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State Adoption of a Value Added Tax: A Desperate Act in Search of the Proper Occasion

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I. INTRODUCTION

Historically, sales tax enactment has often coincided with economic depression or war.[1] For this reason, sales taxes are sometimes called "children of despair."[2] It is no accident, for example, that in the United States many of the states first adopted a retail sales tax during the Great Depression of the 1930s.[3] I believe that a radical change in

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1. BEN TERRA, SALES TAXATION: THE CASE OF VALUE ADDED TAX IN THE EUROPEAN COMMUNITY 3 (1988).
2. *Id.* This phrase is of German origin (*Kinder der Not*). *Id.*
3. *Id.* at 4. (citing JOHN F. DUE & JOHN L. MIKESELL, SALES TAXATION, STATE AND LOCAL STRUCTURE AND ADMINISTRATION 2 (1983)). Forty-five states levy a retail sales tax. *See* John A. Miller, *State Administration of a National Sales Tax: A New Opportunity for Cooperative Federalism*, 9 VA. TAX REV. 243, 247 n.16 (1989). In the absence of some calamity, there is likely to be significant public outcry against major sales tax increases. Consider, for example, what happened in Florida a few years ago when it sought to introduce sweeping tax reforms into its sales tax, including the taxation of many previously exempt services. Within a few months of enactment, a beleaguered Governor and Legislature caved in to

the method of state sales taxation, such as a shift from a retail sales tax (RST) to a European style value added tax (VAT), will only occur in the face of great calamity. This is part of the politics of taxation.

Should circumstances conspire to create great need to dramatically increase state revenues, a switch to the VAT from the RST may seem appropriate. Whether such a change would truly be appropriate is debatable.[4] While many points concerning the relative merits of the VAT and the RST could be raised, the central issues in that debate would be whether the VAT is superior to the RST in its ability to tax services, whether the VAT is more easily enforced than the RST, and whether the VAT is superior to the RST in avoiding "cascading." Cascading is the phenomena in sales taxation of having tax levied upon tax.

In addition to the major issues just mentioned, state enactment of a VAT would raise at least two other significant questions that combine political and technical concerns. First, how would a state VAT handle interstate sales? In particular, would a state VAT assist in resolving a state's problems with sales taxation of mail order sales? Second, how would enactment of state VATs impact the federal tax system? In particular, would state VATs increase or decrease the likelihood of the enactment of a federal sales tax?

Before addressing the questions just raised, it would be useful to consider the economic incidence of both forms of sales taxation and the structural differences between the RST and the VAT.

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opposition groups and repealed the new tax provisions. The political scars may take years to heal. *See* Jon Mills, *The 1987 Legislative Session*, 15 FLA. ST. U. L. REV. 607, 607-09 (1987); Vicki L. Weber, *Florida's Fleeting Sales Tax on Services*, 15 FLA. ST. U. L. REV. 613, 613 n.1, 663-65 (1987); Edward P. Jones, *Florida Politicians Demoralized After Repeal of Services Tax*, 38 TAX NOTES 91 (1988); *Florida Lawmakers Repeal Tax on Services, Raise Sales Tax Rate*, 37 TAX NOTES 1150 (1987). More recently, Massachussetts went through a similar experience. *See* Tom Moccia, *Lawmakers Repeal Sales Tax on Business Services*, 50 TAX NOTES 1273 (1991).

4. For a sampling of opinions as to the relative merits of these two forms of sales taxation, see TERRA, *supra* note 1, ch. XIII; Charles E. McLure, Jr., *State and Local Implications of a Federal Value-Added Tax*, 38 TAX NOTES 1517, 1520 (1988); VALUE ADDED TAX: A MODEL STATUTE AND COMMENTARY, A REPORT OF THE COMMITTEE ON VALUE ADDED TAX OF THE AMERICAN BAR ASSOCIATION SECTION OF TAXATION 6 (Alan Schenk, reporter 1989) [hereinafter ABA MODEL STATUTE]; Sijbren Cnossen, *VAT and RST: A Comparison*, 35 CAN. TAX J. 559 (1987); John F. Due, *The Choice Between a Value-Added Tax and a Retail Sales Tax*, *in* CONFERENCE REPORT 16:1 (Can. Tax Found. 1985); Malcolm Gillis, *Excising Excises: Federal Sales Tax Reform in Canada*, *in* CONFERENCE REPORT 460, 473 (Can. Tax Found. 1984); and Stanley S. Surrey, A Value-Added Tax for the United States—A Negative View, *in* TAX POLICY AND TAX REFORM: 1961-1969, SELECTED SPEECHES AND TESTIMONY OF STANLEY S. SURREY 475, 485 (William F. Hellmuth & Oliver Oldman eds., 1973) (A speech given in February of 1968).

II. THE STRUCTURE AND INCIDENCE OF THE TWO TAXES

Both the RST and the VAT are general consumption taxes. That is, they are broad based excise taxes on the sale of property or services to the final consumer. The final consumer is sometimes referred to as the non-entrepreneurial consumer[5] because, on the theoretical level, the consumption sought to be taxed is personal consumption rather than entrepreneurial consumption.

