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Daniel S. Goldberg

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by

*Daniel S. Goldberg**

Abstract

The U.S. federal government raises tax revenue almost exclusively through income taxes, both corporate and individual, whereas its trading partners and competitors rely for their national revenue on both income taxes and "destination-based" value added taxes (VATs), which are not imposed on exports but are imposed on imports. As a result, U.S. corporations, which are subject to U.S. corporate income tax, may be at a serious trade disadvantage to competitor non-U.S. corporations with respect to both U.S. domestic sales and foreign sales, if the U.S. corporate income tax exceeds the foreign country's income tax imposed on those competitors.

The Biden administration has proposed raising the tax rate on U.S. corporate income from its current 21 percent to 25 percent and perhaps even more likely to 28 percent. The proposed rate increase faces substantial Republican opposition. The opposition to the proposed rate increase argues that such an increase will chase business offshore and put the U.S. at a competitive disadvantage in attracting business and selling products both in the U.S. and abroad that compete with foreign

* Professor of Law, University of Maryland Francis King Carey School of Law; University of Rochester, A.B. 1968; Harvard Law School, J.D. 1971. The author thanks Professor Walter Schwidetzky of the University of Baltimore School of Law for his helpful comments to a draft of this Article. The author also thanks Mark Melmed, a law student at the University of Maryland Carey School of Law, for his research assistance in preparing this Article.

products. The problem, simply put, is that foreign countries rely on VATs and can afford to maintain lower corporate income tax rates than otherwise, but the U.S. does not have a supplemental source of revenue like a VAT.

The issue of a competitive U.S. corporate income tax is not simply a current Biden/Republican tax rate disagreement about raising the U.S. corporate income tax. Rather, it is an issue about U.S. corporations having to compete with foreign corporations from countries that impose a lower income tax (and no VAT on exports) on those corporations than the U.S. imposes on its domestic corporations, and, further, that the U.S. cannot reciprocate by charging a lower income tax on its exports than on its domestic sales because of international treaty constraints. Thus, the issue reaches well beyond a proposed Biden administration corporate income tax increase, but rather to the structure of the U.S. business tax system of not having a VAT in some form as an integral part.

This Article considers revenue raising alternatives to supplement the current business income taxes and recommends that a subtraction VAT should be added to the corporate income tax as, at the very least, a step in keeping the corporate income tax competitive with the U.S.'s trading partner countries, perhaps as the long-term solution but perhaps as a first step to the adoption of a credit VAT to supplement the corporate income tax. In doing the foregoing, the Article compares the two types of business-level consumption taxes, the credit method VAT and the subtraction method VAT, relating them back to the most basic consumption tax, the retail sales tax. The Article argues that the subtraction method VAT, although not adopted by any other country, should be the choice because it can be added to the corporate income tax as a supplemental tax and can most easily coexist and be coordinated with that tax. It thereby allows for the easiest transition and is likely to be most acceptable to the public, which is well used to the corporate income tax and, as many observers believe, would be unwilling to adopt a credit method VAT, seeing it as a refined retail sales tax, which is a consumption tax imposed on individuals.

The Article then describes the proposed "Supplemental Subtraction VAT" that would supplement the tax on a corporation's income and how it can be engrafted onto the existing corporate income tax to minimize the disruption to the current corporate income tax collection system. It then argues that the new supplemental subtraction VAT imposed on corporations, which would be destination-based, should be accepted as a VAT by the WTO and the U.S.'s trading partners for international tax and trade treaty purposes.

Introduction

Every country, including the United States, can choose its own tax system for raising revenue, and the U.S. maintains a federal tax system that is out of step with many of its industrial trading partners and competitors. The U.S. federal government raises tax revenue almost exclusively through an income tax, both corporate and individual, whereas its trading partners and competitors rely for their national revenue on both income taxes and value added taxes (VATs), and those VATs are "destination based," i.e., are not imposed on exports but are imposed on imports. As a result, corporations in the U.S., subject to U.S. income tax, may be at a substantial trade disadvantage to competitor non-U.S. corporations if the U.S. corporate income tax exceeds the foreign country's corporate income tax imposed on those competitors.

U.S. corporations engaged in international selling in competition with domestic sellers in those countries and who compete with foreign sellers for sales in the U.S. are greatly affected by the relative amounts of taxes borne by their products and foreign competitors' products. A U.S. corporate income tax that is lower than the foreign corporate income tax gives the U.S. corporation a competitive advantage but a U.S. corporate income tax that is greater than the foreign corporate income tax causes the U.S. corporation to suffer a competitive disadvantage. Prior to the Trump administration, the U.S. corporate income tax exceeded that of most foreign countries, but because of the Trump corporate tax reduction, it is now lower than those countries'.

The current U.S. corporate income tax rate is 21%, having been reduced in 2017 from 35% (with some graduation for low-income levels with respect to the 35% top rate, which were thereafter recaptured as income levels increase).[1] The Biden administration has proposed raising the tax rate on U.S. corporate income to 25% and perhaps even more likely to 28%.[2] The proposed rate increase faces substantial Republican opposition. That opposition argues that such an increase will chase business offshore and put the U.S. at a competitive disadvantage in attracting business and selling products both in the U.S. and abroad, that compete with foreign products. The problem, put simply, is that foreign countries rely on VATs and can afford to maintain lower corporate income tax rates than otherwise, but the U.S. does not have a supplemental source of revenue like a VATs.

The issue of a competitive U.S. corporate income tax is not simply a current Biden/Republican tax rate disagreement about raising the U.S. corporate income tax. Rather, it is an issue about U.S. corporations having to compete with foreign corporations from countries that impose a lower income tax (and no VAT on exports) on those corporations than the U.S. imposes on its domestic corporations, and, further, that the U.S. cannot reciprocate by charging a lower income tax on its exports than on its domestic sales because of international treaty constraints. Thus, the issue reaches well beyond a proposed Biden administration corporate income tax increase, but rather to the structure of the U.S. business tax system of not having a VAT in some form as an integral part.

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1. I.R.C. § 11(b) (amending I.R.C. § 11(b) (1993)).

2. Garrett Watson et. al., *Details and Analysis of President Joe Biden's Campaign Tax Plan*, Tax Foundation (Oct. 22, 2020), https://taxfoundation.org/joe-biden-tax-plan-2020/ [https://perma.cc/6373-FHTE].

On a related issue, Treasury Secretary Yellen has proposed that the industrialized trading countries establish a minimum rate for the corporate income tax to avoid countries seeking to attract other countries' companies and businesses by competing on tax rates—spurring a so-called "race to the bottom."[3] The G-7 and likely many other OECD (Organization for Economic Co-operation and Development) countries "agree in principle" with the minimum tax rate concept, but propose to set that minimum rate at around 15%, an irrelevantly low rate, since most if not all of those countries in agreement have corporate income tax rates that are higher than 15%,[4] which of course means that they do not agree at all but seek to remain agreeable. Some OECD countries, however, most notably Ireland, have a corporate rate less than the 15% minimum and have objected to the mandate but would adopt it grudgingly and under threat.

The U.S. would be a certain loser in a race to the bottom because it has no national alternative to the corporate income tax for raising revenue, whereas most of the competitive countries raise much of their national revenue with a VAT. So, the race to the bottom would not be much of a race and everyone knows that, notwithstanding what they say in public. As a result, there is a large impediment to the U.S. raising its corporate income tax rate, and if it does so anyway, it is believed that

3. Press Release, Janet L. Yellen, Secretary of Treasury, Statement from Secretary of Treasury Janet L. Yellen on Today's Agreement of 130 Countries to Support a Global Minimum Tax for the World's Largest Companies (July 1, 2021), https://home.treasury.gov/news/press-releases/jy0255 [https://perma.cc/V6BL-UBKV].

4. This 15% rate would affect intangible asset tax havens like Ireland, but not the major European and other trading partners of the U.S. in the G-7, whose tax rates are substantially higher than 15% (e.g., Canada-26.2%; France-28.4%; Germany-29.9%; Italy-27.8%; Japan-29.7%; U.K-19%; U.S. (including state tax add-on) -25.8%.). OCED, Corporate Tax Statistics: Third Edition (July 29, 2021) [hereinafter International Corporate Tax Statistics], https://www.oecd.org/tax/corporate-tax-statistics-database.htm [https://perma.cc/ZVB3-Y66C]; Kelly Phillips, *Weekend Insights: Global Tax Challenges,* Bloomberg Tax, (June 20, 2021), https://www.bloomberglaw.com/product/tax/bloombergtaxnews/daily-tax-report-international/X77BGG04000000?bc=W1siU2VhcmNoICYgQnJvd3NlIiwiaHR0cHM6Ly93d3cuYmxvb21iZXJnbGF3LmNvbS9wcm9kdWN0L3RheC9zZW-FyY2gvcmVzdWx0cy9lNWVlNmZhNDA1YjcwOTAwZDZiNDUzNzE1N-GUwMjRjNSJd [https://perma.cc/C5VN-2ZCJ].

U.S businesses and therefore the nation would suffer lost business and some corporations will seek to move their headquarters and therefore taxing jurisdiction out of the U.S. This problem for the U.S. is particularly troublesome for high tech businesses that have valuable intellectual property as their source of income and therefore are more mobile, in whole or in part, than manufacturing, for which the U.S. may be a more suitable location otherwise because of the availability of worker skills, raw materials, customer base and other factors.[5]

The secret sauce that other countries have found for taxing their domestic businesses without creating competitive difficulties for their domestic producers is their VATs, which are taxes on consumption rather than on income, and, in general, are "destination-based," and thereby apply to imports as well as domestically produced, "home grown," products but not to exports. Indeed, the trend among these trading partner and competitor countries has been to increase their VAT rates, so that, over time, the VAT has increased in importance relative to their corporate income taxes.[6] The U.S. does not currently have a VAT and there is notable and loud opposition to adopting one, at least directly. This last phrase is the issue that I will explore in this Article. I have included a discussion of an economic analysis of the substitution of a VAT for an increased corporate income tax raising the same amount of money for the Federal Government in Appendix A.

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5. In late 2017 when the corporate tax reduction legislation was enacted as part of the Tax Cuts and Jobs Act of 2017, there were other major changes enacted as part of the legislation affecting the U.S.'s treatment of international investments, including changes in the way the U.S. taxes earnings of domestically owned foreign corporations. These changes effectively overhauled major parts of the U.S. taxation of U.S. international trade, principally creating a new tax regime to deal with "Global Intangible Low-Tax Income," the so-called "GILTI" regime of taxation of international earnings in the form of intangible income like foreign sourced dividends and royalties. The enactment imposed a tax of 10.5% on a U.S. corporation on the amount of its foreign subsidiary's GILTI, which was added to the U.S. parent corporation's tax bill. International competitors are presently seeking to arrange to tax a share of this income of U.S. corporations. *See* §§ 951A (requiring inclusion of GILTI in gross income), 250 (providing a 50% deduction for GILTI included by the taxpayer).

6. *See* Bruce Bartlett, *The Conservative Case for a VAT,* The VAT Reader 91-92 (Tax Analysts ed., 1990).

In theory, a VAT as a tax on consumption is well-suited for avoiding international income tax issues facing the U.S., such as abuse of intercompany pricing, royalty payments to offshore subsidiaries, earnings stripping, and corporate inversions. These areas of the tax law abuse have received a large amount of attention from the U.S. Treasury in recent years.

The issue of an uncompetitive U.S. corporate income tax is ripe for attention at the current time. During 2017, former president Trump, as part of the Treasury proposal to reduce corporate income tax rates, sought to include in the proposal his "short-lived" "Border Tax Adjustment" to disallow deductions for purchases of imported goods used in production, effectively seeking to increase their net after-tax price to U.S. business purchasers. This proposed provision was viewed as a significant part of his original proposed plan to overhaul the U.S. income tax system, particularly the corporate income tax. Such a provision, however, was believed to violate the U.S.'s tax and trade WTO (World Trade Organization) agreements treaty commitments and was abandoned by the Treasury.[7] The sentiment evidenced by the proposal, nevertheless, provides an indication of the Trump administration's understanding of how tax and international trade were related.

