awkward, if not misleading, because the “source” of a sale may be thought of as its origin, whereas most of SSUTA’s sourcing rules are in fact destination-based. In adopting this terminology, we are simply playing the hand we were dealt, as it were, by following the terminology employed by SSUTA. See SSUTA §§ 309-15 (describing “sourcing rules”).

¹²⁹ SSUTA § 102(F).

¹³⁰ SSUTA § 102.

¹³¹ For such a discussion, see Hellerstein & Swain, note 122, on which the ensuing discussion is based.

¹³² SSUTA § 309.

specific sourcing rules are more likely to apply to some types of products than to others. In addition to the general sourcing rules, SSUTA adopts a few individualized sourcing rules for specific industries or classes of transactions for which the general sourcing rules may be inappropriate. These include direct mail,¹³³ telecommunications,¹³⁴ and leasing or rental.¹³⁵

ii. General Sourcing Rules

SSUTA provides a hierarchical series of five general sourcing rules for the sale of all products (including services) except those specifically sourced under other provisions or excluded from SSUTA's scope altogether. In broad and somewhat oversimplified terms, these rules are as follows:

1. When a purchaser receives a product in an over-the-counter transaction at the seller's business location, the sale is sourced to that business location.
2. When (1) does not apply, the sale is sourced to the location where the purchaser receives the product – typically, the purchaser's "ship to" or delivery address – if the seller knows the location.
3. When (1) and (2) do not apply, the sale is sourced to the purchaser's address if it is available from the seller's business records.
4. When (1), (2), and (3) do not apply, the sale is sourced to the purchaser's address obtained during the consummation of the sale (including the address of the purchaser's payment instrument).
5. When none of the foregoing rules applies, the source of the sale is its origin (i.e., the point from which property was shipped, from which digital products were transmitted, or from which services were provided).¹³⁶

These rules are designed to implement the underlying principle that a sale should be sourced on a destination basis. In so doing, they take into account the information about the destination that a seller could reasonably be expected to possess at the time of the sale. In the case of an over-the-counter sale or a sale with a geographically determinate delivery address, the sourcing rules follow the physical flow of the product (including services and digital products). When physical product flows cannot be determined, the sourcing rules rely on the purchaser's address if the seller is in a position

¹³³ SSUTA § 313.

¹³⁴ SSUTA § 314.

¹³⁵ SSUTA §§ 310(B)-310(D).

¹³⁶ SSUTA § 310(A).

to know that address. Finally, recognizing that there may well be situations in which one cannot reasonably determine the destination of a sale on the basis of available information regarding physical flows or the seller's address, SSUTA adopts an origin-based sourcing principle as a default rule.

Needless to say, some of these rules are awkward at best as applied to services (and digital products) and only time will tell whether they can be effectively administered. Broadly speaking, however, they do reflect the same general principle that underlies OECD and EU initiatives¹³⁷ to tax trade in cross-border services, namely, by focusing on the customer rather than the vendor in determining the appropriate place of taxation.¹³⁸ Moreover, they provide a marked improvement over the preexisting pattern of rules (especially for services) under the pre-SSUTA RSTs. Most important, the very existence of SSUTA provides an institutional framework within which the interjurisdictional design requirements of a national VAT operating simultaneously with subnational RSTs might be coordinated.

4. *Local Sourcing Issues*

a. Overview

There is one additional feature of the state and local RST landscape that needs to be surveyed in connection with cross-border design issues and coordination with a national VAT, namely, the *local* component of this landscape. Although commonly viewed as an integral and functionally indistinguishable component of the nation's "state and local" RST regime, local sales and use taxes often have a legal and fiscal life of their own in state and local tax administration. Indeed, were it not for the specter of thousands of local tax jurisdictions with their "many variations in rates of tax, in allowable exemptions, and in administrative requirements,"¹³⁹ it is questionable whether physical presence would have remained the jurisdictional touchstone for imposing a use tax collection obligation on interstate sellers. Instead, relying heavily on the administrative burdens imposed on the interstate vendor by local taxing jurisdictions, the U.S. Supreme Court has twice sustained the physical-presence test in this context, fearing that to do otherwise "could entangle a [mail-order house] in a virtual welter of complicated obligations."¹⁴⁰

¹³⁷ The OECD initiatives are described in Section II(C) above; the EU initiatives are described in note 39, text accompanying notes 69-70, and Cnossen, note 37.