The fundamental difference between the American retail sales tax and the European value added tax is structural. The RST is a single stage tax, and the VAT is a multistage tax. The RST is collected in one fell swoop from the ultimate consumer at the retail sale level. The VAT is collected at every stage from manufacture to final consumption.[6]

Without knowing more, one might be tempted to assume that the VAT is not a true consumption tax because it is collected on non-retail as well as retail sales. However, the typical VAT employs a credit system that prevents the entrepreneurial buyer from suffering any loss due to the tax. Ultimately, the full legal incidence of the tax falls upon the non-entrepreneurial consumer. Basically, the noncumulative, multistage, credit VAT works as follows: At each stage of production, the selling entrepreneur collects the VAT as a set percentage of the sales price; the selling entrepreneur deducts the VAT she had paid for her materials from the VAT she collects from her buyer and remits the excess to the government; similarly, when her buyer resells the product or service, he (the buyer) deducts the VAT paid to his seller from the VAT he (the buyer) collects from his buyer before remitting the excess; and so it goes until there is a non-entrepreneurial purchase that carries with it no entitlement to deduct the VAT collected from the purchaser. Thus, the non-entrepreneur buyer bears the full weight of the tax to the same extent as under a RST regime.[7]

Who actually bears the economic burden of the sales tax (whether VAT or RST) is a matter of debate. The general theory is that the consumer bears the burden. However, some have argued persuasively that this view is too simplistic, and that the ultimate economic burden falls, in part, on entrepreneurs or on labor.[8] As noted above, both the

5. *See* TERRA, *supra* note 1, ch. II.2.
6. *Id.* at ch. IV.
7. For a detailed discussion of the nature and character of the VAT, see *id.* at ch. V. A model credit method VAT statute has been developed by a committee of the American Bar Association. *See* ABA MODEL STATUTE, *supra* note 4.
8. *See* TERRA, *supra* note 1, ch II.3; Cliff Massa III & David G. Raboy, *The Canadian Value-Added Tax: Does Anybody Care?*, 45 TAX NOTES 481, 485-88 (1989); DANIEL C. MORGAN, RETAIL SALES TAX, 4-5, ch. VI (1964); *See also* Norman B. Ture, *The Basic Economics of a United States VAT*, 6 J. CORP. L. 49, 56 (1980); Charles Waldauer, *Economic Effects of the Tax Restructuring Act of 1979*, 6 J. CORP. L.

RST and the VAT are designed to have the non-entrepreneur consumer pay the tax. The question is whether the tax creates an incentive for the seller to reduce the price charged to the consumer in order to indirectly bear some of the economic burden of the tax. If the tax is levied across the board on all similar products, the entrepreneur has less reason to reduce his price in order to absorb some of the tax. Since all of his competitors must also collect the tax, the seller is at no competitive disadvantage by collecting the full tax from his customer. However, if similar products are treated differently, some products being taxed and some not being taxed, the retailer whose product is taxed may feel obliged to bear some of the tax in order to compete with the untaxed products. From a tax theory perspective, of course, a system that taxes similar products differently is undesirable.[9] It is generally preferable that any form of taxation should be economically neutral. That is, the tax should not affect economic decisions.[10]

It is commonly asserted that the VAT differs from the RST in form but not in substance.[11] However, some commentators believe that the acknowledged difference in form has important implications with respect to administrative efficiency, the ability to tax services, and the ability to avoid cascading. If these commentators are correct, the differences in form will lead to substantive differences in coverage, revenue raising capability, and market neutrality between the two taxes. To further develop this point, each matter is separately analyzed below beginning with the issue of cascading.

III. AVOIDING THE CASCADE

Suppose we have a broad based sales tax that applies to both prop-

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103, 106, 110 (1980); CLARA K. SULLIVAN, THE TAX ON VALUE ADDED, ch. 7 (1965); NEIL H. JACOBY, RETAIL SALES TAXATION, ch. XI (1938).

9. "Standard economic theory assumes that the market achieves an optimal allocation of resources. Given this assumption, it follows that sales taxes should be neutral in their impact on the market; that is, they should not distort the economic behaviour of producers and consumers." Cnossen, *supra* note 4, at 576-77.

10. James M. Bickley, *The Value-Added Tax: Concepts, Issues, and Experience*, 47 TAX NOTES 447, 455 (1990).

11. *See* Alan Schenk, *Value Added Tax: Does This Consumption Tax Have a Place in the Federal Tax System?*, 7 VA. TAX REV. 207, 226 (1987); U.S. DEP'T. OF THE TREASURY, *Tax Reform for Fairness, Simplicity, and Economic Growth*, 3 THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT 62 (Nov. 1984) [hereinafter TREASURY REPORT]. *See also* Paul R. McDaniel, *A Value Added Tax for the United States? Some Preliminary Reflections*, 6 J. CORP. L. 15, 16 (1980). Cnossen puts it more carefully than I have when he says "... given equal coverage and tax rates, VAT and RST are identical in their economic effects and in the distribution of their respective tax burdens." Cnossen, *supra* note 4, at 574. As will be discussed, Cnossen is of the opinion that the VAT is better able to tax services, and thus, its coverage is typically broader than the RST. This means that in practice one of the "givens" set out in his assertion is unlikely to be met.

erty and service transfers. If a lawyer buys paper on which to record someone's will, the law could require her to pay sales tax on the paper when she purchases it. If so, her charge to her client will include not only the cost of the paper on which the will is recorded, but also the sales tax she paid when she bought the paper. If a sales tax is then imposed on the fee the lawyer charges her client, part of the sales tax collected on the fee will represent sales tax on the sales tax paid at the time she purchased the paper. This is the cascade effect. Cascading is considered an undesirable trait in a sales tax because it introduces competitive distortions into the economy.[12]

Both the RST and the VAT have mechanisms for avoiding the cascade effect. The structure of the European style credit method VAT is specifically designed to avoid cascading even when services are part of the tax base. Because each entrepreneur recoups (by means of the credit) the tax he paid, he need not include the VAT he paid into his selling price in order to maintain his profit margin.[13] Thus, a five percent credit method VAT will collect no more tax than a five percent tax levied only on the final sale in the production chain. In the hypothetical case of the lawyer and her paper, the lawyer need not add the sales tax paid on the purchase of the paper to her bill because she will recoup the tax from the VAT she collects from her client. Thus, no tax is collected on tax.

