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## International Aspects of Fundamental Tax Reconstructing: Practice or Principle

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# International Aspects of Fundamental Tax Restructuring: Practice or Principle?

MICHAEL J. GRAETZ\*

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## I. AMERICAN EXCEPTIONALISM

The globalization of economic activity, including the expansion of international trade, the amazing ability of international capital markets to transfer capital rapidly across borders, and the movement in Europe toward greater economic unification, have made it more difficult for nations independently to fashion tax laws that properly balance their own equity, economic efficiency and simplicity goals. This is what makes this conference to analyze the international aspects of recent proposals to replace the federal income tax with some form of consumption tax, with particular emphasis on the Nunn-Domenici "USA" tax and the Arney-Shelby flat tax ("flat tax"), so important. As the paper by Stephen Shay and Victoria Summers well demonstrates, it would be absurd to consider major tax restructuring in the United States without assessing the potential effects of such a change on international flows of capital and trade, on our existing treaty network, and on our domestic international tax law.<sup>1</sup> We must also anticipate the likely responses of other nations. The first lesson is that the forms of consumption tax proposals that seem to enjoy the most political support in the United States today are unique creations both in their structure, and because they would completely supplant the current income tax system. Indeed, it is this uniqueness that makes the Shay-Summers paper so important and the discussion at this conference so necessary.

At the outset, it is worth emphasizing that the greatest disparity between this nation's tax system and those of our trading partners is that other countries rely more heavily on consumption taxes. On average, the OECD countries collect about one-third of their tax revenues from

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\* Justus S. Hotchkiss Professor of Law, Yale University. This commentary draws from both my book, *THE DECLINE (AND FALL?) OF THE INCOME TAX* (W. W. Norton, 1997) and an article co-authored by Michael O'Hear, *The 'Original Intent' of U.S. International Taxation*, 46 *DUKE L.J.* 1021 (1997).

1. See 51 *U. MIAMI L. REV.* 1029 (1997).

consumption taxes, and over the past thirty years consumption taxes as a percentage of Gross Domestic Product have more than doubled in these nations.<sup>2</sup> As nations' tax systems converge—partly in response to increased capital mobility—the United States seems likely to move toward increased taxation of consumption, perhaps as these proposals suggest, as a substitute for all or a large part of the existing income tax.

If the United States were to add a credit-method value added tax (VAT) or a retail sales tax at the federal level, we would not be forced to face any real issues regarding the imposition of such a tax on international transactions. We undoubtedly would follow the standard practice throughout the world of imposing such a tax on a destination basis, thereby exempting exports and taxing imports.<sup>3</sup> Under such a tax system, no question of allowing foreign tax credits would arise, nor would we be concerned that such a change would destabilize either our domestic international income tax law or our income tax treaty network. The routine treatment of international trade under credit-method value added taxes has become well entrenched in worldwide practice during the past three decades. Through both multilateral agreements and standard operating practices, the revenues from these consumption taxes are generally ceded to the country where the consumption occurs. If we were just considering adding a credit-method VAT to the current federal tax mix, this conference would be unnecessary; the tax would be imposed on a destination basis.

But the proponents of unique consumption tax alternatives—the flat tax and the USA taxes—have forced us to think anew about the standard practices for international taxation under both income and consumption taxes. They make us confess that we are less certain about the reasons for these longstanding practices than we are about what those practices are. To analyze these proposals properly, we should reexamine the basic principles that undergird routine international consumption tax rules.

As the Shay-Summers paper details, the USA tax combines a flat rate subtraction method VAT at the business level with a progressive rate personal expenditure tax at the individual level. Employers can take a credit against the former for their share of payroll taxes. The flat tax proposal essentially divides the collection of a flat rate subtraction-

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2. Ken Messere, *Taxation in Ten Industrialized Countries in the Last Decade: An Overview*, 11 TAX NOTES INT'L, Aug. 21, 1995, at 512.

3. The former Soviet Republic seems to be the most important exception, applying VATs on an origin basis for trade between the republics. See Charles E. McLure, *International Implications of the Flat Tax*, 50 BULL. FOR INT'L FISCAL DOCUMENTATION 511 (1996). Apparently the European community is considering shifting from destination-based VATs to an origin basis with compensation to be paid from revenue-winning countries to revenue losers.

method VAT between businesses and individuals. Rather than denying businesses a deduction for wages—the usual rule under a subtraction method value added tax—the flat tax allows businesses to deduct both wages and purchases from other businesses and collects the tax on the value added from wages at the individual level. Each individual or family would be allowed an exemption for a specified amount of wages. As Shay and Summers demonstrate, the total of the flat tax business and individual tax bases equals total retail sales, putting aside any exemptions. As Alan Auerbach, among others, has observed, the flat tax is “basically a value added tax combined with credit for low income households. It may differ from traditional value added taxes in the method of collection, but this is not significant.”<sup>4</sup> In contrast to the flat tax, a credit-method VAT or a retail sales tax is typically collected entirely from businesses without requiring any individual reporting or remittance of taxes to the government.

