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Structuring a US Federal VAT

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## Structuring a US Federal VAT

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### 1. Introduction

On 18 and 19 February 2009, the American Tax Policy Institute (ATPI) sponsored a conference in Washington, DC, on "Structuring a Federal VAT: Design and Coordination Issues." The conference was co-organized by Charles E. McLure, Jr. of Stanford University and the present writer, and featured many of the world's leading VAT experts from academia, government, and the private sector.<sup>2</sup>

The purpose of the conference was to lay the ground for a potential future adoption of a federal VAT in the United States by discussing some of the technical issues related to two broad topics: Firstly, how should such a US federal VAT be designed, and secondly, how should it be coordinated with existing state Retail Sales Taxes (RST). The assumption underlying the conference was that, as in other OECD countries, the US federal VAT would be levied in addition to, and not as a replacement for, the existing US federal income tax.

This article summarizes the conference papers. The papers are being revised for publication, so what appears below does not necessarily represent the final views of the authors but summarizes the conference proceedings.<sup>3</sup>

### 2. Design issues

#### 2.1. Subtraction or invoice-credit method

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<sup>2</sup> Conference presenters and discussants (in order of appearance) were Itai Grinberg, Michael Graetz (Yale Law School), Emil Sunley (IMF, retired), Alan Schenk (Wayne State University Law School), Arthur Kerrigan (European Commission), Tim Edgar (University of Western Ontario Law School), Satya Poddar (Ernst &Young Pvt. Ltd., India), Robert Conrad (Duke University), Rudolph Penner (Urban Institute), Pierre-Pascal Gendron (The Business School, Humber Institute), Michel Aujean (Taj Advocates), Walter Hellerstein (University of Georgia Law School), Michael Keen (IMF), David Holmes (OECD), Jack Mintz (University of Calgary), Richard Bird (University of Toronto), Peter Merrill (PricewaterhouseCoopers), Sijbren Cnossen (CPB Netherlands), Victoria Perry (IMF), Stephen Smith (University College London), Charles McLure (Hoover Institution, Stanford University), John Mikesell (University of Indiana), Tim Gillis (KPMG), Harley Duncan (KPMG), Brian Mc Cauley (Revenue Canada), Dale Hart (IMF), Reuven Avi-Yonah (University of Michigan), Neil Brooks (Osgoode Hall Law School), and Tom Barthold (Joint Committee on Taxation).

<sup>3</sup> The final versions of the papers and comments by discussants are scheduled to be published in the Tax Law Review.

In theory, a tax based on the VAT system<sup>4</sup> can reach the same result either by using an invoice-credit method, a subtraction method, or an addition method. Under the invoice-credit method (a tax-against-tax calculation) tax on inputs is deductible from tax due on taxable sales upon showing an invoice indicating that the tax has been paid. Under the subtraction method, a business deducts its taxable purchases from other registered firms from its taxable sales to arrive at the tax base, to which the tax rate is applied. Under the addition method, the various factors of production (wages, rent and interest expense<sup>5</sup>, and profit) are added up as the tax base.

The vast majority of countries using the VAT use the transaction-based invoice-credit method. Japan uses a modified form of the subtraction method, but has recently come to rely more on invoices to audit the tax. Israel uses a form of the addition method for financial institutions and insurance companies.

Itai Grinberg's conference paper recommended that the United States follow the rest of the world and adopt a invoice-credit VAT. He gave three reasons for this preference:

- (a) a subtraction-method VAT looks more like an entity-based tax and is therefore more prone to entity-based exemptions, which are generally disfavoured;
- (b) a invoice-credit-method VAT is clearly WTO compliant; and
- (c) a invoice-credit-method VAT is easier to coordinate with the rest of the world and with the state RST.

Grinberg concluded that:

The perceived difference between the subtraction-method VAT and the invoice-credit-method VAT is a result of the "accounts-based"/"transactions-based" distinction. The subtraction-method VAT is perceived to be a tax on an entity, while the invoice-credit-method VAT is perceived to be a tax on specific goods and services. This distinction can affect policy outcomes. For instance, the "entity-tax" characterization of a subtraction-method VAT makes it unlikely that it would be imposed at multiple rates. Multiple rates are generally undesirable. However, the entity tax characterization also makes it less likely that zero rating for specific goods and services would be adopted in a subtraction-method VAT, and more likely that entity-level

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<sup>4</sup> In practice, taxes based on the VAT system are not only levied under the heading VAT but also under the heading GST (Goods and Services Tax). In this article, the term "VAT" also covers "GST".