¹³⁸ As we have already observed, there is a fundamental dichotomy in a theoretical sense between the OECD/EU approach to these issues, which explicitly recognizes the distinction between B2B and B2C transactions, and the U.S. approach, which does not, except insofar as the sale-for-resale "exemption" applies. However, as we have also observed, both the OECD and the EU have drawn a distinction between B2B and B2C transactions when it comes to the practical rules for implementing the destination principle.

¹³⁹ *Quill Corp. v. North Dakota*, 504 U.S. 298, 313 n.6 (quoting *National Bellas Hess, Inc. v. Department of Revenue*, 386 US. 752 (1967)).

¹⁴⁰ *Id.*

In recognition of this problem, one of the key SSUTA reforms is the requirement that member states unify the state and local tax base within each state and administer these taxes on the state level.¹⁴¹ Moreover, and of more direct concern to the cross-border issues with which we are principally concerned, the SSUTA sourcing rules described above apply for both state and local tax purposes.¹⁴² Accordingly, if a product is delivered to a customer in the city of Wichita, Kansas then the seller collects tax at the combined Kansas state rate and Wichita local rate, whether the vendor is based in another city in Kansas or in some other state. Compliance with such a rule would seem simple enough, and the conformity of local to state sourcing rules would simply mean that the only problem, in addition to those identified above at the state level, would be adding the appropriate local rate to the state rate.

The problem, however, is that prior to Kansas's adoption of SSUTA, sellers in other cities in Kansas who delivered products in Wichita, Kansas were accustomed to collecting (and were required to collect) tax at the rate prevailing in the city in which the sellers was located. In other words, *origin sourcing* was, and still is, the rule for local taxes in many jurisdictions in connection with *intrastate* cross-border sales. This disparity between the *origin-based intrastate* cross-border place of taxation rule and the *destination-based interstate* cross-border place-of-taxation rule is threatening SSUTA's adoption in some states (based on administrative and revenue concerns discussed immediately below) and causing other states to consider withdrawal from SSUTA.¹⁴³ More pertinent to our inquiry, it raises additional questions of tax coordination with respect to a national VAT and the presumed continued existence of state *and local* RSTs. As McLure has noted, "in theory it is not enough to identify the state of destination and collect its tax; ideally local sales (or use) taxes should also be collected on a destination basis...."¹⁴⁴

This is not the appropriate place to explore this question in detail.¹⁴⁵ For present purposes, it suffices to describe the problem briefly and identify it as one of the obstacles to be overcome in connection with the adoption of a national VAT – assuming the states have not already resolved it along the lines prescribed by SSUTA.

b. Obstacles to Adopting Destination-Based Sourcing at Local Level

¹⁴¹ SSUTA § 302.

¹⁴² SSUTA §§ 309-15.

¹⁴³ See generally Hellerstein & Swain, note 122, ¶ 6.08; John Swain & Walter Hellerstein, The Political Economy of the Streamlined Sales and Use Tax Agreement, 58 Nat'l Tax J. 605, 612-13 (2005).

¹⁴⁴ McLure, note 87, at ____.

¹⁴⁵ Such an exploration can be found in Hellerstein & Swain, note 122, ¶ 6.08.

At first blush, asking local sellers to use the SSUTA destination-based sourcing rules would seem to be a matter of little concern. After all, would not a single, unified set of sourcing rules ease compliance burdens? However, it is generally easier for businesses that ship or deliver products outside their local taxing jurisdictions to apply an origin rule:

The seller presumably understands the applicable law in the jurisdictions from which she operates more easily than the law of the multiple jurisdictions in which she sells. An origin system also negates the need to know and record the location of the purchaser for application of the correct tax...¹⁴⁶

The burden of retaining delivery information may be particularly acute for local businesses, which are more likely to use “informal” means of delivery (pizza delivery is an oft-repeated example¹⁴⁷) than businesses engaged in making interstate shipments via common carrier. Further, the relative compliance burden under a destination-based system generally is greater for small businesses, and small businesses are more likely to be local businesses that make only intrastate – but inter-locality – sales.