Some cascading is common in RST jurisdictions,[14] but in theory this need not be the case. To the extent the RST avoids cascading, the avoidance is achieved primarily by the mechanism of the resale certificate. In the case of the lawyer, for instance, she may be given written authority by the Revenue Agency to purchase items for resale without paying sales tax. As long as the buyer is purchasing products for resale, no retail sales tax applies and no potential for cascading exists. A

12. For a discussion of the competitive distortions caused by cumulative cascades, see TERRA, *supra* note 1, ch. IV.3.1. Cumulative cascading will tend to favor vertically integrated businesses because the shorter the production and distribution chain, the less tax burden on the business. It also favors labor intensive businesses over capital intensive businesses because capital is taxed but wages are not. Perhaps most importantly, cascading causes sales tax to become embedded in the product in such a way that the tax cannot be removed when goods are exported. This causes such goods to be less competitive in the external market. *See id. See also* Sijbren Cnossen, *Consumption Taxes and International Competitiveness: The OECD Experience*, 52 TAX NOTES 1211, 1212-13 (1991); Bickley, *supra* note 10, at 456-7 (describing how the VAT maintains external neutrality).

13. By allowing each entrepreneur a credit against the VAT he collects equal to the amount of the VAT he paid, the only tax actually imposed at each stage is for the value added at that stage, hence the name of the tax. Cumulatively, that amount will equal the VAT rate applied to the retail sale price.

14. Most RST jurisdictions accept some cascading by taxing some entrepreneurial purchases of capital goods. For instance, the retailer may pay sales tax on all of her purchases of office equipment and furniture. *See* Cnossen, *supra* note 4, at 601.

difficulty arises, however, when the entrepreneur purchases items of which he is the final consumer. For example, suppose the lawyer buys a computer disk on which she records the client's will. Should such purchases be subject to tax? From one perspective those purchases should not be taxable since they were made in an entrepreneurial capacity. They are not true retail sales. Yet, literally speaking, the disk was purchased by its ultimate consumer, the lawyer. Thus, from a different perspective the sales tax should apply. However, if the sale of the computer disk is taxed, the lawyer will pass the tax along in her bill to the client. Thus, when the sales tax is imposed on the lawyer's fee, the cascade effect will occur; tax will be imposed on tax.

One solution to this problem is to indulge in the legal fiction that the lawyer is buying the computer disk in order to resell it.[15] Thus, the lawyer would be permitted to use her resale certificate to purchase the computer disk free of sales tax. Alternatively, the sales tax statute could be written to exempt all entrepreneurial purchases including those in which the entrepreneur is the final consumer of the item or service purchased. However, this solution to the cascade effect would continue to create problems in determining when the RST should apply and when it should not. For example, if the lawyer provides services to a business entrepreneur, should the lawyer collect the RST on her fee or should her fee be treated as a sale for resale? The answer will depend on the entrepreneur's purpose in consulting the lawyer. If the purpose is business related, no RST should be collected. If the purpose is personal, the RST should be collected. Thus, the RST will always require some inquiry into the buyer's motive for the purchase in order to determine whether the sale is taxable.

As the foregoing analysis demonstrates, the avoidance of cascading in the case of the RST can seem more forced than in the case of the VAT. The fact remains, however, that both forms of taxation can be structured to avoid the problem of tax on tax. Thus, the choice between the two forms should not be determined solely by the potential for cascading. Perhaps it could be said that the VAT is ahead on points with respect to the cascade effect.[16]

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15. In a metaphorical sense, the lawyer is buying the disk to resell it, *i.e.*, she is using it in service of her client rather than in her personal service. Thus, the legal fiction of allowing the lawyer to use her resale certificate to avoid tax on the purchase can be justified. After all, the lawyer will include the cost of the disk in her bill to the client. Thus, ultimately the client will indirectly pay sales tax on the lawyer's purchase of the disk.

16. Professor Due appears to accept this view. *See* Due, *supra* note 4, at 16:6-7. Indeed, he concedes that as a practical matter cascading is quite prevalent in RST jurisdictions because entrepreneurial purchases are commonly taxed. *Id.*

IV. TAXATION OF SERVICES

Generally speaking, a sales tax should apply to sales of services as well as to sales of goods. There are two primary reasons for this. The first reason is revenue. By adding services to the sales tax base, much more revenue can be produced with the same rate of tax.[17] Thus, taxation of services allows the sales tax rate to remain relatively low. Second, taxation of services can partially relieve the regressive character of the sales tax since services tend to be purchased to a greater extent by higher income individuals.[18] A third reason sometimes offered for taxing services is to avoid competitive distortions. For example, if the tax is levied upon the sale of washing machines but not upon the sale of laundry services, there is introduced into the economy a competitive advantage to laundry service providers over washing machine sellers.[19]

In this country, many services, such as advertising, legal, and medical services, traditionally have not been subject to RST. However, there is no inherent or structural reason why the RST cannot or should not apply to services. For instance, in the case described in the discussion of the cascade effect concerning the lawyer who provides her client with a will, computation of the sales tax is a simple matter of applying a rate, say five percent, to the amount of the lawyer's fee.[20]

The only change required in the traditional state sales tax in order to tax most services in an appropriate manner would be the need to exclude all of the lawyer's purchases from sales taxation in order to avoid the cascade effect. As noted above, this could be done by allowing the lawyer to treat all of her purchases as if they were purchases for resale.