Finally, in the aftermath of the coronavirus pandemic, and during this international tax maneuvering among international organizations, the Biden administration has made a legislative proposal to increase corporate income tax rates substantially, as stated in the beginning of this Article. That proposal has met with substantial Republican resistance. The proposal and its response have highlighted the need to "reset the table" and reevaluate the corporate income tax in a world of relatively low corporate income tax rates internationally and high VAT rates.[8]

In that connection, this Article will explore alternative VAT proposals that would raise revenue without adversely affecting the

7. Martin Khor, *The Planned US Border Tax Would Most Likely Violate WTO Rules—Part 2*, Inter Press Service News Agency (Feb. 17, 2017), http://www.ipsnews.net/2017/02/the-planned-us-border-tax-would-most-likely-violate-wto-rules-part-2/ [https://perma.cc/GW37-MDX8] ("There is little doubt that the 'pith and substance' of the Republican border tax proposal or ideas will be in violation of Articles II and III of GATT and Article 3.1 of the Subsidies Agreement.").

8. *See supra* note 5.

competitive position of U.S. corporations in international trade. The alternatives are the following: (1) a European style credit method VAT, in which, in general, the seller charges the buyer a percentage of the sale price as a tax, but remits to the government only that amount reduced by any VAT paid in acquiring the intermediate goods or components making up the product, so is taxed on the value added by the seller only; and (2) a subtraction method VAT, which imposes a tax on the same tax base as the European style credit VAT but is facially like an income tax and is collected annually. The credit form of VAT has been adopted by European countries and many other countries around the world. In contrast, the subtraction VAT has not been used (with one possible and short-lived exception by Japan).[9] Both VAT alternatives are further described and discussed and compared in detail in this Article, which notes that a credit method VAT has the significant advantage over the alternative subtraction method VAT, because it will mesh more easily with the European VATs and other worldwide VATs. That meshing, however, should not be the only consideration, as the Article discusses.

As stated above, the Biden administration's corporate tax proposal seeks to undo much of the 2017 tax reduction changes rather than search for an alternative source of additional tax revenue, and thereby again threatens to make U.S. businesses uncompetitive or at least less competitive in world trade. The Biden administration proposal, therefore, raises again the issue of the continued wisdom of reliance solely on the corporate income tax for revenue from corporate businesses in a VAT world in which the U.S.'s international competitors rely on a VAT to raise a substantial portion of their needed tax revenue. The insistence by many, including the Biden administration, in relying on a relatively high tax rate for the U.S. corporate income tax, would allow foreign competitor countries using credit VATs to set relatively low domestic corporate income tax rates[10] and thereby make their exports less expensive competition compared to the U.S. products, particularly in international transactions. In such a world, U.S. corporations would suffer the higher U.S. corporate tax and thereby would be at a competitive

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9. Itai Grinberg, *Where Credit is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT,* 63 Tax L. Rev. 309 (2010).

10. Most of these corporate tax rates are lower than the Biden administration's preferred target for U.S. tax corporate income tax rates of 28%. *See* International Corporate Tax Statistics, *supra* note 4.

disadvantage to non-U.S. corporations incorporated and doing business in countries that use a VAT.

Thus, it is the practically worldwide (except in the U.S.)[11] use of credit VATs that functions as the revenue source that allows other countries to disadvantage U.S. exports vis-à-vis the home country's own internal production. U.S. goods imported into those VAT countries bear both the U.S. corporate income tax and the export country's VAT. Foreign VAT revenues are the means to foreign companies' competitive advantage and a U.S. VAT should be the means to offset that advantage. Accordingly, it is appropriate to look at revenue raising alternatives to a corporate income tax and that is the focus of the next part.

I. Business Level Consumption Taxes

A. The Choices for Business Level Consumption Taxes

The previous, introductory, part of the Article set forth the need for the U.S. to find a source of tax revenue other than the corporate income tax that is compatible with a European style credit VAT and acceptable as a VAT, so that allowing foreign purchasers to purchase U.S. products or services without imposition of a VAT by the U.S. is achievable under the U.S.'s tax and trade treaty commitments. A U.S. credit VAT would fit the European mold and would fit nicely into the world tax pattern of corporate income taxes and credit VATs existing simultaneously and applying to the same transactions.

There is likely to be, however, a large amount of domestic pushback in the U.S. to adoption of a credit VAT, which would be a new tax in the U.S. and cover domestic transactions in a way that would be highly visible to U.S. consumers. It would be highly visible because consumers would be explicitly charged this VAT on their purchases (on top of state sales taxes), even for domestic purchases. This situation contrasts with merely raising the corporate income tax rate, which would also increase customer prices, but indirectly because corporate sellers would reflect all or a part of the additional tax in their cost and price structures. As a result, the increased corporate income tax would not be

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11. Japan is an outlier and uses a form of subtraction method VAT. *See* Grinberg, *supra* note 9. It should be noted that there is not universal agreement that Japan's system can be characterized as a complete subtraction method VAT. *Id.* at 316 n.13.

directly visible to consumers. The secondary price effect resulting from the increased cost and price structures of sellers would be largely obscured to the customers because they would be indistinguishable from general price increases.

There is a form of VAT, however, that would be less visible to customers in the same way as is the corporate income tax: the subtraction method VAT or subtraction VAT. The subtraction VAT, which will be explained in detail in the next section, can be structured as the economic equivalent to the European style credit VAT and would likely be more acceptable in the U.S. On the other hand, there is a question whether it would be acceptable as a VAT in international trade and if it is not accepted as a VAT, it would not be allowed to be abated by the U.S. on foreign sales but rather would have to be charged to the foreign customer and thereby would not achieve the international trade goal of allowing U.S. sales to be made to foreign purchasers free of the tax. Acceptance of a U.S. subtraction VAT, which would allow it to be abated to foreign purchasers as a credit VAT can, would be essential to its adoption because the U.S. would not want to adopt it without assurance that it would not violate its tax and trade treaty obligations to its trading partners, which is a primary objective of adopting that form of VAT.

Having set forth the VAT issues, generally, the next sections of Part I of the Article discuss the alternative forms of consumption tax in more detail that would satisfy the national goals discussed above, and the considerations for the U.S. in making its choice of which one to adopt.

B. The Elements of a Business Level Consumption Tax, in General

The essential elements of all business level consumption taxes like a credit VAT and a subtraction VAT are that the tax is imposed at the business level, and it is a tax on consumption. Importantly, even though the legal incidence of both VAT types is at the business level, i.e., both are assessed on businesses, the economic incidence of the taxes may be shared by consumers, and indeed most of the taxes may be borne by consumers.

Although the credit VAT has been widely adopted internationally by the U.S.'s European and many other trading partners, a VAT need not be structured in the way. Rather, one could match this kind of tax with an alternative type of VAT, using the same tax base as a credit VAT. This alternative form is a subtraction VAT.

The objective of adopting a U.S. VAT, regardless of the form of the VAT, is to relieve the corporate income tax of at least some of its burden so that it can be competitive with other countries' corporate income taxes. To compensate for the lost potential national tax revenue from refraining from raising the current corporate income tax, however, the U.S. would need a business level tax on consumption to match the tax base of the European style credit VAT.

The first part of this task is to describe the three forms of consumption tax: a retail sales tax, which will function as a baseline for how these taxes affect domestic consumers, a credit VAT, which appears to U.S. consumers to be similar and closely related to a retail sales tax, and a subtraction VAT, which looks more like an income tax but is indeed a consumption tax. These alternative methods all impose tax on consumption expenditures.

The retail sales tax imposes the tax on sales to consumers when they make purchases as end users based upon the amounts their purchases cost. It is required to be collected from the retail consumer by the retail seller (but is payable by the seller even if not collected from the consumer and therefore could be viewed as the seller's responsibility, though not by retail consumers and sellers in ordinary commerce), and is generally regarded as the retail consumer's burden (although, economically, it will be shared by the consumer and seller and seller's supply chain).The other two are business level consumption taxes in that the legal incidence of the tax is on businesses, not end consumers, even though it may appear that the tax is charged by the seller to the buyer so that the seller is reimbursed. The subtraction VAT imposes the tax at the business level, which as a matter of economics, may be passed through to the consumer as an addition to the price rather than being separately stated. Thus, the retail sales tax is considered a consumer level tax, whereas the VATs are considered business level taxes, because of how they are assessed, not because of who ultimately pays the economic cost of the tax, i.e., the retail sales tax is only collected in a retail sale to the consumer as a percentage of the price charged, whereas VATs are collected at each stage as the goods move through commerce ultimately to the retail buyer in one form or another. The subtraction VAT represents the smallest change from the corporate income tax in the U.S. Its description will show that a U.S. subtraction VAT in all substantive fiscal ways would be equivalent to a credit VAT, although not identical in form.

The important take-away at this point is that all these consumption taxes have one common attribute: they seek to tax consumption by building the tax into the price at which consumers purchase the product or service, but they use different computation methods to compute and accomplish collection of the tax. Thus, a consumption tax can be accomplished in three ways. These ways can be subdivided into two categories: consumer level consumption tax—the retail sales tax—and business level consumption tax—the credit VAT and subtraction VAT.

The first category of business-level consumption tax, which is most like a retail sales tax, is the credit VAT. Like the retail sales tax, it is collected at point of sale, but is typically built into the price of the item sold to the purchaser so that it is collected by the government from the seller. The retail sales tax and credit VAT are the major forms of consumption tax currently used throughout the world.

The second category of business-level consumption tax is the subtraction method VAT or subtraction VAT, under which the tax is imposed annually on the seller. It is employed by imposing an annual tax on the seller based upon aggregate sales minus certain deductible items that are subtracted to reach the annual consumption tax base, rather than as a separate tax on each sales transaction. In that way, it resembles in form the current corporate income tax and can be processed and collected in a similar way. Importantly, it taxes the same base as a credit VAT, but by using a different mechanism, and are economic equivalents. Each of these choices is discussed in greater detail below.

Before embarking on this more detailed examination and explanation of the three consumption tax methods, however, it is important to understand that an adopting country can make special exemptions from the tax under any of these methods for some products that are deemed worthy of a tax break, regardless of whether the tax in question is a retail sales tax, a credit VAT or a subtraction VAT. The method of making the exception would differ, depending on the form of tax. Special exemptions can be accomplished in varying ways and look different in the three kinds of tax, but they can be replicated in each if desired. The significance of the foregoing observation is that in practice not all versions of each of the three types of consumption tax will be exactly equivalent because it may be easier to accomplish a special rule or exemption in one than in another, depending upon the desired exemption or rule. Indeed, not all versions of even the credit VAT operate in the same way.[12]

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12. *See* Grinberg, *supra* note 10, at 324-29.

Moreover, one can impose different tax rates on different products as well.[13] And, the special rules can be introduced at varying places in the chain of production or sale.[14] Thus, a country might choose to adopt one or another VAT method depending upon what VAT type is most amenable to the special benefits or other rules desired.[15] Nevertheless, the essence of each VAT type, before customization, is the same, so that the ability to customize based on the product involved, the use of the product, or the political power of the seller or purchaser of the product, is more likely to be a bug rather than a feature in the chosen system, causing complexity, cost and political maneuvering (and the incentives for political contributions). Indeed, the desire in the U.S. to adopt one or another of the choices as a supplement to the corporate income tax may weigh heavily in favor of few if any exemptions or special rates or other special treatment of any of the VAT components.

For example, applying the special characteristic in the credit VAT of permitting the VAT to have a "zero rating" for exports entitles the exporter to obtain a refund for all VATs paid in the production and supply chain. In contrast, exempting the product from VAT only provides an exemption to the exporter from paying its VAT on the final sale. It does not affect VATs paid in the supply chain leading to the exporter. Under a credit VAT, the taxing country can do either, the choice depending upon the characteristics of the seller (e.g., charitable on noncharitable) or the nature of the product. The choice may be made by the country based upon how other countries or its trading partner countries impose their VATs. This means that not all credit VAT countries may deal with the issue in the same way.

II. Comparison of the Three Consumption Taxes[16]

A. Point of Sale Consumption Tax: Retail Sales Tax

A retail sales tax is the easiest place to start the more detailed discussion of business-level consumption taxes. A retail sales tax, also called an ad valorem tax, imposes a tax on the final sale of commodities and

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13. *Id.* at 329-37.

14. *Id.* at 329.

15. *Id.* at 332.