Senators Nunn and Domenici have proposed a progressive rate individual level consumption tax in an effort to avoid the substantial tax reductions that would occur for high-income families if a flat rate consumption tax were substituted for the income tax. The principal advantage of the flat tax’s division of a value added tax between business and individuals is that it exempts a certain amount of wages from tax, thereby eliminating the regressivity of standard flat rate consumption taxes for low and moderate wage earners. In contrast to Senators Nunn and Domenici, the flat tax proponents are apparently not concerned with the substantial tax reduction for the wealthy that would occur if income (and estate) taxes were completely replaced with a flat rate consumption tax. It would be possible under such a flat tax to impose progressive tax rates on wages. Some economists have suggested this but have failed to show why, in a consumption tax world, wages, but not investment income, should be subject to progressive tax rates. The key point for our purposes here is that both the flat tax and USA tax variations on the standard form of consumption taxes have been advanced to address their proponents’ concerns about the distributional effects of standard consumption taxes, and to conform consumption taxes to their visions of taxation in accordance with ability to pay.

The concern over the distributional impact of these taxes—a classic domestic tax policy concern—may have important international tax consequences. As the Shay-Summers paper makes clear, neither the flat tax

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4. *Flat Taxes: Some Economic Considerations, 1995: Hearings on S. 488 Before the Senate Committee on Finance, 104th CONG. (1995)* (statement of Alan J. Auerbach, Professor of Tax Policy & Finance), available in 1995 WL 151912; Charles E. McLure, Jr., *International Implications of the Flat Tax*, 50 BULL. FOR INT’L FISCAL DOCUMENTATION 511 (1996); see also McLure, *supra* note 3, at 511.

nor the USA tax is easily conformed to the prevalent world practice of taxing only consumption within a nation's borders. Indeed, the flat tax exempts imports and taxes exports, the opposite result from the value added taxes presently in place in more than one hundred other countries. The business-level USA tax is designed, like other nations' VATs, to be imposed on a destination basis, but, as the Shay-Summers paper points out, this would likely be challenged under GATT. The tax credit for the employers' share of payroll taxes which is allowed against the business level USA tax would have the effect of converting payroll taxes from an origin to a destination basis and would also raise GATT issues. The individual level USA tax would deviate from the common worldwide consumption tax practice by taxing consumption by U.S. citizens and residents anywhere in the world. Moreover, the USA tax recognizes that there is no practical way to collect the personal level USA tax on consumption in the United States by residents of foreign countries, something that a credit-method VAT or retail sales tax routinely accomplishes. Finally, in a sharp departure from common consumption tax practices, the individual level USA tax allows a foreign tax credit for foreign income taxes.

Analyzing these tax proposals is made more difficult by the fact that neither the political proponents of a flat tax nor the initiators of the USA tax have labeled their proposals consumption taxes. They have insisted on using income tax labels, and refer to their proposals as consumed income taxes, savings-exempt income taxes, USA taxes or simply flat taxes, and have constructed their proposals to look more like income taxes than sales or value added taxes. Although most economists and legal analysts have recognized these taxes to be consumption taxes, politicians apparently prefer the income tax label. Professors Hall and Robushka of Stanford University, the inventors of the Armey-Shelby flat tax, have been clear about their desire to tax consumption and have admitted that there are many "economically equivalent ways to impose consumption taxes."<sup>5</sup> Despite their economic similarities, however, the different consumption tax methods are apparently not politically equivalent. For example, it is politically important not to let elderly consumers know that they are paying a new tax on their purchases of goods and services, something these proposals accomplish both by avoiding any separate statement to consumers of the taxes included in the prices of the goods and services they purchase and by looking like an income tax. Politicians' claims that they are imposing an income tax, when their proposals are in substance consumption taxes,

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5. Robert E. Hall and Alvin Rabushka, *Of Revenue and Revolution; Simplify, Simplify*, N.Y. TIMES, Feb. 8, 1995, at A19.

make efforts to evaluate both the domestic and international tax aspects of their proposals more difficult.<sup>6</sup>

## II. THE GATT

As the Shay-Summers paper points out, the structure and political spin of these proposals may have genuine economic consequences in the international arena. I accept the Shay-Summers conclusions that the flat tax and the individual level USA tax would be classified as a "direct" tax under the GATT and that the "direct-indirect" issue would be controversial under the USA business tax. Congressman Arney and Senator Shelby have apparently made it impossible under current GATT rules to impose a consumption tax on a destination rather than an origin basis simply by transferring collection of the wage portion of a value added tax from the business to the individual level. This change alone apparently converts an "indirect" tax, which can be imposed on imports but not exports, into a "direct" tax that must be imposed on exports but cannot be imposed on imports. How can this kind of difference be determinative given our modern understanding of the substantive equivalence of collecting the same tax at different levels?