In a sense, the extension of the sales tax to services would represent a simplification of the RST because such extension would justify exempting all entrepreneurial purchases from taxation. Under the current regime of taxing sales of goods but not sales of services,[21] it is necessary to tax entrepreneurial purchases that do not lead to a sale subject to tax (as when the lawyer buys paper and then uses it to produce a will which is not subject to tax). An RST that applies uniformly to services and goods does not need to tax entrepreneurial

17. Cnossen asserts that "services outside distribution easily comprise half of GDP in industrialized countries." Cnossen, *supra* note 4, at 594.

18. TERRA, *supra* note 1, ch. XIII.2.1. Cnossen, *supra* note 4, at 595-96. However, the sales tax remains essentially a regressive tax.

19. *See* TERRA, *supra* note 1, ch. II.2 (where this example is set out).

20. Certainly many difficult questions would arise in taxing services. For example, taxation of interstate advertising is a much more difficult proposition than my example.

21. Most states do tax at least some services, but the coverage is not generally pervasive.

purchases even when the entrepreneur is nominally the ultimate consumer because the end transaction between the entrepreneur and the non-entrepreneur is always taxed. However, as revealed by the example of the lawyer who provides a service to another entrepreneur, the RST always involves the need to distinguish between entrepreneurial and non-entrepreneurial sales if the cascade effect is to be avoided. Distinguishing between taxable and non-taxable sales can be difficult, and the need to do so exposes the system to potential abuse.[22]

The VAT is well adapted to taxing sales of services. The credit mechanism works just as well for the service entrepreneur as for the goods entrepreneur. In each case, the entrepreneur pays VAT on his purchases and collects it on his sales, remitting only the excess of what he collects over what he paid to the Treasury. Indeed, one might say the VAT is specifically designed to tax everything, goods and services alike. In particular, unlike the RST, there is no need to distinguish between entrepreneurial and non-entrepreneurial sales because the VAT is imposed on every sale. When it comes to taxing services, again it might be said that the VAT is ahead of the RST on points.[23]

V. ADMINISTRATIVE EFFICIENCY

It is sometimes argued that one of the chief advantages of the VAT is that its form makes it easier to enforce than a RST.[24] Because each entrepreneur is required to keep accurate records of the VAT he paid in order to get credit against the VAT he collects, he has an economic incentive against dealing with his suppliers and customers "off the books." Moreover, the record chain that is built up under the VAT system is thought to make evasion more detectable by audit.[25] The value of these administrative aspects of the VAT is not beyond dispute,[26] but it is probably correct to say that the VAT offers an enforcement advantage over the RST. However, sales tax audits (whether VAT or RST) are expensive and extremely labor intensive. Substantial voluntary compliance is necessary for any sales tax to work smoothly.

It is arguable that voluntary compliance with the RST is easier than with the VAT because there are fewer collecting points. How-

22. *See* Cnossen, *supra* note 4, at 597.
23. It is not clear to me that Professor Due would concede this. *See* Due, *supra* note 4, at 16:7-8. He seems more inclined to believe that the two taxes are equally adaptable to taxation of services. *Id.* Cnossen and Terra both hold the opinion that the VAT is superior in its handling of taxation of services. *See* Cnossen, *supra* note 4, at 597; TERRA, *supra* note 1, ch. XIII.2.1.
24. Due, *supra* note 4, at 16:3; TERRA, *supra* note 1, ch. XIII.2.1, XIII.3.
25. Due, *supra* note 4, at 16:3-4; Cnossen, *supra* note 4, at 581.
26. Professor Due, in particular, contends that these arguments in favor of the VAT are overrated. *See* Due, *supra* note 4, at 16:4.

ever, only in a nominal sense is all the tax collected at the retail level in a RST system. In fact, wholesalers and manufacturers are often part of the RST collection network. Their records must sometimes be examined to properly calculate a retailer's liability, and many, if not all of them will have some direct sales or use tax liability of their own. For instance, a gasoline refiner will purchase unrefined oil free of RST because it is a manufacturer. It may consume some of the oil in its operations and, thus, incur a use tax liability. It may also sell fuel directly to ultimate consumers such as airlines or fishing fleets, thus subjecting itself to tax liability as a retailer. Admittedly, this assumes that entrepreneurial consumption is subject to the RST. It was suggested previously that on a theoretical level such consumption should not be taxed. A broad based RST that taxes sales of both goods and services should exclude all entrepreneurial purchases in order to avoid the cascade effect. However, the fact remains that entrepreneurial purchases are commonly taxed under most RST regimes. Consequently, most manufacturers and wholesalers are likely to have sales or use tax liabilities.

Another debatable administrative advantage of the RST over the VAT is its handling of exemptions. Sales tax exemptions have proven prolific in most states.[27] Exemptions create more complications in a VAT than in an RST because they must be "carried, almost of necessity, through all levels of production and distribution."[28] Thus, a VAT system that incorporates a large number of exemptions could be administratively complex. However, it has been suggested that the complicating effects of exemptions on the VAT may tend to discourage the enactment of exemptions under a VAT regime.[29] Thus, the VAT's unwieldiness with respect to exemptions could be seen as an advantage if one believes that exemptions in a sales tax are generally undesirable.[30]

The necessity for distinguishing between entrepreneurial and non-entrepreneurial purchases has already been alluded to as one of the administrative problems of the RST. If a person buys a truckload of

27. *See* DUE AND MIKESELL, *supra* note 3, ch. 3.