16. Part II of this Article is based largely on Chapter 11 of The Death of the Income Tax by the author of this Article. Daniel S. Goldberg,

services at retail to consumers. Those final sales at retail represent personal consumption expenditures made by individuals, who pay the tax in addition to paying the cost of the item. A retail sales tax imposed at a uniform rate is called a general sales tax. A retail sales tax imposed at different rates (including a zero rate) on different commodities is called a selective sales tax or, more commonly, an excise tax.[17] Many states employ one or the other or both, imposing a sales tax on most purchases, but not on food, for example. A well-known commentator proposed a national sales tax several years ago to replace the U.S. income tax.[18]

If a sales tax on the full value of a product were imposed each time it was transferred through the supply chain, it would build up quite a bit of tax by the time it reached the retail sale stage. This phenomenon, known as "cascading of taxes," would have the effect of imposing an aggregate tax on the full sales price plus previous taxes imposed on each transfer in the supply chain or chain of production. A retail sales tax, as its name implies, taxes only sales made at the retail level and exempts nonretail sales, thereby avoiding this potential cascading of tax. [19] Thus, the tax assessed on retail sales ensures that only a set percentage of the value of the final product will be collected as taxes, and this point is useful in comparing a retail sales tax with "business level consumption taxes" discussed in the next subpart. It also avoids discriminating against nonvertically integrated companies in favor of vertically

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The Death of the Income Tax: A Progressive Consumption Tax and the Path to Fiscal Reform 161-71 (2013).

17. *See* Gilbert E. Metcalf, *The Role of Value-Added Tax in Fundamental Tax Reform*, *in* Frontiers of Tax Reform 91, 96 (Michael J. Boskin ed., 1996).

18. Neal Boortz & John Linder, The FairTax Book (2005). It was contended that a national retail sales tax presented a simple solution to the complex problem of national taxation. Its attraction lay in its conceptual simplicity. This national sales tax could remain free from over-personalization if it were imposed at a single uniform rate on all products and services and it would be free of tax expenditure provisions for individuals because the legal incidence of the tax would be on businesses. Further, it could stay simple and not personalized if the legislature resisted the urge to impose different rates on different products or services. Moreover, this tax would be collected from businesses, which have a greater capacity than individuals to handle the administration of the tax and to bear the costs of compliance.

19. *But see* Grinberg, *supra* note 10, at 314 for an example of a situation where a sales tax is doubled up.

integrated companies. The retail sales tax, if collected, nevertheless ensures that all the component costs of production (e.g., raw materials and labor), as well as returns on capital (e.g., interest, rent, and profits) will be in the tax base because they will be reflected in the final price of the product.

The operation of a retail sales tax can be illustrated by the following example. Assume that a consumer ("Consumer") purchases a consumption good for $80 on which a 25% retail sales tax is imposed. Assume that the tax is tax-exclusive (meaning there will be no tax on the tax) as is the case with state sales taxes. She will have to pay $100 to the seller (i.e., $80 for the item and $20 for the 25% sales tax imposed on the retail sale of the item).[20]

A significant, indeed overwhelming drawback of the retail sales tax is that the system requires that one distinguish final consumption sales from intermediate sales to businesses, which will either resell the purchased item or use the item to produce another product for sale to consumers. Failure or inability to draw this distinction will result in at least double or triple taxation of some products as a result of cascading.

More importantly, a retail sales tax is also prone to evasion in the form of simply failing to report the sale or recording the sale as an intermediate sale on which no retail sales tax is due, rather than a final sale at retail, so none would be collected. The resulting auditing burden on the IRS would be overwhelming as would the likely tax gap.

B. Point of Sale Consumption Tax: Credit VAT

A consumption tax could be imposed on businesses so that its "legal incidence" would be on businesses rather than individuals. This means that the tax on individuals' personal consumption is computed and assessed on and collected from businesses. The most common of these consumption taxes, but not the only one, is the credit VAT, which is used throughout Europe and many other industrialized countries. The credit VAT is imposed on the seller business at the time of sale of goods or services by the business, and thus may be considered by the consumer as a part of the price of the purchased item. Nevertheless, even though the legal incidence of the tax falls on the business seller, all, or part of the "economic incidence," the real cost, of the tax may be borne by the consumer, depending upon whether the price of the product is adjusted

20. The Death of the Income Tax, *supra* note 15, at 162.

upward by the seller because of the VAT, which in turn depends upon the competitive nature of the market for the product, including the price elasticity of demand (i.e., the degree to which demand responds to changes in price, which in turn may depend on income levels, and substitute availability) and price elasticity of supply (i.e., the degree to which supply responds to a changes in price, which in turn may also depend upon other factors).

In contrast to a credit VAT, a retail sales tax, which is common in many states in the U.S., is legally imposed on the customer, although collected and remitted by the seller. Thus, it is separately stated by the seller to the retail customer, but for all practical purposes will be built into the gross amount paid by the retail customer. Thus, like the credit VAT, a retail sales tax is likely to be shared by seller and buyer in accordance with the economic incidence of the tax also, which is determined by the elasticities of demand and supply of the product, as explained above.

The "legal incidence" of the tax is a matter of process for describing the tax and remitting it to the taxing authorities and accounting for it. In contrast to the legal incidence of a credit VAT being on the seller, the legal incidence of a retail sales tax is on the customer.

Nevertheless, the credit VAT form of business-level consumption tax and the customer-level retail sales tax are both taxes on personal consumption expenditures, the former imposed by building the tax into the price of the product and the latter by adding the tax to the product price charged by the seller. The retail sales taxing process is accomplished transparently by imposing a tax on final sale consumption expenditures at the point of sale, i.e., when the expenditures are made. The credit VAT ultimately imposes the same amount of tax but does this piecemeal throughout the chain of commerce through which the product moves from manufacture to retail sale. The credit VAT accomplishes this process by imposing a tax on the seller, whether the final retail seller or a seller of an intermediate product leading up to the final seller, equal to the tax rate multiplied by the seller's sale price, but that resulting amount is then reduced by the VAT paid by the seller upon its purchase of the product from its supplier. This process results in the net tax on the seller being equal to the tax rate multiplied by the difference between its sale price and its purchase price, which may be viewed as the value added by the seller. This process is applied through the supply chain for the final product and ultimately results in an aggregate tax equal to the sales tax that would have been paid by the customer on a retail sale under a "non-porous" retail sales tax. An example in the next subpart provides a numerical demonstration to illustrate the computations.

The difference between a retail sales tax and a credit VAT derives from the differing processes of collecting the tax. Under both systems, however, the ultimate cost of the tax is pushed to the ultimate consumer of the final product (although may be shared by the sellers as an economic matter, as explained earlier), notwithstanding that under a credit VAT the tax is paid to the government piecemeal as the product moves through the supply chain.

The two above forms of tax also involve different processes for remittances of the tax to the taxing authorities throughout the supply chain. A sales tax is imposed and collected only upon a retail sale to the ultimate customer and is remitted to the government by the retail seller. A credit VAT, on the other hand, is collected any time the product moves through commerce, so that sales of intermediate products result in tax to those sellers as well, albeit offset by a credit for the remittance of taxes paid by their immediate suppliers throughout the supply chain. This more complicated process for tax remittances is necessary so that a credit VAT avoids cascading of taxes throughout the supply chain or production process and thereby remains the economic equivalent of a retail sales tax, which only imposes the tax once and on the retail buyer.[21]

The credit VAT collection process, often viewed by observers as a form of sales tax, has several advantages over a sales tax. Its advantages over a retail sales tax lie in its greater ability to command substantial compliance and avoid leakage of tax revenue than a retail sales tax. A credit VAT contains built-in protection against evasion because of the method by which it is collected. A credit VAT also avoids the risk of cascading, which would be endemic to a retail sales tax if it were not limited to sales at retail.

A credit VAT is collected in stages. Each seller of a good pays a tax on the value added to the good being sold. The combined VAT paid on the good from its inception to its retail sale will be equal to what the retail sales tax would have been on the good. Retail consumers may view a VAT, in its effect on them, to be indistinguishable from a retail sales tax because the VAT is implemented by imposing a tax at the full rate on the full value of the product when sold at retail (offset to the seller by the interim VAT amounts paid in the supply chain, as if they were

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21. It is possible that a sales tax can be charged twice on the same good in some circumstances. For example, a sale of wine to a restaurant may attract a sales tax and its subsequent sale to the diner, another sales tax. *See* Grinberg, *supra* note 10, at 314.

advance payments of the final VAT, as discussed more fully below), just like a retail sales tax at the retail level.

To the seller, however, the two are quite different because of the way in which VAT payments for intermediate goods are treated. In contrast to a retail sales tax, under a credit VAT, the retail seller of the product is permitted a credit for the VAT that the seller paid to its suppliers. The credit offsets a portion of the tax that must be paid by the seller to the government upon retail sale of the product. The credit equals the VAT that the seller paid for raw materials, equipment, and other input materials, which were included in the price paid by the retail seller to its suppliers. This process in effect causes the retail seller to pay tax only in the amount of the VAT rate multiplied by the value that the retail seller added to the product.

Each intermediate seller in the supply chain of the good goes through this same process: collecting a VAT on the sales price, taking a credit for the VAT paid to its suppliers, and remitting the difference. A credit VAT thereby collects tax at each stage of production up until and including the ultimate retail sale, but the aggregate amount of the tax collected in the supply chain is the same as the amount that would be collected under a retail sales tax on a sale of the good to the final consumer. To the extent that the ultimate retail seller fails to pay the VAT portion of a sale, the retail seller will not be entitled to its VAT credits. Only the tax on the retailer's mark-up, however, will be lost, because the VAT would have been paid for each intermediate sale.

The equivalence of a retail sales tax and a credit VAT can be further illustrated by a simple example. As you read the example, it will be helpful to refer to Table 1, below, to observe that the credit VAT simply collects in stages in the chain of production the amount of tax that would have been collected as a retail sales tax. The operation of the VAT can be illustrated by viewing the business side of the transaction as a series of stages in the supply chain or production process for the final product.

Consider the example of a retail customer ("Customer") making a consumption purchase from a retailer ("Retailer") of shoes for $80 on which a 25% (tax-exclusive) retail sales tax of $20 will be paid. Thus, Customer would pay the seller $100, which would include the $20 tax. One might also configure the retail sales tax as a 20% tax-inclusive sales tax. Under this configuration, Retailer would charge Customer a price that already incorporates the sales tax on the shoe purchase, that is, 20% of ($80 + $20), for a total payment of $100. The concepts of tax-inclusive and tax-exclusive rates are explained in more detail in Appendix B.

The taxing process is best understood by looking at the entire manufacturing and distribution chain and observing the serial collections of tax under a credit VAT. Assume a tax-inclusive VAT rate of 20%, which is equivalent to a tax-exclusive VAT of 25%. Consider the manufacturing and distribution chain in which Manufacturer manufactures shoes. Manufacturer sells a pair of shoes at wholesale for $70 to Retailer, who buys shoes from Manufacturer and then resells them at retail to Customer, the ultimate consumer, for $100. Further, Manufacturer pays wages of $10 to his only employee, ("Employee"). Retailer pays no wages. If one assumes that those are the only sales that Manufacturer and Retailer engage in during the year, one can isolate the VAT at each point in the supply chain and see how it would be collected.[22]

Table 1 Tax Under Alternative Indirect Consumption Tax Methods[23]

Taxpayer	Retail Sales Tax	Credit VAT
Manufacturer	0	14
Retailer	20	6
Customer	0	0
Employee	0	0
Total Tax	**20**	**20**

A credit VAT is imposed at each stage of the supply or production chain. Under a tax-inclusive credit VAT of 20%, Manufacturer would be taxed upon the sale of his manufactured shoes to Retailer in the amount of $14 ($70 × 20%), and Retailer would be taxed on his sale to Customer in the amount of $6 ($100 × 20% - $14). No VAT would be due upon Manufacturer's payment of wages because typical credit VATs expressly do not apply to wages.

The VAT paid by the ultimate seller, Retailer, upon the retail sale by Retailer to Customer, is reduced by means of VAT credit by the amounts paid in the supply chain. Beginning with the final stage of the sale, a tax of $20 would be imposed on the full sale price ($100 × 20%), payable by Retailer, but Retailer would be allowed a credit of $14 ($70 × 20%), the portion of the shoe price paid to Manufacturer that represented the VAT on Retailer's purchase transaction. Retailer would thus owe $6 in tax on the final sale to Customer (i.e., the $20 VAT collected

22. The Death of the Income Tax, *supra* note 15, at 165.
23. *Id*. at 166.

from Customer, less the $14 VAT paid to Manufacturer, for which Retailer receives a credit against his VAT liability).