A second impediment to adoption of destination-based sourcing for intrastate transactions is the shift in local revenue allocation that will result in some states. Local governments in states that previously used origin-based sourcing will gain revenue to the extent that the dollar volume of taxable incoming intrastate deliveries exceeds the dollar volume of taxable outgoing intrastate deliveries, but lose revenue to the extent such outbound dollar volumes exceed inbound dollar volumes.¹⁴⁸ Thus, a shift from origin-based to destination-based sourcing of sales from one locality to another would produce “winners” and “losers” within each affected state. Of course, local jurisdiction revenue might be reallocated by state law, but local governments are wary of relying on state legislatures to reallocate revenues to maintain the status quo.

These general observations are supported by the reception with which some jurisdictions greeted destination-based sourcing. Governing Board member states Ohio, Tennessee, and Utah all struggled with the transition to destination-based sourcing at the

¹⁴⁶ Streamlined Sales Tax Project, Sourcing Issue Paper 1 (Jan. 2002), available at www.streamlinedsalestax.org (site visited June 1, 2009).

¹⁴⁷ The idea of saddling a pizza parlor that makes deliveries in a multi-county metropolitan area with the burden of tracking, and charging different sales tax, based on the county of delivery, is typically offered as an irrefutable example of why local sourcing rules are appropriate.

¹⁴⁸ This shift is particularly acute in those localities where distribution facilities are located. For instance, if a locality contained a large distribution center for a computer manufacturer, it is possible that this locality would receive the local tax revenue of *all* the sales and use taxes associated with sales within the state. Shifting from origin-based to destination-based sourcing would result in this locality losing a large percentage of these sales and use tax collections.

local level,¹⁴⁹ and destination-based sourcing has been the major impediment to Texas membership. Destination-based local sourcing is also inhibiting other states from considering SSUTA compliance legislation. Resolution of the local sourcing issue is critical to the long-term viability of the streamlining movement.

Because of fears that failure to accommodate local concerns about origin-based local sourcing might cause the loss of some associate member states¹⁵⁰ and impede efforts to attract new member states, the Governing Board agreed in 2007 to amend SSUTA *on a conditional basis* to allow states to elect origin-based local sourcing.¹⁵¹ The concession to local governments was a clear deviation from the SSUTA's initial embrace of destination-based sourcing. Accordingly, in apparent recognition of the fact that the origin-based local sourcing amendment was a pragmatic compromise, the amendment's coming into force was conditioned on proof that it had actually achieved its objective of increasing SSUTA membership. The amendment becomes effective only if at least five states that were not full SSUTA member states prior to December 31, 2007 make the election and become full members states by January 1, 2010.¹⁵² As we go to press, it remains to be seen whether the origin-based local sourcing option will come into force.

c. Obstacles to Retention of Origin-Based Sourcing on the Local Level

Despite the possibility of an elective origin-based “solution” to the local sourcing problem, there are both constitutional and policy-based objections to this approach. This can be illustrated by example. Assume the following facts:

1. Buyerville and Sellertown are located in State A.
2. The local sales and use tax rate is greater in Buyerville than in Sellertown.
3. Buyer in Buyerville is considering making a purchase for delivery to Buyer's home from one the following three sellers: (a) Local Seller in Buyerville, (b) Intrastate Seller in Sellertown, or (c) Interstate Seller in State B.

If State A has an origin-based sourcing rule for intrastate transactions, but a destination-based rule for interstate transactions, then there is a risk of constitutionally impermissible discrimination against interstate commerce because Buyer has an incentive to place an

¹⁴⁹ All these states initially had the more limited “associate member” status due in whole or in part to lack of local sourcing uniformity. See note 123 and accompanying text.

¹⁵⁰ See note 149 and accompanying text.

¹⁵¹ SSUTA § 310.1. The provision is described in detail in Hellerstein & Swain, note 122, ¶ 6.08[3].

¹⁵² SSUTA § 310.1(D)(2).

order with Intrastate Seller rather than with Interstate Seller.¹⁵³ Origin-based local sourcing would allow Intrastate Seller to collect only the lower Sellertown tax, while destination-based interstate sourcing would require Interstate Seller to collect the higher Buyerville use tax. Note that a destination-based local sourcing rule eliminates this risk because it would require Intrastate Seller to collect the higher Buyerville use tax, just as Interstate Seller is required to do.