28. Due, *supra* note 4, at 16:7.

29. *Id.*

30. Most commentators believe the avoidance of exemptions and differing rates to be highly preferable despite the implications this may have for regressivity. *See, e.g.*, TERRA, *supra* note 1, ch. VI.3.; Cnossen, *supra* note 4, at 607-09. The obvious advantage of permitting few or no exemptions is that revenue needs can be met with a lower rate of tax. To illustrate the point, one need only point to the Tax Reform Act of 1986 which dropped the top individual income tax marginal rate from 50% to 28%. The Act was designed to be revenue neutral. As mentioned in the text, exemptions also create complexity.

It might be noted that a commonly suggested solution for the VAT's regressivity is some form of direct rebate to low income persons. *See, e.g.*, TERRA, *supra* note 1, ch. VI.3.

gravel from a quarry in order to cover the driveway at his home, the RST should apply to the sale. If that same person buys a truckload of gravel from the same quarry in order to make concrete blocks for resale, the RST should not apply to the sale. How is the quarry to know whether to collect RST on the sale of any given truckload of gravel? To some extent, the quarry is simply obliged to take the buyer's word as to his intentions. If the buyer shows the seller his resale certificate issued by the taxing authority, the seller is unlikely to collect the tax. Thus, the RST is inherently susceptible to complexity and abuse.

The VAT system does not call for the exercise of discretion by the seller in collection of the tax. The seller must always collect the tax. Thus, the onus is on the buyer to establish that he is entitled to a credit for the VAT he paid against the VAT he subsequently collects from his buyer.[31] In this way the VAT avoids the significant danger of cascading while also limiting its exposure to the potential for complexity and abuse that discretionary judgments about collection entail.

One of the chief enforceability comparisons between the VAT and the RST involves interstate sales. That issue is left for the next section of this article. However, leaving aside the issue of interstate sales, it can reasonably be said that the VAT is structurally superior to the RST from an enforcement perspective due to the lack of discretion the VAT permits in the collection of the tax. This structural advantage is particularly important if one wishes to include most services in the tax base.

VI. INTERSTATE SALES

A controlling principle in interstate sales taxation in this country is the Destination Principle.[32] By this it is meant that when goods are sold in interstate commerce, the sales tax applicable to the transaction is that of the state of destination rather than the sales tax of the state of origin. (The reverse of the Destination Principle is aptly referred to as the Origin Principle.) This assumes a true interstate sale where title or possession passes to the buyer in the state of destination. For sales tax purposes, a sale is intrastate if it is completed in the seller's state of residence even though the purchase may have been made for

31. *See* Cnossen, *supra* note 4, at 581. He asserts that this is a significant enforcement advantage of the VAT over the RST.

32. This term is used because it has a certain universal meaning. *See* TERRA, *supra* note 1,] ch. II.4. In a broad context the Destination Principle taxes goods where they are consumed. *Id.* It is employed in the EC VAT system. *Id.* at ch. IX.3.1. Whether a product is "consumed" in one state or another may be a close question, but in this context "consumed" simply refers to the place where the taxable event takes place. Terra's discussion of the concept of "consumption" gives it a meaning which is quite compatible with our method of levying sales taxes in the state where the transaction is completed. *See Id.* at ch. II.3. *See also* Cnossen, *supra* note 4, at 579.

the purpose of using the goods in another state.[33]

The Destination Principle may be seen as a natural concomitant to the limits of state sovereignty. Sales that take place beyond the state's border are beyond the state's ability to tax.[34] This creates an obvious tax incentive for residents in sales tax states to make their purchases in non-sales tax states. Hence the need for a use tax as an enforcement mechanism for the sales tax.[35] The importance of the use tax has diminished as sales taxes have become more prevalent because most states allow a credit against their use tax for sales tax properly paid to another state.[36] Thus, if a taxpayer makes a purchase in a state with a four percent sales tax and brings the item into a state which levies a five percent sales and use tax, he is liable for only the one percent difference in rate between the first state's sales tax and the second state's use tax. The utility of the use tax has always been severely circumscribed by the practical difficulties of administering it, but *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois*[37] served to greatly exacerbate those practical difficulties.

In *National Bellas Hess* the Supreme Court ruled that Illinois lacked the authority to require an out-of-state company to collect Illinois use tax on a mail order sale to an Illinois resident. Whether Congress has the power to overturn the Court's decision is a matter of some debate.[38] This debate stems from the ambiguous wording of the Court's opinion[39] which leaves it unclear whether the result rested on

33. State Tax Comm'n v. Pacific States Cast Iron Pipe Co., 372 U.S. 605 (1963); International Harvester Co. v. Department of Treasury, 322 U.S. 340 (1944). This comports with the meaning of "consumption" in sales tax law. *See supra* note 32.

34. But this view is subject to challenge. *See infra* notes 47 and 48.

35. *See* DUE AND MIKESELL, *supra* note 3, at 245.

36. *Id.* at 247.

37. 386 U.S. 753 (1967).

38. *See, eg., Interstate Sales Tax Collection Act of 1987 and the Equity in Interstate Competition Act of 1987: Hearings Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary*, 100th Cong., 2nd Sess. 75-76, 143-44 (1988)(statement of Lucas A. Powe, Jr., Professor of Law, University of Texas School of Law and statement of Jerome R. Hellerstein, Adjunct Professor, New York University School of Law).