The total amount of tax paid on the manufacture and the sale of the shoes ultimately sold to Customer would be $20, the same amount that Customer would have paid under the retail sales tax. The difference is that the VAT is paid piecemeal, with a portion paid at each stage in the chain of the product's sale (in this example, $14 by Manufacturer and $6 by Retailer), whereas the retail sales tax is paid all at once (in the previous example, $20 by Retailer) upon the ultimate sale to the Customer.

A credit VAT has the same ultimate consequences as a retail sales tax. As a result, it has some of the same attractions and drawbacks as a retail sales tax. A credit VAT, like a retail sales tax, is imposed ultimately on consumption purchases. That is because every payment of VAT on a business to business "intermediate" sale is matched by an equal VAT credit to the intermediate business purchaser. Only the retail consumer does not get a VAT credit for his VAT paid.

In addition, like a retail sales tax, a credit VAT can be free from over-personalization and excess individual-level tax expenditures because the legal incidence of a credit VAT is on businesses, not individual taxpayers. But this freedom will not necessarily be the case. A credit VAT, like a retail sales tax, is prone to over-personalization problems if different goods and services are taxed at different rates or sales to some purchasers are "zero-rated."

A credit VAT represents an improvement over a retail sales tax, however, mainly because it contains built-in safeguards that limit cheating in a way that a retail sales tax does not. Under a retail sales tax, if a retail seller fails to report and remit the sales tax to the government, the entire tax is lost to the government. In contrast, under a credit VAT, if the retail seller fails to remit, then only the retail seller's portion of the tax is lost to the government because the taxes collected by the retailer's suppliers from the retailer would have been collected and the retailer would not be entitled to any credits for them. Furthermore, if a supplier to the retailer does not report (and, if the law requires, remit) the tax collected from the retailer, the retailer would not be entitled to a credit for those taxes to offset the VAT payable by the retailer upon its sales. Thus, any purchaser in the chain of production has an incentive to see that the VAT that purchaser pays to his supplier is accurately reported to the government because the report establishes his entitlement to the VAT credit. This matching, which is generally mandated in VAT countries by allowing a credit only if the VAT is "invoiced" by a registered dealer, aids significantly in the enforcement of a VAT and avoidance of false claims of credits. This incentive towards accurate third-party reporting and automatic enforcement mechanism in large measure makes the VAT self-enforcing (up until the ultimate retail consumer), if modern technology can be employed to match the VAT credits with the VAT payments. Tax cheating and the tax gap can most effectively be controlled with the mandated third-party registration and reporting, coupled with the government's use of modern technology.[24]

Also, a credit VAT fits more neatly with the tax systems employed by this country's trading partners, particularly the European Union. These trading partners almost all use credit VATs. The meshing among the systems that would result could have significant and positive international implications for U.S. exporters if the U.S. adopted a credit VAT, because it is clear that a credit VAT can be "destination-based" and an exporter can sell its goods to a VAT-country purchasing company or consumer without charging a VAT.

Finally, a credit VAT can be collected automatically and electronically, if appropriate mechanisms were put into place, and can be monitored electronically. Electronic monitoring would prevent or at least substantially limit evasion. This attribute is very significant, as it makes a credit VAT an efficient and potentially leakproof way of collecting taxes, if employed using modern technology.

As already noted, the efficacy of a credit VAT, of course, depends upon the intermediate seller remitting its VAT to the government, for which the subsequent seller will receive a VAT credit. To ensure this compliance, the European credit VAT requires an official "invoice" setting forth the VAT amount paid by the purchaser and collected by the seller, and, further, insists upon and only recognizes such an invoice and allows a credit when the purchase is made from and invoiced by a "registered trader." As stated earlier, the European credit VAT is often referred to as a "credit invoice VAT." Presumably, the U.S. would have to create a similar mechanism to ensure compliance as well if the U.S. adopted a credit VAT.

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24. As noted previously, a credit VAT avoids the problem of cascading because it imposes a tax on all sales transactions and allows a credit for purchases against that tax. It thereby assures that the aggregate of the taxes paid by the retail consumer on the purchase of the product is no more than the retail price multiplied by the tax rate.

C. Business-Level Consumption Tax That is Collected Annually: Subtraction Method VAT

A business level consumption tax can also be constructed using a different method than the retail sales tax and the credit VAT by imposing the tax on an annual basis on both sellers at retail and sellers of intermediate goods. This method is called a subtraction method VAT or subtraction VAT. The subtraction VAT achieves the tax collection goal of a "point-of-sale" credit VAT by collecting the VAT annually instead of on a transaction-by-transaction basis like the credit VAT. Thus, the subtraction VAT can be used to tax business taxpayers on the same tax base as the credit VAT except impose the tax annually like the corporate income tax (although the subtraction VAT is a consumption tax and not an income tax). A subtraction VAT has never been employed in practice.[25]

The Government Accounting Office ("GAO") considered a Subtraction VAT in a June 1989 Report to the Joint Committee on Taxation entitled "Tax Policy—Tax Credit and Subtraction Methods of Calculating a Value Added Tax" ("GAO Report").[26] The GAO Report was intended to set forth revenue options to deal with the impending budget deficits expected at that time and to maintain U.S. competitiveness with countries that employ a VAT that is rebated upon export and charged to imports. The GAO Report was a "staff study that had not been reviewed or approved by IRS or Treasury officials."[27]

Under a subtraction VAT, each seller computes, reports and remits its tax on an annual basis in a manner that ensures that in the

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25. *But see* Grinberg, *supra* note 10 (Re Japan's quasi-VAT). The subtraction method has been considered and written about, however. *Id.* (discussing subtraction method VAT as alternative to credit VAT); Eric Toder, *What is the Difference between the Current Corporate Income Tax and a Destination-Based Cash Flow Tax?*, Tax Policy Center (Feb. 27, 2017), https://www.taxpolicycenter.org/publications/what-difference-between-current-corporate-income-tax-and-destination-based-cash-flow/full [https://perma.cc/H9C4-SZBX] (discussing subtraction method VAT as alternative to corporate income tax).

26. U.S. Gov't Accountability Off., GAO-89-97, Report to the Joint Committee on Taxation, U.S. Congress: Tax-Credit and Subtraction Methods of Calculating a Value- Added Tax (June 1989) [hereinafter GAO Report].

27. *Id*. at 5.

aggregate, only the value added by that seller (and therefore in combination with all sellers of the item throughout the entire chain of sales and production) is subjected to tax. As observed above, the mechanism employed on its face looks something like the corporate income tax, but its tax base is the same tax base used in a credit VAT.

The computation of a subtraction VAT amount begins with annual sales revenue and then subtracts (deducts) the costs incurred in earning that revenue. These deductible costs include cost of goods sold and other normal business operating costs like advertising and similar services provided by other businesses, but some costs that would be allowed under an income tax would not be allowed under a subtraction VAT. The nondeductible costs are wages of employees, interest and rent and other costs for which no VAT credit would be allowed under a credit VAT. These nondeductible costs will be discussed in more detail later. After subtracting all deductible costs, the tax base of the subtraction VAT will match the tax base of the credit VAT. The mechanics of the subtraction VAT computation will be illustrated later in this part of the Article.

The subtraction VAT is sometimes referred to and described, incorrectly, as the "Destination Based Cash Flow Tax ("DBCFT"), which was briefly introduced by the House GOP several years ago as a potential new tax form to replace the corporate income tax,[28] and which is best characterized as a modified income tax form. A subtraction VAT differs from the DBCFT in a significant way, because the DBCFT allows a deduction for wages. Therefore the DBCFT is best described as a modified income tax or a hybrid of the two rather than as a subtraction VAT, and will not be discussed further in this Article.

In theory and in its simplest form, an annually collected business-level consumption tax could emulate a point-of-sale retail sales tax but instead impose the tax only on a business's gross sales at retail for the year, without any subtractions. This system would leave businesses that sell intermediate goods rather than at retail not subject to a tax.

Alternatively, and far more practically for fitting into a world economy of credit VATs, it could emulate a credit VAT and impose the tax piecemeal on every business, whether wholesale or retail, in the chain of supply or production and sale through the ultimate retail sale of the product, based upon each company's annual sales minus its cost of inputs

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28. *See* Toder, *supra* note 23.

from other businesses. This alternative form of business-level consumption tax is referred to as a subtraction method VAT or subtraction VAT, because the tax base allows a full subtraction for the amount paid by a business on its purchase of intermediate goods and services. When aggregated among taxpayers, with each taxpayer in the chain of supply or production and sale allowed to subtract the amount paid to its respective suppliers, intermediate sales and purchases offset one another, so that the aggregate tax base becomes the sales price of the final goods at retail. In contrast to an aggregate annual tax on retail sales only, however, a subtraction VAT collects the tax from each business throughout the supply chain, as products proceed from raw materials through production to finished goods sold at retail to the ultimate consumers.

Under a subtraction VAT, the tax due at each stage of production is computed by multiplying the VAT rate by the excess of the business's gross receipts over its deductible expenditures.[29] The cost of raw materials and capital expenditures such as equipment (but not wages, interest and rents) are considered deductible expenditures,[30] as are expenditures that would be capitalized under the current income tax. Wages, interest, and rents are considered component parts of the value added by the taxpayer. Thus, a producer or seller is taxed on the excess of its sales of goods over its deductible costs. In that manner, the producer is taxed only on the portion of the price of the product attributable to the value it adds to the product, including its costs for employees' labor and costs of capital, in converting raw materials into a finished product sold at wholesale, and a retail seller is taxed only on the portion of the price of the product attributable to its mark-up in going from the wholesale market to the retail market, including its costs for employees' labor and capital, which is the value it adds in the production chain.

In comparison to a corporate income tax, a subtraction VAT includes gross receipts in the tax base, but unlike the corporate income

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29. Alan Schenk, *The Plethora of Consumption Tax Proposals: Putting the Value Added Tax, Flat Tax, Retail Sales Tax, and USA Tax into Perspective*, 33 San Diego L. Rev. 1281, 1312 (1996) (noting that a feature of the retail sales tax is to refrain from taxing purchases by businesses for resale).

30. *See generally* U.S. Dep't of the Treasury, Treasury Department Report To The President: Tax Reform for Fairness, Simplicity, and Economic Growth: Value-Added Tax (1984) (hereinafter Treasury Report). The cost of capital is only fully deductible in a consumption style VAT.

tax, the cost of labor and payments for the use of capital in the business (such as interest, rents, dividends, or other distributions of profit) are not deductible. Thus, a subtraction VAT is not an income tax as such. Rather, the portion of the business taxpayer's revenue that is attributable to the cost of labor and capital is treated as part of the value that the taxpaying business adds during the chain of production. Accordingly, the tax base for a subtraction VAT includes the value of labor and return to capital, just as it does in a credit VAT.[31]

In this way, it departs from the DBCFT, mentioned earlier, which would allow a deduction for employee compensation. This deductible treatment of employee compensation under the DBCFT, in essence, leaves the tax attributable to the employee's services taxable to the employee only and not to the employer/business, which gets a deduction. In contrast, the double tax on the value of employee services, i.e., employee compensation, remains under a subtraction VAT, under which no deduction is allowed, but the existing separate individual income tax imposes an individual income tax on employees on their wages. This situation obtains under a credit VAT as well, when coupled with an individual income tax on employees.

The subtraction VAT proposed for international commerce would follow the general European credit VAT rules and be destination based. Thus, export receipts would be excluded from the tax base and the cost of imports would not be deductible.[32] The aggregate of the taxes incurred by the business are then included in the prices at which the final products are sold at retail to the ultimate consumers of the products, but as part of the internal but nondeductible costs of the businesses in the chain of production. As explained earlier, a credit VAT also pushes the tax along to the ultimate consumer, but does so explicitly, because the taxes are stated as an add-on to the retail price or can be easily computed as such. Nevertheless, whether hidden in the subtraction VAT or explicit in the credit VAT, the taxes are indeed pushed on to the ultimate consumer. The extent to which the consumer

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31. In the form proposed by the House GOP and explained by Eric Toder, the base exempts exports from tax and the cost of imports is not deductible. Toder, *supra* note 23, at 2.