The crux of the problem is now apparent: whenever a state allows political subdivisions to impose a local sales or use tax, we move from two classes of sales (intrastate and interstate) to three classes of sales—intralocal/intrastate,¹⁵⁴ interlocal/intrastate,¹⁵⁵ and interstate.¹⁵⁶ As a result, the potential for discrimination exists not only between intrastate and interstate sellers in general, but more specifically, between (1) intralocal/intrastate sellers and interstate sellers¹⁵⁷ and (2) interlocal/intrastate sellers and interstate sellers.¹⁵⁸

d. Concluding Observations

As the foregoing discussion reveals, state and local tax policymakers are on the horns of a dilemma. Adherence to the destination principle on the local level presents compliance challenges for some local taxpayers and revenue loss concerns for some local governments. To allow local origin-based sourcing in combination with destination-based taxation of interstate sales, however, can give rise to claims of unconstitutional discrimination against interstate commerce and related claims in the political arena of unfair treatment of interstate sellers. Moreover, it violates basic norms of tax policy described in some detail above. The existence of a national VAT would facilitate a destination-based approach and surely bring additional pressure on the states to adopt a destination-based approach to sourcing intrastate sales in accordance with the demands of SSUTA and sound tax policy.

¹⁵³ Although not a Commerce Clause concern, this rule also discriminates against Local Seller.

¹⁵⁴ Sales that do not cross local borders.

¹⁵⁵ Sales that cross local, but not state borders.

¹⁵⁶ Sales that cross state borders.

¹⁵⁷ Because the states apply a destination rule to all interstate sales, in principle there is no risk of discrimination in this context.

¹⁵⁸ This potential discrimination could be avoided by the uniform imposition of a single statewide local tax rate, as well as by the adoption of identical intrastate and interstate sourcing rules. But the revenue would still flow to the “wrong” (origin) locality under the former approach.

B. State-level VATs: How Should They Be Structured?

1. *The issue*

As Charles McLure suggests in his Article in this volume,¹⁵⁹ adoption of a federal VAT seems unlikely to be accompanied by wholesale adoption of VATs at the state level.¹⁶⁰ But it might be a good thing if it were, if not immediately then over the longer run. A core design question would then be how interstate commodity trade would be treated under the state-level VATs.

The rationale for the destination principle, set out above, applies with the same force to the treatment of distinct states (and indeed localities) within a federation as it does across independent countries. Implementation, however, becomes systematically more difficult as jurisdiction size falls, both because smaller economies tend to be more open, so that the treatment of trade becomes a large issue, and because direct sales to consumers in other jurisdictions become more pervasive. Geography and other circumstances matter in this context: in relation to goods at least, the latter problem may be less severe for the non-contiguous states, for instance. Nevertheless, the destination principle retains its force as a benchmark policy objective.

The standard way of implementing the destination principle under the VAT in the presence of interjurisdictional trade in goods, as has been noted, is by zero-rating exports and bringing imports fully into tax. Though not without its difficulties, this has proved broadly manageable in developed countries that have effective fiscal controls at borders, enabling some significant degree of physical monitoring to verify that goods were indeed exported and to bring imports into tax. The standard approach creates potential difficulty, however, when—as with trade between the states (and localities) in the US—there are no such controls. The opportunities for fraud are then enhanced, and governments are faced with a difficult balance to strike between combating evasion and ensuring that denial of legitimate refund claims does not turn the VAT into a de facto export tax. The point is neatly put by Richard Ainsworth:¹⁶¹ not only does zero-rating exports weaken the VAT chain, undermining the fractional collection that is the essential and distinctive rationale

¹⁵⁹ McLure, note 87.

¹⁶⁰ McLure's Article also discusses in some detail the design of local VATs, conditional on the existence of state VATs. For brevity, the focus in the discussion here is on the state level (so that we speak specifically of "states" rather than lower-level jurisdictions). Broadly speaking, the difficulties posed by a state-level VAT implemented by zero-rating interstate trade, which motivate much of this discussion, would apply a fortiori to local-level VATs.