<sup>5</sup> Under the assumption that the value added by individual businesses consists of labour, the letting of immovable property and the granting of credit, which were not subject to VAT at the preceding stage of the distribution process.

exemptions would be considered. Exemption or zero rating of specific goods and services is inconsistent with the conceptual appeal of a summary entity-level calculation of a business' gross receipts from its sales of goods and services minus the costs of its purchases of goods and services. Thus, a subtraction-method VAT may be less likely to be enacted with narrowly tailored exemption or zero rating for specific goods or services, as is recommended by other authors at this conference for supplies of goods provided for nil or nominal consideration by non-profit organizations and state and local governments, residential housing, and specific types of financial services. On the other hand, a subtraction-method VAT may be more likely to be enacted with broader entity-based exemptions, including for non-profit and governmental entities, or even for all pass-through entities. Further, as an entity-based tax, even a sophisticated subtraction-method VAT may be vulnerable to WTO challenge if imposed on a destination basis. This is particularly true if special allowances, for instance, for small businesses, are incorporated into the subtraction-method VAT.

International coordination, for example, in the area of cross-border services, would be easier with an invoice-credit-method VAT. The potential for coordination with state sales taxes seems higher, as well.

Finally, an invoice-credit-method VAT alongside the corporate income tax seems less vulnerable to amendment to include features of the corporate income tax than a subtraction-method VAT. Invoice-credit-method VATs thus seem, on balance, more likely than subtraction-method VATs to be adopted with the VAT design best practices described by other authors at this conference. This is perhaps unsurprising, as those best practices, developed based on fifty years of worldwide experience, were designed for invoice-credit-method VATs. As one author at this conference has written previously, it is not clear whether the United States should try to "reinvent the wheel," or why doing so would be desirable.<sup>6</sup>

## **2.2. Destination or origin basis**

Keen and Hellerstein's conference paper discussed the choice between the destination and origin basis of implementing a federal VAT. They concluded that:

The destination principle –with revenue accruing to the country of importation– is the norm in international trade, and sanctioned by WTO rules... What though does economic theory say of the appropriate choice of principle? For once, it

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<sup>6</sup> Grinberg, ATPI conference paper.

gives a reasonably clear answer: though the case is not unambiguous, the destination principle is noticeably the more attractive.<sup>7</sup>

Keen and Hellerstein then went on to discuss some of the problems associated with enforcing a destination-based VAT. They concluded that, while cross-border trade in goods poses no significant problems, there are issues in the Business-to-Consumer (B2C) context for services. However, the OECD is working on those issues and Keen and Hellerstein recommended paying attention to their recommendations.

### **2.3. Financial services**

Most VAT systems exempt financial services and insurance from tax because it is administratively difficult to fit intermediation services within a transaction-based, invoice-credit VAT system. However, as Alan Schenk pointed out in his contribution to the conference, exempting financial services and insurance leads to several distortions:

1. The under-taxation of the household consumption of financial services compared with the consumption of other goods and services because the value added by financial institutions is not taxed.
2. The over-taxation of the consumption of financial services by VAT-registered businesses because any VAT buried in the costs of financial services is not recoverable as input tax. There likely is a cascade of tax resulting when any VAT buried in these costs is included in the prices of goods and services sold by the business users of these exempt financial services.
3. The incentive for a financial service provider to vertically integrate and self-supply services in order to avoid some or all of the VAT on its purchases from registered domestic traders that would not be recoverable. Smaller financial service providers may be less able to vertically integrate than larger providers, creating another kind of non-neutrality.
4. There is a competitive advantage to an offshore financial service provider if it can render services to domestic household consumers or other domestic purchasers (such as units of government and other suppliers of exempt services) free of VAT.<sup>8</sup>

Schenk surveyed the VAT treatment of financial services and insurance in several countries (the European Union, Canada, New Zealand, South Africa, Singapore and Australia) and concluded

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<sup>7</sup> Keen and Hellerstein, ATPI conference paper.

<sup>8</sup> Schenk, ATPI conference paper.

that exemption is not justified. Specifically, the South African and Singapore experiences show that fees for intermediation services can be subject to VAT without leading banks to bundle them with interest charges that are not subject to tax.

Schenk therefore recommended extending the VAT to financial services and insurance to the extent possible. For financial services, he proposed that the United States tax all (or almost all) fee-based financial services, exempting only intermediation services, and other financial services buried in other bank charges. He recommended zero rating only exports of financial services. The United States should therefore tax at a positive rate a broad range of financial services in B2B and B2C transactions.