32. *See id.; See generally* Treasury Report, *supra* note 29; *see also* Metcalf, *supra* note 16, at 93-94; Schenk, *supra* note 30, at 1309 (explaining that value added includes, among other items, the value of labor and return to capital, so a value-added tax includes both in its tax base).

or the business seller ultimately bears the economic cost of the tax, whether a credit VAT or a subtraction VAT, of course, depends on the elasticity of demand for the product and other, supply market, factors.

A numerical example will illustrate how a subtraction method VAT works and how this tax method is economically equivalent to a retail sales tax and a credit VAT. Returning to the example above,[33] again assume a 20% tax-inclusive VAT rate collected annually.[34]

Manufacturer produces shoes and sells them at wholesale for $70 to Retailer. Retailer buys them from Manufacturer and resells them at retail to Customer, the ultimate consumer, for $100. Manufacturer pays wages of $10 to Employee. Retailer pays no wages. Assume also that those are the only sales that Manufacturer and Retailer engage in during the year.[35]

Manufacturer has a VAT base of $70 with no deductions because wages paid by an employer are not deductible under a subtraction VAT. Manufacturer, therefore, is liable for $14 of tax (20% of $70), which would be payable at the end of the year. Retailer has a VAT base of $30 ($100— $70) and is liable for $6 of tax (20% of $30), which would also be payable at the end of the year. The total tax collected on the sale of Manufacturer's shoes is $20. These results are set forth in Table 2.

Table 2 Tax under Alternative Indirect Consumption Tax Methods, including Subtraction[36] VAT

Taxpayer	Retail Sales Tax	Credit VAT	Subtraction VAT
Manufacturer	0	14	14
Retailer	20	6	6
Employee	0	0	0
Customer			
Total Tax	**20**	**20**	**20**

Facially, a subtraction VAT resembles the corporate income tax. However, unlike the corporate income tax, the business-level subtraction VAT allows business entities to deduct from gross income any amounts spent on investment in plant and equipment or on inventory

33. The Death of the Income Tax, *supra* note 15, at 169.

34. *See infra* Appendix B for a comparison between "tax exclusive rates" and "tax inclusive rates."

35. The Death of the Income Tax, *supra* note 15, at 169.

36. *Id.*

during the year, in addition to expenses paid to other businesses (but not to employees and other internal expenses like rent and interest, as explained below).[37] This treatment contrasts with the current U.S. corporate income tax, which generally, but with some significant statutory exceptions,[38] requires capitalization of expenditures of this nature if they create an asset or benefit extending beyond the year in which the expenditure is made.[39]

Also, in addition to a VAT allowing investments to be expensed, no deduction is allowed under a VAT for labor and returns to capital used in business, like interest costs and rent.[40] In other words, whereas the corporate income tax grants deductions for wages and payments for the use of capital, like interest and rents, a subtraction VAT does not.

Note that if wages, interest, and rents were allowed as a deduction at the business level under a subtraction VAT (but taxed to the respective recipients, as they are under the current corporate and individual income taxes), then the only remaining difference in the tax base between a business-level subtraction VAT and the corporate income tax (and to a large extent, the current business-level treatment of pass-through entities like partnerships and LLCs) would be in the treatment of capital expenditures. Capital expenditures for assets used in sales or production would be deductible under a subtraction VAT, but generally must be capitalized and depreciated, if appropriate, under the corporate income tax (and the computation of income of pass-through entities).[41]

A subtraction VAT is an attractive tax method for the U.S. to adopt to fit into the VAT-economy world, because of its facial similarity to the corporate income tax, which makes it likely to be accepted by businesses. This facial similarity contrasts with U.S. businesses'

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37. *See, e.g.*, Lawrence Zelenak, *Radical Tax Reform, the Constitution, and the Conscientious Legislator*, 99 Colum. L. Rev. 833, 836 (1999) (explaining that under a consumption tax, like the USA Tax, businesses would pay tax on their total sales, reduced by inputs from other firms, and on their purchases of business products, such as plants and equipment).

38. *See* I.R.C. § 168(k).

39. I.R.C. § 263.

40. *See* Treasury Report, *supra* note 29 at 7–8; Joel Slemrod & Jon Bakija, Taxing Ourselves: A Citizen's Guide to the Great Debate Over Tax Reform 197-99 (4th ed. 2008).

41. This distinction would be important in understanding the many consumption-tax features of the current income tax, if one desired to compare the two.

unfamiliarity with a credit VAT, which would constitute a whole new and unprecedented national tax in this country. The subtraction VAT also allows for some businesses (e.g., high income or high-volume businesses) to be taxed at higher VAT rates than other businesses (e.g., low income or low-volume businesses)—a form of progressivity at the business level, which a credit VAT does not have. It is unclear, however, why this flexibility would be an advantage. It is no more justified than imposing a higher sales tax on a high-volume seller than on a low volume seller.

The principal disadvantage of a subtraction VAT, in comparison to a credit VAT, is the subtraction VAT's reliance on annual computations and collections. The annual nature of this system precludes it from being able to be collected automatically and therefore electronically on each sale, because it requires an aggregation of a producer's or seller's total sales and expenditures for the year. Indeed, in the long run, it may be a significant disadvantage if it impedes the use of modern technology to achieve third-party reporting. On the other hand, it may be a stepping-stone to adoption of a credit VAT that can be collected automatically and electronically as the technology and comfort with it progress.

In addition, a VAT, particularly a credit VAT, lends itself to special treatment for favoring a particular good, by allowing it to be exempted from tax when sold. If this good were an intermediate good, the ultimate retail seller would not be entitled to a VAT credit, so the uncollected tax would not be lost to the government; it merely would be collected from the retail seller who would not have the intermediate seller's unpaid VAT available for a credit.[42] With a subtraction VAT, however, an intermediate seller's unpaid VAT would be unknown and irrelevant to the next buyer in the supply chain and that VAT amount could go undetected by the IRS absent an audit. No other mechanism to track intermediate taxes has been developed yet, likely because a subtraction VAT is hypothetical now. Thus, evasion of an intermediate seller's VAT is easier to accomplish under a subtraction VAT because it does not have the invoice requirement that the European the credit VAT

42. *See* GAO Report, *supra* note 24, at 16-21, which sets forth other potential advantages (and disadvantages) of a credit VAT over a subtraction VAT for "zero rating" or exempting a good at various stages of the commerce or production chain or entirely from the VAT as well as the potential consequences and the added complexity of employing those tools in the VAT computation and collection process.

has that ensures that any uncharged tax of an intermediate seller will not be available as a credit to a reseller buyer in computing the amount of that reseller's VAT.

Importantly, a subtraction VAT would be comparable in the ultimate tax amount collected to a credit VAT, the tax systems of this country's international trading partners, as the European Union uses a variation of the credit VAT system. The GAO Report concluded that if a single rate were to apply to all value added, the credit VAT and the subtraction VAT would achieve similar effects, but the subtraction VAT would be simpler and would be easier for the affected firms to compute.[43]

Although the subtraction VAT would not mesh as well with those credit VAT systems as would a U.S. credit VAT, it could be made to fit. That is the subject of the next section of this Article. This drawback, however, may cause a U.S. subtraction VAT to prove inferior to a U.S. credit VAT for international transactions, but its substantive equivalence would make it superior to an increase in the current U.S. corporate income tax and worth pursuing if a credit VAT were not achievable.

Interestingly, the GAO Report noted that there were no reliable estimates of the administrative costs of compliance with even a simple subtraction VAT, the subject of a portion of the report, although a "business transfer tax," described as a variant of a subtraction VAT, was the subject of an estimate and generated an administrative cost to the Treasury of $700 million (1989 dollars), assuming all firms paid the tax. There were no estimates, however, of taxpayer compliance costs.[44] The GAO did not make any recommendations and as stated earlier, the IRS emphasized that the GAO Report was a "staff study that had not been reviewed or approved by IRS or Treasury officials."[45]

III. Creating a Supplemental Subtraction VAT to the U.S. Corporate Income Tax

A. Comparison of a Credit VAT to a Subtraction VAT

An understanding of a VAT as a business level tax like the corporate income tax is the beginning of the process of understanding the

43. *Id.* at 25.
44. *Id.*
45. *Id.* at 3.

relevance of such a tax in the U.S. for raising revenue without undermining the U.S.'s competitive trade position. That understanding can then lead to tailoring the subtraction VAT to a form that meshes reasonably well with the corporate income tax for taxpayer reporting, auditing and other administrative purposes.

Comparing the corporate income tax base in the U.S. with that in a credit VAT, such as the European style Credit VAT, can be done in a two-step process. First, construct a VAT tax base by including all the entity's sales and then subtracting all the entity's expenditures for purchases of intermediate products and non-employee services to determine the entity's "gross profit." (This computation is discussed in detail in Part II.C., above.) Then impose a single level of tax on the difference. The result of this computation imposes a tax on the aggregate amount the taxpayer received minus the aggregate amount the taxpayer paid to its suppliers. This difference measures the value added by the taxpayer to the intermediate goods and nonemployee services during the year and embedded in the products sold by the taxpayer.

The tax computed this way, using a computation of all sales and subtracting all relevant purchases, imposes the same amount of tax as would a tax computation of the European-style credit VAT. The credit VAT imposes a full tax on the sale of each product but allows a "tax credit" subtraction from that tax for the VATs paid on the inputs. It then aggregates the taxes for all these transactions. The subtraction VAT, in contrast, aggregates the sales and the purchases and then subtracts the aggregate purchases from the aggregate sales. Thus, the difference in the two methods is that the credit VAT is computed on a transaction basis and remitted for each sale, and the subtraction VAT is computed on an aggregate basis annually and paid at the end of each year, like the corporate income tax. These two methods create the same tax base and, if imposed at the same tax rate, the same amount of tax, so that the ultimate tax on the entity resulting from the subtraction VAT is the same amount as the tax from the credit VAT. The difference between the two types of VATs is in the way the tax is computed and paid: the credit VAT on the transaction basis, and the subtraction VAT on a cumulative, annual, basis.

B. Adding the Subtraction VAT to the Corporate Income Tax

The second step in the analysis is to compare the current U.S. corporate income tax base to the subtraction VAT tax base and construct a supplemental tax by modifying the corporate income tax base so that a portion of the corporation's tax is imposed on the traditional income tax base and a portion on the subtraction VAT base. The latter portion will mesh with the credit VAT. Finally, and importantly, the income tax base portion can continue as it has without modification of tax rates. Any additional tax at a tax rate to be chosen can be imposed on the supplemental subtraction VAT base. Both tax computations can be set forth separately and the totals aggregated on the corporate income tax form, Form 1120 (as modified to accommodate the dual computation). This choice may be helpful in gaining acceptance for the new supplemental corporate tax domestically and recognizing that the two computations use the same inputs but operate in a different fashion so require separate partial computations of tax. Alternatively, a separate form can be used for the new annual subtraction VAT, which may be helpful in having the U.S.'s trading partners and the WTO accept the new subtraction VAT as a VAT that is comparable to their credit VATs and therefore acceptable as a destination-based VAT.

The new supplemental subtraction VAT portion of the corporate tax should be viewed by the U.S.'s trading partners as equivalent to their credit VATs, because the tax bases are the same. For example, no tax credit under a credit VAT is allowed for wages, interest payments or rent of machinery and facilities, because those items are viewed as included in the value added by the producer. Similarly, under a subtraction VAT, no deduction would be allowed for wages, interest payments or rent of machinery and facilities either. In addition, under a credit VAT, a VAT is paid on the purchase of machinery and other long-lived assets that under the income tax would be capitalized (absent the application of accelerated cost recovery provisions such as section 168(k)), and a VAT credit is allowed to the business purchaser for that VAT payment. Similarly, under a subtraction VAT, a deduction would be allowed for the purchase price of the machinery and other long-lived assets even though, in the income tax portion of the corporate tax return, the amount would have to be capitalized (absent the application of accelerated cost recovery provisions). This exercise may lead one to embrace the possibility that any proposed increase in the corporate income tax could instead be done by adopting a supplemental subtraction VAT to supplement the existing corporate income tax imposed at its current tax rate.