¹⁶¹ Richard T. Ainsworth, *Carousel Fraud in the EU: A Digital VAT Solution*, 42 *Tax Notes Int'l* 443 (2006).

for the tax, but it does so at a particularly weak point in that chain, namely, where control is passed from one tax administration to another.¹⁶²

These difficulties are significant. The sums at stake are substantial: refunds in developed economies commonly amount to 30 percent or more of gross collections. Importantly, relative to gross VAT revenues they are likely to be even larger in smaller jurisdictions, since they will typically also be more open to trade. Experience with subnational VATs¹⁶³ indicates that, with the sole exception of Quebec's GST,¹⁶⁴ in no federal country does any lower-level jurisdiction apply a VAT that implements the destination principle by zero-rating sales to other jurisdictions. The EU, which has not had internal fiscal controls since 1992, does zero-rate exports of goods between member states (bringing imports into the VAT not at the border but in the traders' next periodic return). And in the last few years the EU has perceived a significant loss from the fraud thereby facilitated.¹⁶⁵

One other feature of this problem is worth noting.¹⁶⁶ This is that the absence of fiscal controls makes the problem of taxing cross-border trade in goods essentially the same as that of taxing cross-border trade in intangible services, discussed above. What makes taxing transactions in intangibles difficult is the inability to monitor and, if need be, intercept them at border points, and removing fiscal frontiers creates the same problem for goods. This suggests that a coherent approach to either problem must also embrace the other, and the need for a more coordinated approach to both than has commonly been found.

2. Options

There are a number of possible responses to these difficulties. It may be that while the individual frauds associated with the standard approach can be spectacular (and, not least, make good media copy), their quantitative significance is modest, relative not only to other (less spectacular) forms of VAT fraud (such as simple under-declaration of final

¹⁶² Graham Harrison & Russell Krellove, "VAT Refunds: A Review of Country Experience, International Monetary Fund Working Paper WP/05/218b (2005). In some cases—notably the UK, where the figure rises to 40 percent—this also reflects domestic zero-rating. Ebrill et al., note 29, provide a simple formula for gauging the rough magnitude of refunds to be expected given, inter alia, the economy's degree of openness.

¹⁶³ These are reviewed by Perry, note 5, elsewhere in this Symposium.

¹⁶⁴ The QST is discussed by Bird & Gendron, note 38, elsewhere in this Symposium.

¹⁶⁵ See Cnossen, note 37, and McLure, note 87, elsewhere in this Symposium. See also Michael Keen & Stephen Smith, VAT Fraud and Evasion: What Do We Know and What Can Be Done?, 59 Nat'l Tax J. 861 (2006).

¹⁶⁶ This point is also stressed in Cnossen, note 37, elsewhere in this Symposium.

sales) but also compared to alternative taxes.¹⁶⁷ And it may be, in the EU context, that much can be achieved by improved information sharing and other cooperation between national tax authorities, as Sijbren Cnossen has argued¹⁶⁸ (and as the Commission is indeed seeking to do). The discussion of the Quebec experience by Richard Bird and Pierre-Pascal Gendron¹⁶⁹ shows too that the presence of a central VAT overarching lower-level VATs, creating a *dual VAT*, can considerably reduce the risks of interstate zero-rating. Clearly, a federal VAT in the US would greatly facilitate the zero-rating of interstate sales under state VATs: the VAT chain would be weakened, but control would not wholly pass between distinct administrations. Some see great potential too in emerging technologies: the DVAT of Richard Ainsworth, for instance, combines these with a requirement of third-party guarantees of payment.¹⁷⁰

Administrative solutions have their limits, however.¹⁷¹ As Charles McLure points out,¹⁷² and Harley Duncan discusses further,¹⁷³ the federal tax authority has only limited incentive to root out frauds affecting only state revenues. And if breaks in the VAT chain could always be fixed simply by reasonably good administration, one would arguably not need a VAT in the first place even in a closed economy setting: liability could simply be postponed until the final sale to a non-registered person. This makes it worth considering a range of alternatives that have been developed—conceptually at least, though not applied—to implement the destination principle without zero-rating interstate exports. (Exports to the rest of the world, it is assumed, would be zero-rated under the state VATs, and imports somehow brought into them).