39. In his majority opinion Justice Stewart wrote, ". . .the test whether a particular state exaction is such as to invade the exclusive authority of Congress to regulate trade between the States, and the test for a State's compliance with the requirements of due process in this area are similar." National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois, 386 U.S. 753, 756 (1967). He went on to discuss the facts of the case in relation to both due process and interstate commerce legal principles without ever specifying the ultimate foundation for the result reached. In the end though, the Court implied that Congress possesses the authority to change the result when it said, "[t]he very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements. Under the Constitution, this is a domain where Congress alone has the power of regulation and control." *Id.* at 760.

the Due Process Clause[40] or the Commerce Clause[41]. If the decision rested on the former, then Congress presumably is powerless to change the result. But, if the decision rested on the Commerce Clause, then Congress's authority to regulate interstate commerce is plainly sufficient to overrule the result in *National Bellas Hess*. As an aside, it might be noted that a recent Supreme Court decision indicated that *National Bellas Hess* rested on the Commerce Clause.[42]

If the ruling paradigm in state taxation of interstate sales is the Destination Principle, then *National Bellas Hess* must be seen as aberrational. From a sales tax theory perspective, the decision in *National Bellas Hess* should be overruled since the decision distorts the market by giving mail order companies a competitive advantage over local sellers of the same or similar products.[43] The states have a strong interest in seeing the decision overturned[44] since it is extremely impractical for them to collect the use tax on mail order sales directly from consumers. This impracticality stems from the fact that the needed assessment information is not available to the states,[45] and, even if it were available, a great deal of administrative inconvenience would be involved in collecting the usually small tax liabilities from such a large pool of taxpayers. Over time, the states have sought to minimize the significance of *National Bellas Hess*, and there is some uncertainty

40. U.S. CONST. amend. XIV, § 1.

41. U.S. CONST. art. I, § 8, cl. 3.

42. D. H. Holmes Co., Ltd. v. McNamara, 486 U.S. 24 (1988).

43. Whether constitutional principles support such an outcome is another matter. As a rule of thumb, we might say that the Commerce Clause should not be applied to defeat non-discriminatory state taxes. Since state sales taxes are uniform in their application to resident and non-resident sellers, one could argue that there is no compelling reason to give the non-resident sellers exempt status (and the resulting competitive advantage that exempt status conveys). The dormant Commerce Clause, it has been cogently argued, simply forbids states from engaging in purposeful protectionism. *See* Donald H. Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause*, 84 MICH. L. REV. 1091, 1093 (1986). Though Professor Regan was writing about what he called "movement of goods cases," perhaps the same logic could be made to apply to state sales taxation of interstate sales in a manner consistent with the Destination Principle.

44. It has been estimated that, nationally, state revenue losses from untaxed mail order sales are in excess of $1.5 billion annually. *Progress Reported in Negotiations on Mail Order Sales Tax Bill*, 80 DTR G-3, 4 (3-1-88).

45. The same barrier which prevents the states from collecting the tax from the mail order companies also prevents them from auditing the mail order houses' records. The statute in issue in *National Bellas Hess* not only imposed an obligation to collect and remit the Illinois use tax, it also required recordkeeping and submission to necessary "investigations, hearings, and examinations". National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois, 386 U.S. 753, 755 (1967). Though the Court did not specify, it seems clear that when it released *National Bellas Hess* from the obligation to collect the tax, it also released it from the other burdens imposed by the statute in issue.

about its continued vitality.[46]

If *National Bellas Hess* is not overruled, then perhaps, as has been suggested,[47] the states in which the mail order companies reside could attempt to apply their own sales taxes to these interstate sales.[48] It would be anomalous if one class of retail sales was immune from sales taxation in both the state of origin and the state of destination.[49] Even so, application of the Origin Principle to interstate sales is undesirable since such an approach invites competitive distortions by taxing goods destined for export and conflicts with the essential nature of the sales tax as a tax upon consumption. The Destination Principle is the logical standard to adopt. It effectively frees exports of tax and taxes imports at the rate equivalent to the rate on competing domestic goods. This external neutrality of the Destination Principle is a major virtue.[50] Constitutional considerations aside, the Destination Principle makes sense for purposes of state sales taxation.[51]

Both the VAT and the RST are suited to the Destination Principle. In theory, the RST is destination based since it is collected at the final point in the sales chain. However, since most RSTs permit some cascading, such as by taxing entrepreneurial purchases of capital goods, it is probable that exports from an RST jurisdiction are not entirely free of tax.[52] This means that those exports will be at a competitive disad-

46. Recently, the Supreme Court of North Dakota has concluded that *National Bellas Hess* has lost much of its significance. *See* North Dakota v. Quill Corp., No. 900257, slip op. (May 7, 1991). For commentary on this decision, see Maryann B. Gall, *Commentary: The Nexus Wars*, 69 TAXES 541 (Sept. 1991); James H. Peters, *Why Nexus?*, 1 STATE TAX NOTES 77 (Sept. 16, 1991). The U.S. Supreme Court has granted certiorari in the *Quill* case. *See* Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co., 1991 U.S. Lexis 4777, 60 U.S.L.W. 3257 (Oct. 7, 1991).

47. Michael F. Baccash, *State Taxation of Interstate Commerce—Can a State Constitutionally Levy Its Sales Tax on an "Interstate Sale"?*, 3 N.Y.U. INST. ON ST. AND LOC. TAX'N § 1.01, 1-5 (1985).