The attractive feature of the adoption of a new supplemental subtraction VAT to supplement the existing corporate income tax is that it adopts the tax base equivalent to the credit VAT but uses the method of computation (although not the same computation) and payment of the current corporate income tax. Its computation thereby can be made from the seller's normal books of account,[46] from which the corporate income tax is computed, and collections of the tax can use the current and familiar administration mechanism of the current corporate income tax. The net result of the changes would be a new subtraction VAT base that is equivalent to the base used by a credit VAT, in that the tax base would be the excess of gross sales or services receipts (like gross income) over deductions for expenditures for intermediate products and non-employee services incurred in earning that gross income (deductible expenses) and its computation can be made from the seller's normal books of account from which its income tax is computed.

In this way, the tax imposed by the subtraction VAT can be included by the corporation on its annual tax return or separately, as discussed above, using a newly created appended schedule for the add-on subtraction VAT computation. The subtraction VAT computation would thereby be readily auditable by the Internal Revenue Service together with the corporation's regular corporate income tax computation. Furthermore, the tax would be invisible to retail purchasers because all or a portion of it would be included implicitly in the prices of goods sold by the taxpayer, just as all or a portion of the corporate income tax is implicitly included in those prices. Making use of the existing and familiar tax collection structures may be an important feature and would likely make its adoption an easier political task.

On the other hand, a credit VAT has several significant advantages over a subtraction VAT, if an evaluation were to be made on a clean slate. First, most of the rest of the industrial world uses a credit VAT, so worldwide acceptance of the allowable tax credits discussed above would be substantially easier than employing the novel subtraction VAT.

Second, a further difference and a potential advantage of a European credit VAT over a subtraction VAT in a "credit VAT world," is that the credit VAT is separately stated to the next purchaser in the line of production or sale, i.e., the intermediate goods supplier states the tax on a special "invoice" and collects the VAT from the next company in the line of production and ultimately from the customer. This invoice mechanism creates a trail for the taxing authorities to follow in making sure that for each VAT payment subtracted by a purchaser, there is a

46. *See id.* at 13.

VAT collection by the seller. As indicated earlier, that is the reason that the credit VAT is sometimes called the "Credit Invoice VAT."

In a subtraction VAT, by contrast, the tax is not separately stated and the gross proceeds of every sale by a company must be reported as part of the seller's "income," and the gross expenditures incurred in purchasing or manufacturing intermediate products or non-employee services for manufacturing, or inventory would be reported as "(VAT) deductible" by the purchaser without regard to a precise matching of the income item of the seller to the deduction item of the purchaser. As a result, the more complicated income tax auditing procedures would be followed rather than the much simpler and more effective credit invoice VAT method of matching VAT credits to VAT payments. This difference in form and therefore difference in leak-proof administration would likely make European acceptance of the U.S. subtraction VAT uncertain because it may raise suspicion of the reliability of the reporting to the tax authorities and therefore could make worldwide acceptance of the U.S. "variant VAT" problematic.

Third, even evaluated as an isolated comparison without regard to the current U.S. reliance on a corporate income tax and the U.S.'s aversion to a direct consumption tax, whether a VAT or national sales tax, a credit VAT is likely a superior form of consumption tax than a subtraction VAT not only for the above reasons but also because it is simply more visible to everyone involved. This attribute of visibility, however, may present a political difficulty that would impede and could make impossible its adoption in the U.S., so may be a defect rather than a feature from some taxpayers' point of view.

IV. Choosing the Subtraction VAT: The Mechanics of the Subtraction VAT and its Acceptance as a VAT

This part of the Article recommends that the U.S. adopt a subtraction VAT as a supplement to the corporate income tax, because (1) it is more readily attainable for the U.S., politically, than a credit VAT, (2) it is readily adaptable to supplement the existing corporate income tax, (3) it can be tailored to co-exist with credit VATs around the world, and (4) it should be recognized under international tax and trade treaties as an "indirect tax," and therefore can be destination-based, like a credit VAT. It is this fourth point that this Article will turn to now.

The WTO seeks to regulate international trade by setting forth its policy against subsidizing exports and disadvantaging imports and thereby dissuading and effectively precluding countries from employing subsidies to advantage their international trade.[47] This goal is furthered and reflected in Articles VI, XVI, and XXIII of the General Agreement on Tariffs and Trade (GATT)[48] and the 1994 WTO "Agreement on Subsidies and Countervailing Measures" (SCM Agreement).[49] Disputes regarding matters that come under these treaties go to a multinational forum provided by the WTO.[50]

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47. *What we stand for: Fair Competition*, World Trade Organization, https://www.wto.org/english/thewto_e/whatis_e/what_stand_for_e.htm [https://perma.cc/B5FD-5XJH] (last visited Dec. 15, 2022).

48. Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the General Agreement on Tariffs and Trade, Apr. 12, 1979, GATT BISD 26th Supp. 56 (1980). See "Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the General Agreement on Tariffs and Trade," which states that members of the WTO shall not use export subsidies to injure the domestic industry of another member state. This agreement was replaced and bolstered by the "Agreement on Subsidies and Countervailing Measures." These articles also demonstrate the general goal of preventing countries from using subsidies to distort international trade. Article VI disallows products from an exporting country to be introduced into the commerce of an importing country at less than normal value resulting in material injury to an established or developing industry in the importing country. Article XVI states "contracting parties shall cease to grant . . . any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market." Article XXIII prescribes how impacted countries should resolve a distortion to their domestic markets.

49. *Trade Guide: WTO Subsidies Agreement*, International Trade Administration U.S. Department of Commerce, https://www.trade.gov/trade-guide-wto-subsidies [https://perma.cc/GMY6-3BHM] (last visited Dec. 15, 2022) ("The Agreement on Subsidies and Countervailing Measures (Subsidies Agreement) of the WTO provides rules for the use of government subsidies and for the application of remedies to address subsidized trade that has harmful commercial effects.").

50. Agreement on Subsidies and Countervailing Measures art 4.4, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1869 U.N.T.S. 14 [hereinafter SCM Agreement]. A country seeking withdrawal of an exporting country's subsidy can use WTO's dispute settlement procedure or launch its own investigation and ultimately charge a duty (countervailing measure).

The SCM Agreement defines a subsidy, generally, as a financial contribution provided by a government that confers a benefit on an exporter.[51] Some of these subsidies, known as "red light subsidies," are expressly prohibited.[52]

A subsidy is defined as a "financial contribution" by a government that provides a benefit to a producer or exporter.[53] It includes various sorts of financial assistance like grants, loans, loan guaranties and some others, but also includes tax credits and failure to collect taxes.[54] An export subsidy, therefore would include a forgiveness or reduction of income tax on an exported product, such as an export tax credit.

Expressly omitted from this list of tax subsidies is the remission of "an indirect tax," such as a sales tax or VATs, because it is not a specific subsidy if it is not excessive.[55] More specifically, an indirect tax is a tax collected by one entity in the supply chain and paid to the government but passed on to the consumer as part of the purchase price of the good or service.[56] In contrast, a direct tax is a tax on the person paying the tax whom the government desires to bear the tax.[57] By example, an income tax is a direct tax. A consumption tax such as a VAT is an indirect tax, because it will be borne by the ultimate consumer.[58]

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51. *Id.* art. 3.1(a). The definition of subsidy contains three elements: (i) a financial contribution (ii) by a government or any public body within the territory of a member (iii) which confers a benefit. SCM Agreement art 1.1. SCM Agreement art. 3.1 prohibits export subsidies. Annex 1 provides a detailed list of specific types of export subsidies that are prohibited.

52. *Id.* art. 3. Subsidies and Countervailing Measures, Japanese Ministry of Economy, Trade, and Industry, at 86 (last visited Dec. 15, 2022), https://www.meti.go.jp/english/report/downloadfiles/gCT0006e.pdf [https://perma.cc/572N-N8V8] (describing prohibition on "red-light" subsidies, which also appears on the WTO website).

53. SCM Agreement, *supra* note 49, at art. 1.1; art. 3.1.

54. *Id.* art. 1.1(a)(1)(i); 1.1(a)(1)(ii).

55. *Id.*, Annex I (g).

56. Liu et. al., *Direct versus Indirect Taxation: Trends, Theory and Economic Significance* 1-2 (Georgia State University, Andrew Young School of Policy Studies, Working Paper No. 09-11, November 2009).

57. *Id.*

58. Jost Angerer, *Indirect Taxation,* Fact Sheets on the European Union (May 2021), https://www.europarl.europa.eu/factsheets/en/sheet/81/indirect-taxation [https://perma.cc/R9XP-V3XD] (last visited Dec. 15, 2022).

Many other countries have enacted a consumption tax and virtually all have chosen a credit VAT, which is an "indirect tax," because it is not a tax on the business but rather is expected to be passed along to customers, who are the real payers of the tax.[59] This characterization of the tax as indirect contrasts with an income tax, which is assessed and paid for by the earner of the income and therefore is a direct tax on the earning business. Thus, it is a direct tax, rather than an indirect tax.

A subtraction VAT, also a consumption tax, is assessed on the business based upon the consumption of the product by someone else and is equally passed through to the consumer although not as a separately stated item. Rather, it is passed through because the business seller knows it will be due to be paid to the taxing authority as a result of the sale of the product to the consumer and would not be paid in the absence of that sale or a sale to another consumer. Thus, as a matter of economics, the seller reserves for its payment by building it into the price of the good. The credit VAT and the subtraction VAT are both taxes on consumption and are both passed through to consumers, the credit VAT explicitly and the subtraction VAT implicitly by the business in setting sales prices, knowing that it will remit the tax when it aggregates all its sales at the end of the tax period. Neither is a tax on the seller's income because the measurement of the tax does not take into consideration many or even most of the costs of producing or delivering the product to the customer, such as wages paid to employees and the costs of the use of capital in running the business operation (e.g., interest and rent). Both forms of VAT are consumption taxes and neither is assessed directly on customers, notwithstanding that it is expected that under a credit VAT the portion of the purchase price attributable to the VAT will be stated by the selling business, whereas under a subtraction VAT it will not be expressly stated but can be computed by the merchant and the customer by doing a bit of arithmetic, knowing the tax inclusive VAT rate and converting it to a tax exclusive rate, which can be affixed to a sales receipt if that is what it takes. Both forms of VAT are assessed on businesses, and neither is assessed directly on individuals. Accordingly, a U.S. subtraction VAT, adopted as a supplement to the corporate income tax, should be treated as an "indirect tax," and in that respect, equivalent to a credit VAT for purposes of international trade rules.

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59. James A. Fellows, *Consumption taxes: A view of future tax reform in America*, 64 CPA Journal no.4, 28 (Apr. 1994).

A. The Challenges of Designing the Supplemental Subtraction VAT

The proposal in this Article is to enact a supplemental subtraction VAT to supplement the current U.S. corporate income tax, instead of simply increasing the present corporate income tax rate. In this connection, the tax on corporations could be modified by (1) retaining a straight corporate income tax but with tax rate reduction or no rate increases, and (2) enacting the supplemental subtraction VAT. The subtraction VAT component would (i) allow immediate expensing for business purchases of tangible personal property for business use in the way the current U.S. income tax provides for at least some business property, at least temporarily,[60] and (ii) eliminate deductions for wages, interest, and rent, for corporate businesses (the proposal does not include pass-throughs), all in the manner that a subtraction VAT would operate, as described earlier. The legislative proposal could also include various simplifying (and revenue enhancement) changes as part of a new subtraction VAT. The new subtraction VAT would require annual filing, which would be done as part of the filing for the corporate income tax.

A U.S. VAT of this sort as part of the U.S.'s national tax system would alleviate the need for a corporate income tax increase and its hindrance of U.S. business competitiveness internationally. Previous parts of this Article have explained the theory of the subtraction VAT, its mathematical equivalence to a credit VAT and how it could be engrafted onto the current U.S. corporate income tax without upsetting the corporate income tax system as it currently exists.

The U.S. supplemental subtraction VAT should be treated by U.S. trading partners as a VAT and therefore as an indirect tax, but in the absence of precedent it is not certain whether the U.S.'s trading partners and the WTO will accept its treatment as a VAT for purposes the international trade rules, allowing it to be treated as a destination-based VAT so that the U.S. government, i.e., the IRS, could forgo collecting it on exported products. That uncertainty exists, even though a subtraction VAT's tax base is equivalent to that of a credit VAT, because there is no functioning subtraction VAT that would confirm that treatment. The certainty that a U.S. subtraction VAT will be treated in the equivalent way under international trade agreements as a credit VAT with regard to U.S. exports is likely a precondition for Congress to adopt it as a part of the corporate tax.