3. The Destination Principle Without Zero-rating Interstate Trade

Several schemes have been suggested for implementing the destination principle—having tax ultimately levied on consumption in the jurisdiction where it occurs—without zero-rating interjurisdictional trade, and there is a sizable literature comparing them. Here we focus on what seem to us the three most important to evaluate

¹⁶⁷ In the UK, the “VAT gap,” reflecting all forms of evasion, is officially put at around 13 percent of potential revenue—which is the same order of magnitude as the personal income tax gap in the United States. On this, and VAT fraud more generally, see Keen & Smith, note 166.

¹⁶⁸ Cnossen, note 37, elsewhere in this Symposium.

¹⁶⁹ Bird & Gendron, note 38, elsewhere in this Symposium.

¹⁷⁰ Ainsworth, note 161.

¹⁷¹ A variety of other essentially administrative approaches to resolving the problems caused by the zero-rating of exports, such as the use of reverse charging and VAT accounts are reviewed in Keen & Smith, note 166.

¹⁷² McLure, note 87, elsewhere in this Symposium.

¹⁷³ Duncan, note 2, elsewhere in this Symposium.

in the U.S. context,¹⁷⁴ and in doing so do not attempt an exhaustive assessment but focus on describing their key structural features (leaving administrative aspects, in particular, largely aside): more detailed accounts can be found in Article in this Symposium by Charles McLure¹⁷⁵ and the references there.

- *Exporter rating*: Under this scheme (which was proposed for the EU by the European Commission in 1987,¹⁷⁶ but not adopted) states (the Member States, in the EU context) would tax sales to other states just as they would sales within their own boundaries, and would give registered taxpayers full credit against their own output VAT for that paid on their purchases from other states. That would in itself achieve the destination principle, as the term is used here. Beyond that, revenue would ultimately be reallocated so to accrue entirely (as at present in the EU) to the state in which final consumption takes place (exporting jurisdictions reimbursing importing for the credit that the latter give), by means of clearinghouse arrangements based either on invoices or data on aggregate consumption by state.

CVAT:¹⁷⁷ Each state would zero-rate sales to other states under its own VAT, but interstate transactions would be subject to a special “compensating VAT” that would be fully refundable (or creditable against some other liability). In this way, goods entering interstate trade would not be fully relieved of VAT; and, for example, a false claim for a refund of VAT on exports to another state would trigger liability to the compensating VAT. Net tax raised by the compensating VAT would be zero if all taxed exports were to registered traders entitled to credit, so there would be no need for a clearinghouse of the kind envisaged under exporter rating. Instead there would be a fund into which compensating VAT is paid and from which refunds are made. In practice, since some interstate sales would be made to exempt entities or others not entitled to refund, the fund would be expected to operate in (fairly modest) surplus. While this would raise revenue

¹⁷⁴ Others include the “PVAT”, which retains zero-rating but requires assurance of payment in the importing state: see Satya Poddar & Eric Hutton Zero-rating of Interstate Sales under a Subnational VAT, 94th Ann. Nat’l Tax Ass’n Procs. 200 (2001).

¹⁷⁵ McLure, note 87.

¹⁷⁶ Commission of the European Communities, Commission Communication on completion of the internal market: Approximation of indirect tax rates and harmonization of indirect tax structures, COM (87) 320 (1987).

¹⁷⁷ The CVAT was first proposed (for Brazil) by Ricardo Varsano, Subnational Taxation and Treatment of Interstate Trade in Brazil: Problems and a Proposed Solution,” in Decentralization and Accountability of the Public Sector (Shahid Javed Burki & Guillermo Perry, eds.), Procs. of the Annual World Bank Conference on Development in Latin America and the Caribbean 339 (2000). It is developed further in Charles E. McLure, Jr., Implementing Subnational VATs on Internal Trade: The Compensating VAT (CVAT), 7 Int’l Tax & Pub. Fin. 723 (2000).

allocation issues, these would be very much less pressing than those under exporter rating. A scheme of broadly this kind—a uniform 15 percent VAT on trade between member states—has recently been raised for consideration by the European Commission.¹⁷⁸