For insurance, Schenk recommended including in the VAT base intermediation services rendered by an insurer under both life and non-life policies. He noted that "the taxation of these services is workable administratively, it produces a broader tax base, and it avoids the cascading of tax in B2B transactions that occur in countries that exempt these services."<sup>9</sup>

#### **2.4. Housing**

The treatment of housing is crucial because of the importance of this sector of the economy and because of its political sensitivity. Satya Poddar wrote in his conference paper that:

Historically, real property transactions have been exempted from VAT (e.g., as under the VAT in the European Union), partly on the grounds that they are already subject to stamp duties and/or registration charges and the levy of VAT would lead to excessive burden. The exemption also reflected the view that land (the main distinguishing component of real property) did not constitute value added and should thus not be subject to VAT. This treatment has resulted in significant complexities and distortions. Primary among them is the complexity in defining supplies of real property. This is specially the case in the event of mixed supplies where supplies of real property get bundled with those of goods and services, and where real property supplies are in the form of rights and interests related to real property (e.g., time-share interests). The exemption system leads to tax cascading and other economic distortions through blockage of VAT on inputs going into the construction of commercial/industrial real properties.<sup>10</sup>

Poddar instead recommended a different approach (Option C), which is similar to that applied in Canada, South Africa, Australia and

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<sup>9</sup> Schenk, ATPI conference paper.

<sup>10</sup> Poddar, ATPI conference paper.

New Zealand. He described the mechanics of this Option as follows:

- no tax is applied on long-term residential rentals;
- construction, repair, renovations of residential property is taxable, with no right to deduct input tax;
- no tax on resale of used residential property (whether owner-occupied or rented); and
- all other supplies of real property would be taxable, including first sale of residential property and short-term rentals.<sup>11</sup>

## 2.5. Exemptions

The prevalent treatment of government entities, public sector bodies, non-profit and charitable organizations, and similar entities under VAT is exemption. Pierre-Pascal Gendron argued that this treatment is wrong, and leads to significant distortions since the sector amounts to one fifth of GDP.<sup>12</sup>

Gendron concluded as follows:

Firstly, the case for the exemption of the sector under VAT is very weak, while the case for full taxation under VAT is quite strong. Secondly, the options to *replace* the exemption regime dominate the options to *modify* it. Thirdly, the Australian-New Zealand models appear to be the best option to replace the exempt treatment. Under the Australian-New Zealand model, essentially all the goods and services supplied by public sector bodies, non-profit organizations and charitable organizations are within the scope of VAT and treated like any supplies from the private sector. The Australian-New Zealand models feature very few instances of zero-rating or exemptions. While the Canadian model - which provides ex post rebates for VAT paid -- works reasonably well, it gives rise to several non-neutralities, is too gradualist, and ultimately delays the benefits of subjecting all the outputs of the sector to VAT. To minimize long-term compliance and administrative costs, a country adopting a VAT would be well advised to get the design right from the start and subject the sector to VAT along the lines of the Australian-New Zealand model.<sup>13</sup>

## 3. Coordination issues

### 3.1. Lessons from Canada

Canada has a federal VAT (GST), introduced in 1991. Most Canadian provinces have a Retail Sales Tax (RST), although Quebec has a

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<sup>11</sup> Poddar, ATPI conference paper.

<sup>12</sup> Gendron, ATPI conference paper.

<sup>13</sup> Id.

provincial VAT (QST) and three small eastern provinces implement a VAT (HST) that is harmonized with the federal GST. Bird and Gendron concluded in their conference paper that, despite its complicated nature, this system works reasonably well.<sup>14</sup>

Bird and Gendron wrote that there are three lessons to be learned from the Canadian experience:

The first lesson is that, from the point of view of the federal GST, it simply does not matter what form provincial sales taxes take. In contrast, the second lesson is that the nature of their sales taxes matters a great deal to the provinces concerned. Finally, the third lesson is that federal cooperation, while not essential, can both provide critical support to any provincial sales tax and an incentive to improve those taxes from both an economic and administrative perspective.<sup>15</sup>

Bird and Gendron then concluded that the Canadian experience has several lessons for the US:

With good tax administration, it is thus perfectly feasible to operate a VAT at the sub-national level on a destination basis, at least for large regional governments. In principle, it is immaterial whether there are two separate administrations or one; or, if there is one, which level operates it. Clearly, a single central administration and a common base is likely to be more efficient, but this degree of convergence in this respect is less essential than a high degree of intergovernmental cooperation, e.g. through unified audits or at least through a uniform VAT registration system and a very high level of information exchange. Most importantly, from the perspective of improving accountability, each taxing government should be able independently to determine its own VAT rate (although, as mentioned, this is not how the HST system in Canada currently operates).