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60. *See* I.R.C § 168(k).

Complicating the argument for such treatment and thereby creating some uncertainty is the fact that computation of the equivalent credit VAT would require an adjustment that would reduce the export sale price by the amount of the U.S. subtraction VAT that would be charged on the sale, because the unadjusted sale price under a subtraction VAT is a tax-inclusive price and the VAT is not separately stated. That complication, however, is mere arithmetic and should not preclude a U.S. exporting corporation from being treated equivalently to a European corporation subject to a credit VAT.

U.S. adoption of a VAT that can be reconciled with the European-style VAT, which has been adopted by many countries inside and outside of Europe, would play an important role in achieving fairness of international trade of those countries that have adopted a VAT and therefore could play an even more important role in achieving international tax harmonization. Getting WTO agreement to the foregoing proposition and allowing VAT treatment for U.S. exports subject to a U.S. subtraction VAT, however, may be a steep uphill climb, particularly if the credit VAT countries and the WTO do not want the hill to be climbed. If that agreement cannot be reached or is met with opposition, challenge and litigation, the U.S.'s adoption of a subtraction VAT could be a troublesome choice.

The Biden administration and much of Congress acknowledge the U.S. need for both additional tax revenue and avoidance of a tax increase that will put the U.S. at a competitive disadvantage to its treaty partners in international trade. They also likely recognize the international trade difficulty of seeking to achieve the same result as a VAT by using the discarded Border Adjustment Tax disallowing deductions for foreign expenditures by business, which the Trump Administration considered adopting as part of the income tax to make foreign business purchases more expensive than equivalent domestic expenditures, as inconsistent with the U.S.'s tax and trade treaty obligations under the WTO Agreements. The adoption of a credit VAT by the U.S. would, and the adoption of a subtraction VAT should, overcome any similar international objections. There is no assurance in advance, however, that the foregoing proposition would be accepted, particularly because some VAT countries at present have a higher corporate income tax rate than the current U.S. rate and even than the Biden administration's proposed rate,[61] so that an increased U.S. corporate income tax rate would benefit those countries' international trading position.

61. *See* Watson, *supra* note 2.

Furthermore, the likely increased gap between the European and other G-7 corporate income tax rates and the Biden administration's proposed higher U.S. corporate tax rate could lead a future administration to consider adoption of a credit VAT more seriously, even though the credit VAT appears to be unpopular in the U.S. in general.

Even though this Article has argued for adoption of a subtraction VAT, one must recognize that it may not be a viable option politically or because of the views of other countries in declining to accept it as a "true" VAT, although those countries would be on shaky ground. Thus, the next section of this Article will assume that a U.S. credit VAT is not currently viable politically and will reasonably assume that a subtraction VAT, which is assessed against a corporation and so appears to be a corporate tax increase, although it is not a corporate income tax increase, may be a viable compromise option. Thus, assuming the new supplemental subtraction VAT, modeled on the same tax base as the credit VAT as discussed earlier, and justified as an indirect tax on consumers, were adopted by the U.S, the Article discusses the issue of trading partner recalcitrance of accepting the novel supplemental subtraction VAT as a VAT under international tax and trade treaty agreements and the prospects of its ultimate acceptance as a VAT and therefore an "indirect tax."

B. Would the U.S. Choice of a Subtraction VAT Over a Credit VAT be Acceptable as a VAT Worldwide?

As set forth earlier, a U.S. subtraction VAT taxes consumption and can be created to be the mathematical equivalent of a credit VAT. Is that enough, however, to satisfy the VAT countries, and will they accept it as a VAT, like a credit VAT, and therefore allow it to be excluded from the exporting company's U.S. corporate income tax base under law by the U.S. for U.S. corporations' exports?

The starting point for answering this important question is accepting the equivalence of a subtraction VAT and a credit VAT, because both forms create consumption taxes, in that they both impose a tax on the ultimate purchaser's personal consumption. Further, they have identical tax bases, which is the same tax base as a retail sales tax, the archetypical and poster child for consumption taxes. Moreover, the subtraction VAT can be formulated to precisely replicate the amount of a credit VAT.

Are the administrative differences in the two types of VAT consumption taxes enough to justify the WTO's and U.S. trading partners' rejection of the subtraction VAT as a VAT and therefore an indirect tax? Arguably, subtraction VAT equivalence proponents would have to establish that a subtraction VAT would accurately establish the amount of U.S. subtraction VAT tax from which the exporting company would be excused, and the computation would be as reliable as determining the amount that a credit VAT would have yielded in tax if the item had not been exported. These factors would assure confident computation of the equivalent subtraction VAT tax forgone. Arguably, this means a subtraction VAT-adopting country like the U.S. would have to have what commentators have called a "sophisticated VAT"[62] and establish a similar cross-check procedure to the credit invoice system of the credit VAT, accurately establishing allowable deductions under the subtraction VAT. This requirement may in turn create a requirement that a VAT deduction for the purchase could be conditioned on purchasing the intermediate good from a registered dealer who would provide proof of the purchase and assure that the VAT was computed and paid on the sale. This procedure for exports would be a somewhat awkward add-on to the normal corporate income tax, under which a taxpayer establishes its purchases to the taxing authorities when requested on audit and the government does not have ready access in its own database to the intermediate seller's records. This additional requirement may be deemed necessary because the seller would lack the ready assistance of its supplier companies to furnish directly matching invoices identified for each component of the export sale transaction of the exporting seller. On the other hand, the intermediate seller would have the ability to match aggregate annual sales to the exporter on a yearly aggregate basis in the event of an audit, but those amounts would not be readily available to the country receiving the exports and to the extent they can be provided, they may not divide those sales as being for the exporter's export sales rather than its domestic sales. Such a subtraction VAT has been called an "Open VAT,"[63] and likely is more susceptible to abuse and therefore challenge.

On the other hand, under both the credit VAT and open subtraction VAT systems, the aggregate exports and VAT totals are the same, and the absence of invoices allowing item for item matching per

62. *See* Grinberg, *supra* note 10, at 310; Reuven S. Avi-Yonah, *Summary and Recommendations*, 63 Tax L. Rev. 285, 290 (2010).

63. *See* Grinberg, *supra* note 10 at 310; *see also* Avi-Yonah, *supra* note 61.

transaction is simply a matter of form and not substance, because under both systems, the buyer's tax payments would match the seller's tax collection and VAT remission to the government and the seller's tax credits for VAT paid to its suppliers would match the tax seller's reporting of VAT payments to the government for the transactions. The difference lies in ease of verification, which, it should be noted, is a feature and perhaps necessary shortcoming of the U.S. corporate income tax system itself but is tolerated as an inherent part of the tax system.

A solution to bridging the gap is to create a procedure for U.S. corporations involved in exporting to provide audited financial information to foreign countries of the corporation's foreign sales and costs associated with those sales in a format that allows for some cross checking readily and, if desired, greater assurance if the foreign country was willing to do the additional work or could force the U.S. corporation to do so. Non-exporting companies would not need to adhere to this procedure. In this regard, even a credit VAT is susceptible to fraud and abuse. Credit VAT fraud can involve the "fictitious payee" scam, using fictitious payees to create a fictitious VAT credit, the "missing trader" scam, in which a VAT credit is claimed on a deferred payment purchase to a trader which has disappeared without paying the VAT to the government, which is a variation of the missing trader scam, and the "carousel scam," all of which have been described in the VAT literature.[64]

Alternatively, if necessary to obtain WTO approval, item by item crosschecking could be done under a subtraction VAT using a system of withholding and payments to the government of a portion of the purchase price, which an intermediate seller can claim as a VAT credit. This system would resemble the method by which a current credit VAT seller crossmatches collected VAT with VAT paid in credit VAT countries and is also like the way wage taxes are currently withheld by employers in the U.S. for remittance to the government and reported to employees as well. The system could also use the less intrusive means of reporting by intermediate goods purchasers like issuing IRS Forms 1099 to intermediate goods sellers without any withholding of tax amounts.

The upshot of this discussion is that a map has already been drawn for the creation of a subtraction VAT. The principal hurdle that

64. *See* The Death of the Income Tax, *supra* note 15, at 224-27; Richard Thompson Ainsworth, *Carousel Fraud in the EU: A Digital VAT Solution*, Tax Notes Int'l, 443 (May 1, 2006).

must be overcome is winning its acceptance as a credit VAT equivalent and therefore an indirect tax on business (assuming that this term has discernable meaning) by the WTO and VAT countries. If it wins VAT acceptance, "VAT-equivalent payments"[65] made by VAT country buyers would be allowed as VAT credits by those countries, just as U.S. companies' payments for foreign intermediate goods to VAT country companies would be allowed as subtraction VAT deductions.[66]

It must be recognized, however, that a U.S. subtraction VAT would be seeking to break new ground in international taxation. It can be explained, as I have above, as an algebraic equivalent of a credit VAT, but if rates are different for different products or if one of the components in the computation is taxed at a different rate than others so that the tax is not a uniform single percentage of the finished good, then there could be differences in effect. It would seem highly unlikely that under the WTO treaty that a subtraction VAT amount in any given case would have to be identical to what the credit VAT amount would be, particularly in a world in which it is allowable for each country to charge a different VAT rate on different products. And, if not, should that affect the product sale only or the entire application of the tax equivalence of the two methods for the taxpayer and therefore acceptance as a matter of law of the equivalence of the two VAT methods for treaty purposes? This Article argues that if the two VAT forms would yield different tax amounts, only an adjustment should be made, and the adjustment should be similar to the adjustment that is made between corporations of two VAT countries that have different VAT exemption or rating rules.

Thus, the question remains whether the subtraction VAT will be recognized as equivalent to a credit VAT in all instances, only in some instances, or in no instances by the WTO for purposes of WTO treaty treatment. If the equivalence were recognized only for some transactions, adopting a VAT method different than the credit VAT may make it unworkable as a practical matter. In this connection, the subtraction VAT would have to be destination-based like the European credit VATs to be "WTO-compatible,"[67] i.e., chargeable on domestic

65. This would be the VAT country's tax rate multiplied by the amount of the purchase.

66. President Trump's tax reform proposal had sought to disallow deductions for such payments.

67. *See* Avi-Yonah, *supra* note 61, at 286. Avi-Yonah favors a credit VAT for this reason because the standard credit VAT is destination based and

sales but not necessarily on exports, which is the method used by European credit VATs.

In contrast to the cautions that have been identified above, if the U.S. adopted a credit VAT, the process could be seamless and clearly acceptable to the WTO and VAT countries (although those countries may be unhappy that they would now have to compete with U.S. corporations in world trade on a level playing field). In that event, U.S. corporations would not be required to charge the VAT to their customers on exports, just as VAT-countries do not charge credit VATs on exports. The similar treatment hoped for, justifiably, under a U.S. subtraction VAT is that the U.S. corporation would not have to pay the VAT to the U.S. Treasury upon its sales to foreign customers, thereby allowing it to price the export item more cheaply to reflect the absence of VAT incurred on the sale.

C. Prospects for the Acceptance of a Subtraction VAT as a Credit VAT Equivalent

One can assert that a U.S. destination-based supplemental subtraction VAT, as proposed in this Article, should obtain credit VAT-equivalent treatment by the WTO, but European and other credit VAT countries' acceptance of that treatment is not assured and there is no WTO case law to support it, although there is no WTO case law that has held otherwise.[68] In that it is only the U.S. among most if not all its major trading partners that lacks a credit VAT, which is not assessed by those trading partners on exports, there may not be an easy agreement to be reached allowing export nontaxability of exports. Nevertheless, the adoption of a U.S. subtraction VAT should be raised with the European Union and WTO as the U.S. seriously considers its adoption.

Nevertheless, as indicated above, the foregoing plan for a U. S. subtraction VAT agreeably blending with its trading partners' credit VATs is uncertain, because, although logical and justifiable, it has not been done before. Accordingly, it is highly possible that the U.S. would ultimately and after much discussion with its trading partners be left with the choice of (1) adopting a credit VAT to achieve parity treatment with its trading partners or (2) litigating the subtraction VAT with

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there are no existing uses of subtraction VATs to look to as precedent. *Id.* at p. 290.