48. Baccash contends that application of the four prong test in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), will validate taxation of interstate sales by the state of origin if credit is allowed for sales or use tax paid in the state of destination. *See* Baccash, *supra* note 47, at 1-21 to 1-25.

49. Of course *National Bellas Hess* involved simply requiring the seller to collect the use tax owed by its buyer, but it is implicit in such an approach that the more direct route of collecting the sales tax from the seller was unavailable to the State.

50. TERRA, *supra* note 1, ch. III.3. A retail sales tax is also neutral in its impact on internal competition (as compared with a cumulative, multistage sales tax) since the RST falls equally upon goods produced under integrated and non-integrated conditions. *Id.*; ALBERT J. ROBINSON, THE RETAIL SALES TAX IN CANADA 33 (Can. Tax Paper No. 77, 1986). However, since not all purchases by entrepreneurs are exempt from most RSTs, some cascading of tax does occur.

51. For an analysis of the applicability of the Destination Principle in a federal VAT context, see Sijbren Cnossen, *The Irrelevance of the Restricted Origin Principle*, 20 TAX NOTES 521 (1983).

52. Cnossen, *supra* note 4, at 602.

vantage *vis-a-vis* similar goods produced in a jurisdiction where such cascading is avoided.[53] Still, one may say that for the most part the RST allows exports to leave the origin state free of tax.

The VAT's compliance with the Destination Principle takes a different form from the compliance of the RST. This is because the multistage structure of the VAT means that exports will almost certainly have been subjected to some tax prior to shipment out of state. Thus, the VAT's compliance with the Destination Principle requires that the tax collected on goods and services prior to their export must be refunded, or some other mechanism must be found for freeing the goods from domestic VAT.[54] In the context of our federal system, refunds are the most likely approach unless we posit a scenario under which a large number of states all adopt a VAT within a short time of one another. In the event of multiple adoptions of the VAT, it is conceivable that some sort of clearinghouse system could be adopted in the form of an interstate compact.[55]

Such a clearinghouse system would avoid the necessity for refunds to the exporter by allowing him to deduct the VAT he paid from the VAT he collects (even though the VAT he paid was remitted to the exporting state's treasury and the VAT he collects is remitted to the importing state's treasury). Instead of making refunds to exporters, the exporting state would credit the account of the import state in the amount of the tax it collected prior to export.

A simple example will serve to illustrate the clearinghouse system. Suppose Exporter Alpha, located in California, makes a sale to Buyer Beta, located in Delaware. Suppose further that Alpha had previously paid forty dollars of VAT on its product when it purchased that product in California. Suppose also that the Delaware VAT applicable to the sale to Beta is fifty dollars. Under the clearinghouse system, Alpha will collect the fifty dollar Delaware VAT but remit only ten dollars to the Delaware treasury (the excess of the fifty dollars it collected over the forty dollars it paid). Delaware will obtain the remaining forty dollars of the Delaware VAT from California.

Since it is likely states will be both importers and exporters with respect to all other VAT states, actual cash payments would be minimized. Instead, each state will receive or pay only the net difference between the tax it collects on its exports and the tax it is owed on its imports.[56] Obviously, such a system would involve elaborate bookkeeping. Ideally, it would operate with a single central authority

53. *Id.*

54. Due, *supra* note 4, at 16:5.

55. For an early, seminal work concerning the Compact Clause, see Felix Frankfurter & James M. Landis, *The Compact Clause of the Constitution: A Study in Interstate Adjustments*, 34 YALE L.J. 685 (1925).

56. Presumably, the accounts would be cleared by actual payment on an annual basis.

keeping track of the balances in all of the states' accounts with one another.

The interesting point about the clearinghouse approach, for present purposes, is the potential it possesses for addressing the *National Bellas Hess* problem. If an exporter can only recover the VAT he has already paid by deducting it from the VAT he collects from his buyer, then the mail order companies will have an economic incentive to collect the tax from their out-of-state purchasers. Thus, the VAT holds the potential for creating voluntary compliance among mail order companies in the collection of the VAT on their out-of-state sales.[57]

To summarize this somewhat lengthy section, both the VAT and the RST are largely compatible with the Destination Principle in the context of interstate sales. The VAT is somewhat more complicated to administer in the interstate sales context, but that complexity is manageable. Neither form of sales tax offers any particular advantage with respect to the neutrality problem posed by *National Bellas Hess* unless the clearinghouse approach is adopted by those states employing the VAT. However, the clearinghouse approach holds out the potential for voluntary compliance with the VAT by mail order companies in order to obtain the indirect return of the VAT they paid on their purchases.

VII. SPECULATIONS ON THE EFFECT OF STATE VATS ON THE FEDERAL TAX SYSTEM

Whether the United States government will ever enact a broad based sales tax is an open question.[58] To a great extent, it depends on

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The clearinghouse system is described by both Terra and Cnossen. *See* TERRA, *supra* note 1, ch. XII.4; Cnossen, *supra* note 4, at 604.

57. I do not wish to oversell this idea. Another possibility is that the mail order company would simply add the VAT it paid to its retail price for its mail order goods. Thus, it could recover the VAT without officially collecting it and, thereby, avoid having any obligation to remit any tax to the destination state.