There is, however, a third model for state sales taxes that clearly emerges from the Canadian experience: do nothing. Six provinces have not made any significant changes in their RSTs (or, in the case of Alberta, non-RST) in the last 15 years: the federal VAT is simply irrelevant. Achieving a "coordinated" two-level sales tax structure requires a considerable effort. Firstly, basic political agreement has to be secured between governments with different interests. Secondly, an appropriate legal framework to implement that agreement has to be worked out. Thirdly, an appropriate administrative structure must be agreed. Fourthly, to make

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<sup>14</sup> Bird and Gendron, ATPI conference paper.

<sup>15</sup> Id.

the system work over time, appropriate oversight and cooperation systems between governments need to be developed and put into place. The result of about a decade of discussion of all these matters in Canada was the two quite different provincial-federal sales tax systems described above. However, even after these systems have been working, successfully, for over a decade, only four of Canada's 10 provinces have signed on to either of them. That they have not done so has harmed the residents of those provinces. It has not, however, hampered the functioning of the VATs either at the federal level or in those provinces that have them (whether in the form of QST or HST), in any way at all.

On the whole, even taking into account the existence of numerous local sales taxes in some US states, we think that these lessons should be broadly applicable to the US case. In other words, if the US federal government wants to adopt a VAT for its own reasons, from an economic or administrative perspective, it can certainly do so regardless of what the states do or do not do with respect to their sales taxes.<sup>16</sup>

### **3.2. Lessons from other economic unions and federations**

Cnossen reviewed the experience with VAT in G-7 countries and concluded likewise that the Canadian experience is the most relevant to the United States, and that the United States can adopt a Federal VAT on top of either state RSTs or state VATs. He reached several conclusions:

Firstly, VAT is superior to RST in including most consumer goods and services in the base and in excluding most producer goods. Accordingly, VAT does a better job in effecting correct border tax adjustments (BTAs).

Secondly, the EU experience shows that VATs along with destination-based BTAs can successfully be administered in common markets without border controls. The replacement of deferred payment by some exporter rating scheme is not necessary, and would not solve the problem of cross-border fraud.

Thirdly, to control cross-border fraud, the focus should be on effective cross-border audits, which extends the jurisdictional reach of each state's VAT administration. Undue reliance should not be placed on extensive cross-border information exchange systems, which are not found on the domestic scene either.

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<sup>16</sup> Bird and Gendron, ATPI conference paper.

Fourthly, to allocate taxing rights properly in a common market or federation, it is important to define the place of supply precisely, especially with respect to services. B2B services should be taxed in the destination state and B2C services in the origin state (which generally is also the destination state). This distinction is best made by the kind of service supplied backed up by the VAT registration number or a general taxpayer identification number issued for, say, income tax purposes. Hence, it would not be necessary to issue VAT registration numbers to out-of-state buyers in non-VAT states.

Fifthly, the existence of a (supra)national VAT would facilitate but is not a *conditio sine qua non* for exercising compliance control over state or provincial VATs. In the United States, for instance, the cross-border audit of state VATs can be carried out in conjunction with the Internal Revenue Service's audit of the income taxes. This implies that state VATs can be administered successfully in a common market or federation where other states do not have VATs or, instead, have RSTs (and/or various local RSTs).<sup>17</sup>

### 3.3. Recommendations on Coordination

McLure addressed the potential issues that arise from adopting a federal VAT on the assumption that states would retain their RSTs, at least initially.<sup>18</sup> He concluded as follows:

1. The VAT is to be the best form of sales tax for use by the federal government, because of the complications of compliance and administration, the risk of cascading, and opportunities for evasion inherent in the RST.
2. While states probably will not quickly switch to a VAT, some may do so over time. This would facilitate administrative cooperation with the federal government and allow them to avoid the taxation of business inputs, which is pervasive in extant state RSTs.
3. Whether states should switch to the VAT depends in part on the need to make massive refunds on interstate trade and the risk of carousel fraud, neither of which plague the RST, and the possibility of improving their RSTs, for example, by implementing the zero-rate VIVAT<sup>19</sup>, which can be seen as a special form of RST.