- *VIVAT*:¹⁷⁹ The essence of this scheme—the “viable integrated VAT”—is that sales to registered traders, including interstate, would be taxed (and credited) at a common rate by all participating states, while sales to final consumers would be taxed at a rate that might differ between them. This ensures that interstate trade is not conducted VAT-free, achieves “compliance symmetry” in the sense that interstate and intrastate trade are treated identically, and (since crediting means that the rate at which tax is cumulated is irrelevant to the ultimate treatment of final sales) that autonomy can be preserved for each jurisdiction to determine the final rate applied to consumption within its borders. The Integrated Sales Tax (IST) proposed by Charles McLure¹⁸⁰ is a particular VIVAT in which states would apply a zero-rate to B2B sales, interstate and intrastate—which avoids any need for refunds on interstate trade—and some positive rate to B2C sales.¹⁸¹ As he stresses, the IST would in effect be an improved form of RST. Note too that a set of state-level ISTs combined with a federal VAT (applied in the usual way at the same rate¹⁸² on B2B and B2C sales) is itself a form of VIVAT, in which the common rate on B2B sales is the federal rate and that on B2C sales is the sum of the federal rate and the state-specific IST rate (a scheme of this kind being discussed in the U.S. context by Michael Keen).¹⁸³ A federal VAT rate of 10 percent, for example, combined with an IST of 3 percent, is a VIVAT with a B2B rate of 10 percent and a B2C rate of 13 percent.

Each of these schemes anticipates special arrangements to deal with substantial out-of-state sales to non-registered traders, such as requiring distance sellers to register in

¹⁷⁸ Commission of the European Communities, Communication from the Commission to the Council and the European Parliament on measures to change the VAT system to fight fraud,” SEC(2008) 249 (2008).

¹⁷⁹ First proposed (in the EU context) by Michael Keen & Stephen Smith, *The Future of Value-Added Tax in the European Union*, 23 *Economic Policy* 375 (1996) and Michael Keen & Stephen Smith, *The Future of Value-Added Tax in the European Union*, 23 *Economic Policy* 419 (1996), and developed further in Michael Keen & Stephen Smith, *Viva VIVAT!*, 7 *Int’l Tax & Pub. Fin.* 741 (2000).

¹⁸⁰ McLure, note 87, elsewhere in this Symposium.

¹⁸¹ McLure also considers the possibility of a “positive rate VIVAT” at the state level, and the possibility of local-level VIVATs.

¹⁸² For simplicity, it is assumed here that the federal VAT and each of the state-level ISTs would all be levied at a single rate.

¹⁸³ Michael Keen, *States’ Rights and the Value Added Tax: How a VIVAT Would Work in the US*, 94th *Ann. Nat’l Tax Ass’n Procs.* 195 (2001).

any state where their sales exceed some threshold, and (exploiting registration requirements) in relation to motor vehicles. As discussed above and by McLure,¹⁸⁴ the adoption in the United States of devices of this kind, which seem needed to deal effectively with such sales, requires overturning *Quill*.

If implemented perfectly, these schemes for implementing state-level VATs would all be essentially equivalent to one another (and hence also to the standard zero-rating approach). The choice between them thus turns on practical considerations. A difficulty with exporter rating, for instance, is that if clearing is based on invoices then the importing state has little incentive to verify claims for credits on imports from other states (since it will simply pass the bill to the exporting state),¹⁸⁵ while if it is based on independent estimates of consumption, each state's incentive to collect the VAT is blunted by the knowledge that it will share the revenue with other states. The CVAT adds another level of complexity for firms and businesses in accounting for the compensating VAT and arranging proper credit. To the extent that it applies a rate to intermediate sales lower than that on final sales, the VIVAT may involve a weakening of the VAT chain relative to the normal practice of applying the same rate to both B2B and B2C sales. Unlike the other schemes, it also requires sellers to determine whether their customers are registered for VAT or not. This distinction, however, is one that, as seen above, is at the heart of emerging recommended practice in the taxation of border-crossing services. Under a VIVAT, for example (as indeed, under a well-designed RST), the question of which state should tax an interstate B2B service transaction simply does not arise: since the purchaser is registered, only the federal VAT would be applicable.