68. President's Advisory Panel on Tax Reform (2005).

uncertain prospects of victory but certain prospects of delay. Both alternative possibilities suggest a stand-by plan for the U.S. to adopt a subtraction VAT to be replaced by a credit VAT in the event the WTO decides unfavorably to the subtraction VAT. This course of action will put maximum pressure on the WTO to decide favorably on a subtraction VAT. Such a position by the U.S. might even convince its domestic "no new tax" adherents to accept this new VAT proposal. The stand-by credit VAT plan, however, could also doom the entire VAT proposal.

Thus, in seeking to achieve both additional revenue and fairness in international trade, the U.S. may ultimately face the conundrum of choosing between adoption of a new subtraction VAT, which would more closely match the taxing structure of the U.S. current income tax and, as an addition to the corporate income tax, be an easier tax to gain domestic acceptance, but would very well meet with trading partner opposition, or adoption of a credit VAT in the European model to supplement the corporate income tax, and meet with substantial domestic opposition, which could doom the VAT domestically.

The foregoing conundrum, the "prisoner's dilemma" in game theory, would be the case, even though adoption of either form of VAT may very well be better than raising the forgone VAT revenue with additional income taxes, which would appear to be the default position. On the other hand, just as the way out of a prisoner's dilemma is communication and the parties' fully understanding the situation, there is hope that the U.S. can get it right.

D. The Prospect of Double Tax— One Final Impediment to Adoption of a VAT

The adoption of a U.S. VAT, whether subtraction or credit, in lieu of raising the corporate income tax rate, will likely have other individual wealth effects because of the economic incidence of the VAT. For example, industries that are labor-intensive and as a result have high payroll costs are likely to be most affected by the introduction of a VAT, because wages are not deductible or creditable in a VAT, although they are includible in the income of employees. Double tax results because payroll costs are taxed to the worker and again to the purchaser (presumably shared by the seller in some way as a component part of the VAT) for which there is no tax credit allowed for employee taxes. This situation could influence the seller's price and be reflected in lower general wages as compared to increasing the corporate income tax.

The effect of this double tax will differ among industries and may affect labor decisions more than capital purchase decisions and affect labor-intensive industries more than capital-intensive industries. That will likely occur because the cost of capital is immediately deductible in a subtraction VAT or will give rise to a VAT credit in a credit VAT, whereas labor costs will be neither. Will this put downward pressure on employment and wages? It seems likely at the introduction of the VAT, but the economy may adjust. These secondary adjustments are difficult to predict, because over time and with technological advances, the labor/capital mix in businesses' needs is not fixed and businesses adjust to changing costs. Moreover, the issue is not simply whether to enact a new VAT or nothing but rather whether to enact a new VAT or an increased corporate income tax. Nevertheless, if the new VAT were reliably predictable to be reflected in substantially lower wages, then adopting a new U.S. VAT, whether subtraction or credit, could be politically unviable.

On the other hand, people pay taxes and not corporations, because corporate taxes appear to be borne by the owners of those corporations but are actually borne by labor and capital generally. There is both a need and impetus for more taxes (less spending seems unattainable), so the questions are "from whom and how can negative incentives to produce be minimized?" My answer to the last question is through a consumption tax, and that takes me back to a VAT rather than an increased income tax.

Conclusion and Prospects

The previous section of the Article sought to make the case for the international treatment of a subtraction VAT as the economic equivalent to a credit VAT for purposes of international trade rules. It then evaluated the argument objectively and thereafter made an evaluation of whether this U.S. tactic and process could be met with principled opposition, challenge, and litigation, which could make it a troublesome choice. Accordingly, it is appropriate to look at revenue raising alternatives to a traditional business or individual income tax. The alternative that appears most appropriate, and has been chosen by other countries, is a consumption tax that is not assessed directly on individuals but rather is assessed on businesses, i.e., a business level rather than an individual level consumption tax. The choice for those that have followed this route is the credit VAT.

Americans, however, have no history with the credit VAT, unless they have traveled abroad, and then have only experienced it on the consumer end as being like a super national sales tax. They have no experience with the inner working of a VAT and its means of collection throughout the supply chain. On the other hand, Americans have a long and personal history with the income tax, most on an individual basis, and many on a business basis with respect to their corporations' business income.

A corporate income tax involves special treatment for many different receipts and expenditures. Receipts are characterized as income (e.g., for sales or services) or not, and expenditures are characterized as deductions (e.g., rental expense and salaries) or not. Typically, accountants make the characterization determinations based upon a set of tax accounting rules, and business owners accept the net income result as income minus deductions of various sorts, and thereafter the tax computation based upon the net "taxable income" amount.

If the corporate income and deduction computations were changed a bit for a supplemental, business add-on tax that would not allow deductions for wages, interest or rent, but allow deductions for expenditures that would otherwise be capitalized under the regular income tax (as section 168(k) now does in lieu of some depreciation deductions), such a tax could be acceptable to the business community just as the corporate and individual alternative minimum tax add-ons have become acceptable. Note that the income tax computation of wage earners themselves would not be affected directly by the changes because the legal incidence of the partial non-deductibility of wages would be on the employers and included in the corporate tax computation only. The foregoing is the theory behind acceptance of a subtraction VAT. It is a small computational step, and in the long run reflects a simplification by accomplishing the same result as a credit VAT. Perhaps in the future a new credit VAT in the U.S. as a substitute for the subtraction VAT can be promoted as an adoption of an identical tax to the supplemental corporate add-on tax, rather than a new national sales tax.

One should be very hesitant to predict the foregoing result, however, because of the political world in which we now live, however logically compelling it may be. The logic reveals the substantive identity of the two VAT methods, and if a subtraction VAT is acceptable, then a credit VAT logically should be as well. Accordingly, if the U.S.'s trading partners decline to accept the proposed U.S. subtraction VAT as inapplicable to exports in a manner like the European credit VAT, it should behoove our representatives in government to follow the logic and recognize the international trade benefits to the U.S. of adoption of the VAT as a credit VAT.

Appendix A. Economic Analysis of Substituting a VAT for an Increase in Corporate Income Tax.

The general assumption that business persons (and commentators) make and believe is that destination-based VATs, which include European credit VATs, disadvantage imports relative to domestically produced products, because the imported product must bear the importing country's tax as well as the producing country's taxes on the product (unless the exporting country allows the exporter to escape the home country's VAT, if there is one, which is typical among VAT countries, of which the United States is not currently one). Two noted economists, Martin Feldstein late of Harvard and the National Bureau of Economic Research (NBER), and Paul Krugman of MIT and the NBER at the time, argued in their article "International Trade Effects of Value-Added Taxation"[69] that this proposition is wrong, and that the foregoing disputed proposition would lead to the mistaken conclusion by its proponents that "countries that have a VAT have an advantage in international competition over countries that rely on an income tax."[70]

They caveat this proposition, however, with the caution that the foregoing proposition would not necessarily be true if there were an export rebate of the VAT, in which case the VAT would act as the equivalent of an import tariff, which would disfavor imports relative to domestically produced products. They then list several other factors that could cause a VAT to be non-neutral regarding trade effects. Factors that would cause VATs to be non-neutral are that (1) a VAT may be a substitute for an income tax, and since an income tax is non-neutral in its effects, substitution would have "allocative effects, tending, other things being equal, to improve the trade balance in the short run,"[71] and (2) a VAT, as a consumption tax, can have a great effect as a replacement for an income tax, on choices between saving and consumption. Their analysis then proceeds to a series of equations, demonstrating or proving their points.

The subtraction VAT that I am proposing in this Article is such a substitute for an increase in the corporate income tax, either as a proposed substitute for a proposed rate increase, or, if the rate increase is

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69. *In* Taxation in the Global Economy 263-82 (Assaf Razin & Joel Slemrod, eds., 1990).

70. *Id.* at 263.

71. *Id.* at 264.

enacted, a replacement for the newly enacted rate increase. This factor, under the Feldstein-Krugman analysis, fits within their exception to a VAT having trade neutrality.

Nevertheless, Joel Slemrod in his contribution to *The VAT Reader*,[72] takes the general Feldstein-Krugman proposition stated above to mean that countries that have a VAT do not enjoy trade advantages against countries that rely solely on an income tax to raise revenues, and companies in the VAT-less countries are not really disadvantaged when it comes to international trade, even though they appear to face special double taxation on their sales to purchasers in VAT countries because they pay both domestic income tax and foreign VAT on their export sales and thereby find themselves at a trading disadvantage.[73] Slemrod asserts in an example the equivalent effect of a local sales tax and an import assessed VAT and finds the non-VAT country export seller in the same position in both situations, and of course that is correct. But I would assert that the non-VAT country export seller is indeed at a disadvantage in both cases because in both cases his costs have included the seller's home country income tax and the foreign, export country's VAT or sales tax assessed on the export sale.

Slemrod ultimately says that, in any event, life is more complicated than that, and all prices will adjust in real terms, because exchange rates will adjust in the long run to put sales and purchases back into balance.[74] That reliance on exchange rates, however, gets to the final point on this subject, which is that a few sales here or there are unlikely to change the exchange rates in the real world, at least in the short run when so many countries are taking on extraordinary national debt and financing a large portion of it with printing money. The substitution of a new U.S. VAT for an increase in the corporate income tax in the world that I just described is unlikely to affect currency valuations in the short run, and if it does, the effect would not be nearly as great as the avoided importing county's VAT upon the export and sale.

The upshot of this long introductory appendix's discussion is that U.S. businesses' instinct that higher corporate income taxes will adversely affect their export businesses is likely correct and that the enactment, instead, of a VAT that is not charged on exports instead of

72. Joel Slemrod, *Does a VAT Promote Exports?*, The VAT Reader 186-91 (Tax Analysts ed., 2011).

73. *Id.* at 188-89.

74. *Id.* at 189.

an increase in the corporate income tax will not similarly adversely affect their export businesses. The Article discusses the domestic tax policy and political aspects of the enactment of a new VAT and the choice of type of VAT—subtraction or credit—based on this conclusion, or at least assuming that it is correct, the choice of which I leave to the reader.

Appendix B. Tax-inclusive Rate vs. Tax-exclusive Rate and Gross-up[75]

The examples used in Part II assume a 20% tax-inclusive rate. This means that the money used to pay the tax will be subject to tax. Thus, a tax-inclusive sales tax rate of 20% on a $100 sale means that the sale price of $100 generates a sales tax of $20, which must be paid out of the $100 sales proceeds. Similarly, a tax-inclusive VAT rate must be paid out of the proceeds as well.

As we know, the typical state sales tax, unlike the above illustration, is set at a tax-exclusive rate. This means that a sale for $80, subject to a tax-exclusive rate of 25%, generates a tax liability of $20, but the liability is added to the transaction price, so that the seller charges and the buyer pays the $20 liability in addition to the $80 sales price and thus pays a total of $100. Importantly, the concept of the tax, whether a sales tax, a subtraction method VAT, a credit method VAT, or a Flat Tax, is the same, regardless of whether the tax rate is expressed as tax inclusive or tax exclusive. Indeed, there is an algebraic relationship[1] between a tax-exclusive rate and a tax-inclusive rate that can be seen by using a simple example. A tax-exclusive rate of 25% is equivalent to a tax-inclusive rate of 20%. A sale for $80 subject to a tax-exclusive 25% sales tax rate generates $20 tax liability, or 20% of the $100 combined sales proceeds and sales tax amount. This consequence is the same as the seller selling the product for $100 subject to a 20% tax-inclusive sales tax, which also generates $20 ($100 × 20%) of sales tax. The same principles hold true with VATs and the Flat Tax.

The subtraction method VAT is generally discussed and illustrated using a tax-inclusive tax rate, because of the way the tax would be collected, which is similar to the current corporate income tax, which also uses a tax-inclusive tax rate (a taxpayer is taxed on the income used to pay the income tax liability). In contrast, a sales tax and a credit invoice VAT are generally discussed and illustrated using a tax-exclusive tax rate, although in practice these methods do not have to use a tax-exclusive rate. Nevertheless, as explained and illustrated above, the two methods represent different ways of describing the same tax and can easily be compared.

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75. Appendix B is excerpted from Appendix A of The Death of the Income Tax, *supra* note 15 Appendix A.