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<sup>17</sup> Cnossen, ATPI conference paper.

<sup>18</sup> McLure, ATPI conference paper.

<sup>19</sup> VIVAT (Viable Integrated VAT) is a theoretical model under which VAT would be imposed EU-wide on the basis of a uniform rate on all B2B transactions between registered businesses established within the same Member State or in different Member States, supplemented by a surtax at

4. Conformity, or at least general consistency, of requirements for registration is crucial for administrative cooperation. Conformity is obviously desirable for a state VAT and it would facilitate implementation of state sales tax systems that rely on the distinction between sales to registered traders and those to households and unregistered traders, such as an RST that reflects best-practice, such as the zero-rate VIVAT. Conformity is clearly easiest to achieve and produces the best result if both federal and state governments rely on the VAT. Conformity could be achieved under a state zero-rate VIVAT, but at the cost of leaving unregistered traders out of the tax net for the zero-rate VIVAT. Under a standard RST, registration for the federal VAT would probably need to be supplemented by a state RST registration system. The threshold for registration under the federal VAT may need to be set lower - and that for state RSTs and zero-rate VIVATs - than might otherwise be desirable.
5. Compliance, administration, and administrative cooperation would be easiest if the bases of state RSTs or VATs and the federal VAT conformed. One hopes that conformity would be on the basis of "best practice" - no unrelieved tax on sales to registered businesses and relatively comprehensive taxation of sales to households and unregistered traders, as that would eliminate the insane line drawing (e.g., between types of sales to businesses and between types of products bought by households) that is necessary under current RSTs.
6. Contrary to conventional wisdom, it appears that local reliance on RSTs is not a barrier to adoption of state VAT. A local VIVAT could be piggy-backed on a conventional state VAT, and a local zero-rate VAT could co-exist with either a conventional state VAT or a state zero-rate VIVAT.
7. The federal government probably could - and perhaps should - encourage state conformity by over-riding the *Quill* decision<sup>20</sup>

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the retail stage if the government of the Member State of consumption wishes to impose VAT at a higher rate. In respect of transactions between businesses established in different Member States, VAT is deductible in the customer's Member State and, to that end, the VAT due by the supplier is transferred by the tax authorities of the supplier's Member State to the tax authorities of the customer's Member State through a clearing-house system.

<sup>20</sup> In *Quill*, the US Supreme Court reaffirmed its position that, in the absence of substantial nexus, a state cannot force the seller to collect use tax. At issue was whether an out-of-state seller had nexus, where his contacts in the customer's state were confined to licensed software and common carriers delivering office equipment to his customers. The minimum physical contacts to establish nexus under the Due Process standard, as formulated in *Quill*, are easily met. In that respect, the Supreme Court only requires that a company purposefully

(which limits vendors' duty to collect tax on remote sales) for states whose sales taxes conform sufficiently closely to the federal VAT.

#### 4. Conclusion: Summary of Recommendations

The recommendations of the ATPI VAT conference papers can be summarized as follows:

1. the United States should adopt a federal VAT in addition to, and not as a replacement of, the federal income tax (Avi-Yonah). It should not adopt a federal RST (McLure, Cnossen);
2. the federal VAT should be based on the invoice-credit method, not the subtraction method (Grinberg);
3. the federal VAT should be destination-based, with reverse charging when needed to ensure compliance (Keen and Hellerstein);
4. fee-based financial services should be taxable. Services that are bundled in interest rates should be exempt, and export of financial services zero rated (Schenk);
5. the VAT base should include intermediation services rendered by an insurer under both life and non-life policies (Schenk);
6. the VAT should not be applied to long-term residential rentals. Construction, repair, and renovations of residential property are taxable, with no right to deduct input tax. There should be no tax on the resale of used residential property (whether owner-occupied or rented). All other supplies of real property would be taxable, including the first sale of residential property and short-term rentals (Poddar);
7. goods and services supplied by public sector bodies, non-profit organizations and charitable organizations should be within the scope of the VAT and treated like any supply from the private sector (Gendron); and
8. federal VAT can be adopted without regard to whether the states maintain the RST or switch to a VAT (Bird and Gendron, McLure). If states switch to a VAT, a zero-rated VIVAT can be applied to prevent carousel fraud (McLure). Carousel fraud is not a problem for a federal VAT (Cnossen and Perry).

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directs activities towards residents of the state imposing the tax. (*Quill Corp. v. North Dakota*, 504 US 298 (1992)).