IV Summary and Conclusions

This paper has argued that the theoretical case for applying the VAT (indeed any commodity tax) according to the destination rather than the origin principle—taxing consumption, not production, where it occurs—is not unambiguous, but is extremely strong. It is more conducive to efficient production patterns (that is, to maximizing output) and less vulnerable to transfer pricing difficulties.

The real difficulties are ones of implementation. Consumption, and where it occurs, may not be observable, so that proxies need to be used. And for B2B transactions that cross jurisdictional borders, the destination principle itself provides no guidance as to where VAT should be levied, since the consumption that is the ultimate object of taxation is by people, not by businesses: in this case, only practical considerations can guide the choice. And the practical possibilities for taxing trade between jurisdictions depend importantly on whether these transactions can be monitored, and if need be intercepted, as they cross the border between them. For goods traded between nations—as between

¹⁸⁴ See text accompanying notes 96-97; McLure, note 87, elsewhere in this Symposium.

¹⁸⁵ Catherine Lee, Mark Pearson & Stephen Smith, *Fiscal Harmonisation: An Analysis of the Commission's Proposals*, Report Series 28, London: Institute for Fiscal Studies ((1988)

the U.S. and rest of the world, for instance—existing frontier controls mean that they typically can be. At this level, implementing a VAT by zero-rating exports of goods is unlikely to be problematic. Intangible services, however, and goods traded between lower-level jurisdictions—states and localities in the United States, for example, and Member States of the EU—cannot be monitored at the border, making implementation more challenging.

The paper has reviewed possible solutions to these various problems, as they would be posed by adoption of a federal VAT in the United States. At the national level, the key challenge is determining the jurisdiction in which to tax international services. This has been the subject of much analytical attention within the OECD, with emergent guidelines pointing to the taxation of both B2B and B2C transactions in the country where the recipient is established or resides. This leaves largely open the question, however, as to how such treatment of B2C sales is to be enforced when the seller cannot effectively be compelled to register in the jurisdiction of all its customers. While much thus remains unresolved, to avoid double or undertaxation of international services coherence of the U.S. rules with those adopted elsewhere, which are likely to be broadly consistent with OECD guidelines, will be important.

At the state and local level, the absence of border controls and higher levels of openness amplify the problems. The physical-presence requirement for compliance with a distance selling rule embodied in the *Quill* decision, and the complexity of state and local arrangements that underpins it, have made coherence in the rules for interstate and interlocality transactions under the current RST very hard to achieve, with the consequence—combined with such weaknesses of the RSTs themselves as the extensive taxation of business inputs—that current arrangements are a haphazard mixture of destination and origin elements. Indeed coherence is likely to remain elusive while the *Quill* rule remains in force. Nevertheless, there is some basis for hope that states' efforts to simplify and harmonize their RST regimes through the Streamlined Sales Tax system incorporated in SSUTA may lead to the elimination of the *Quill* rule, whether by voluntary vendor registration under SSUTA or by congressional legislation endorsing the SSUTA system and superseding *Quill*. Moreover, adoption of a federal VAT, which would raise a host of coordination issues beyond those traditionally encountered by the states, could well lead to “global” solution that would dispense with *Quill*.

There is little doubt that adoption of VATs at the state (and local) level could reduce many of the distortions that the current RSTs create. Though it seems unlikely that the introduction of a federal VAT would quickly lead lower-level jurisdictions to follow suit, over time the advantages of a coordinated approach should, one hopes, become evident. The question would then be how to implement a destination-principle VAT at the state level without risking the fraud and other control problems that are created by zero-rating interstate transactions (implying a need for refunds on such transactions), which the EU has found so troublesome. There is disagreement as to how best the EU should respond to this problem, which reflects the particular historical development of the VAT there. But in designing an interjurisdictional VAT regime from scratch, as would be the case in the United States, it is surely wise to consider ways of simply design

the problem away. In this context, the Integrated Sales Tax proposed by Charles McLure¹⁸⁶ has considerable appeal in eliminating the refund problem by zero-rating all B2B transactions (so that there is no input tax to refund) while enabling states full flexibility in determining the rate applied to final sales in their jurisdiction and having the potential to turn the RSTs into broad-based taxes on consumption.

¹⁸⁶ McLure, note 87, elsewhere in this Symposium.