58. The desirability of Congressional enactment of a national sales tax has long been a topic of debate. *See* Alan Schenk, *Value Added Tax: Does This Consumption Tax Have a Place in the Federal Tax System?*, 7 VA. TAX REV. 207, 225 (1987); Surrey, *supra* note 4, at 475. It is frequently considered for inclusion in the Congressional tax agenda. *See, e.g.*, Karin M. Skadden, *1989 Tax Agenda May Include a Value-Added Tax*, 38 TAX NOTES 547 (1988). *See also* Ellin Rosenthal, *The 1989 Tax Debate: Consumption Taxes and Sacred Cows*, 39 TAX NOTES 1501 (1988). There are a number of important policy issues bearing on the question of whether such a tax should be enacted. For the moment the most prominent argument in support of enactment is that a national sales tax is necessary if we are to eliminate our persistent federal budget deficits. *See, e.g.*, Henry J. Aaron, *The Political Economy of a Value-Added Tax in the United States*, 38 TAX NOTES 1111 (1988); *Koch Makes a Case for a National Value-Added Tax as a Revenue Enhancing Measure*, 37 TAX NOTES 1205 (1987); Lee A. Sheppard, *Why We Need a VAT*, 34 TAX NOTES 529 (1987); Gerard M. Brannon, *The Value Added Tax is a Good Utility Infielder*, 37 NAT'L TAX J. 303 (1984). This argument was being considered

the condition of the U.S. economy. If the federal government does enact a broad based sales tax, it will probably choose the VAT over the RST. The works of John Due, Charles McLure, Sjibren Cnossen, Ben Terra, Alan Schenk, and many others have laid the groundwork for such an eventuality. Also, the tides of history presently run in favor of the VAT. The recent enactments of VATs in Canada and Japan are the most obvious indicators of this fact.[59] This being true, what effect would the adoption of VATs by the states have on the federal tax system? One can posit at least two divergent scenarios.

It is possible that the states could head off the enactment of a federal VAT by staking out the VAT as their "tax turf." The states could be perceived as saying to the federal government that broad based sales taxation, whether VAT or RST, is their exclusive province. On the other hand, numerous state adoptions of the VAT could lead to widespread public acceptance of this hitherto little known form of taxation. This, in turn, could pave the way for public acceptance of a federal VAT. Which of these scenarios is more likely? It is uncertain. However, under either scenario the states would probably come out ahead of where they would be if the federal government adopted a VAT in an environment where there were no state VATs. This is because federal adoption of a VAT at a time when no state VATs exist might make it more difficult for the states to enact VATs of their own or even to enlarge the coverage of their existing RSTs.[60]

If state adoptions of the VAT prevent the federal government's entry into the field of sales taxation, the states will have saved their tax turf. If the federal government adopts a VAT despite state adoptions of a VAT, at least the states will be in position to assert their right to continue to levy the tax in the face of possible preemption claims.[61] Moreover, it is even possible that the states would be better suited to

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even prior to the Reagan Era deficits. *See* Hugh Calkins, *The Role of The Value Added Tax in the Developing United States Tax System*, 6 J. CORP. L. 83, 101 (1980). But there are, of course, many points of debate regarding the wisdom of such an enactment. *See, e.g., A Report of a Subcommittee of the Special Committee on Value Added Tax, Should the United States Adopt the Value Added Tax?—A Survey of Policy Considerations and the Data Base*, 26 TAX LAWYER 45 (1972); Michael A. Schuyler, *Consumption Taxes: Promises and Problems*, 25 TAX NOTES 571 (1984). These include the regressivity of sales taxes, their potential for fueling inflation, their role in encouraging savings and capital formation, and the possible detrimental effects on state revenue raising capabilities of a national sales tax.

59. *See* Cnossen, *supra* note 12, at 1211. In all, twenty-one of the twenty-four members of the Organization for Economic Cooperation and Development (OECD) have adopted VATs, and thirty-five countries in Latin America, Asia and Africa have done the same. *Id.*

60. *See* McLure, *supra* note 4, at 1529-30.

61. I do not use preemption in a technical legal sense here. Instead, I use it to describe the possible resistance to enactment of a state VAT that a preexisting federal VAT might generate. *See Id.*

administer the federal tax than would the federal government since the states would already have a tax collection bureaucracy in place.[62] Such a system would be analogous to that employed in the European Community.[63]

VIII. CONCLUSION

On balance, the VAT is technically superior to the RST and is worthy of adoption by the states. The VAT's superiority is relatively slight with respect to any single aspect of the two taxes, but cumulatively the clear advantage lies with the VAT. The VAT is better suited to avoid cascading, it taxes services more easily, and it has a better enforcement scheme. In addition, widespread state adoption of the VAT holds some promise for improving state taxation of interstate mail order sales. This is because the clearinghouse method of collecting VAT on interstate sales would give the mail order companies an economic incentive to voluntarily collect the destination state's VAT. Finally, state adoption of the VAT would tend to insure that the field of sales taxation will remain subject to state sovereign control even if the federal government should later adopt a VAT.

From all this one might assume that I believe the states should immediately switch from their retail sales taxes to a value added tax. On a technical level this is probably correct. However, such a change involves more than a technical question. The switch to a VAT would impose the sales tax in new and unfamiliar ways and would arouse public controversy. Providers and consumers of services, in particular, might find the tax bite intolerable under a broad based VAT regime. Thus, I conclude that state adoption of a value added tax is a desperate act in search of the proper occasion. Sales taxes, after all, are children of despair.

62. I have developed this idea at some length elsewhere and will not repeat myself here. *See* Miller, *supra* note 3. Charles McLure has explored a variety of possible arrangements for coordination of state and federal consumption taxes. *See* McLure, *supra* note 4, at 1526-30.

63. Miller, *supra* note 3, at 247-48.