The GATT rules for permitting border adjustments for "indirect" taxes while forbidding them for "direct" taxes can be viewed as GATT's answer to the question of tax incidence. On this view, a retail sales tax or VAT is assumed to be borne by the consumer, and therefore, if the tax is imposed on a destination basis, tax revenues are sent to the national government whose residents (purchasers) actually paid the tax. Likewise, assuming the corporate income tax reduces corporate profits implies that rebating such a tax would simply serve to transfer money from the nation of consumption to the nation of production. There is, however, no certainty that the GATT answer is correct.<sup>7</sup> As the Princeton economist, Harvey Rosen, reasons: "If, in fact, the corporation tax is included in the price of goods produced in the corporate sector, then in some sense, American producers do not receive the rebate to which they are 'entitled'."<sup>8</sup> Indeed, when the ability to border adjust a broad-based flat rate consumption tax turns on how the tax is collected, there is every reason to regard the GATT "direct-indirect" distinction as archaic and formalistic, and completely divorced from economic substance.

Nevertheless, one need not believe that the "direct-indirect" distinc-

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6. Parenthetically, the income tax shape of these taxes may also make it easier to return to income taxation simply by eliminating the immediate deduction of capital expenditures.

7. See, e.g., HARVEY S. ROSEN, PUBLIC FINANCE 549 (2d ed. 1988).

8. *Id.*

tion of the GATT is any more sensible (or transparent) than the same distinction under the U.S. Constitution to recognize the potential real world consequences of an adverse GATT determination. Even though this kind of tax issue does not fit into the "national security" exception, the United States might nevertheless refuse to abide by an adverse World Trade Organization interpretation of GATT.<sup>9</sup> But it seems unlikely that the United States would undermine the authority of the WTO over this issue; after all, GATT objections led to the demise of the Domestic International Sales Corporation and have long blocked the United States from imposing an oil import tax. If we are bound by GATT constraints, the income tax garb of these proposals and the way they are collected may affect not only the U.S. public's perception of these taxes, but also may ultimately determine their international tax consequences, including which nation gets the revenue, perhaps in a manner contrary to that envisioned by their originators and supporters.

### III. ADDITIONAL RESPONSES OF OTHER NATIONS

Shay and Summers, along with some other commentators such as Reuven Avi-Yonah, also seem correct when they suggest that foreign nations could be concerned that the United States would become a major new tax haven for capital income, if such proposals were enacted, responding in this case to the consumption tax economics of these proposals rather than their income or "direct" tax structure. A further word of explanation seems appropriate. Some analysts have suggested that rather than regarding the consumption tax as exempting all capital, as is suggested by the Shay-Summers paper, we should view a consumption tax as exempting only the "normal" or "riskless" rate of return on capital.<sup>10</sup> Even under this view of a consumption tax, however, the United States would always be more attractive than a country with an income tax for investments that yield a normal or above-normal rate of return. The relative advantage of U.S. investments would depend on the tax rates in the two countries and the portion of the return that is above-normal.<sup>11</sup> For example, if the above-normal return were half the total return, the United States would be more favorable to investment unless its tax rates were double that of the foreign nation.

A foreign tax credit system could protect foreign nations against runaway capital attempting to take advantage of the new U.S. tax

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9. Cf. David E. Sanger, *U.S. Rejects Role for World Court in Trade Dispute*, N.Y. TIMES, Feb. 21, 1997, at A1.

10. E.g., McLure, *supra* note 3; Alvin C. Warren, *How Much Capital Income Taxed Under an Income Tax Is Exempt Under a Cash-flow Tax?* (forthcoming).

11. McLure, *supra* note 3, at 513.

regime. Therefore, it seems reasonable to expect territorial foreign nations to move toward a foreign tax credit system if the United States were to replace its income tax with a consumption tax.<sup>12</sup> In fact, simply moving to a foreign tax credit may not be regarded as an adequate response if other nations come to view the United States as a tax haven for capital investments. Even under a foreign tax credit system, the current practice of deferring tax on earnings of foreign subsidiaries offers advantages for investments in low tax countries until the earnings are repatriated. Foreign nations might reconsider this practice if the United States were to replace the income tax with the flat tax, the USA tax, or any other consumption tax. Alternatively, nations that now exempt foreign source income earned in an active foreign business may treat the United States as a tax haven and refuse to allow such exemption for investments in the United States.<sup>13</sup> The U.S. repeal of the income tax might then have the effect of changing the focus of exemption systems from looking at types of income (e.g., Subpart F) to asking whether the foreign country is a tax haven.<sup>14</sup>

Enacting either the USA tax or the flat tax proposal would represent the kind of shift in tax regimes that seems likely to prompt the kinds of responses that Shay-Summers and other commentators have predicted would undermine the existing tax treaty equilibrium. Given the pace of such negotiations, a renegotiation process could take many years, and the uncertainties during the interval could prove daunting to taxpayers and governments alike.

#### IV. PRINCIPLE OR PRACTICE?

The most vexing issue regarding the international aspects of the flat tax and USA tax proposals is their departure from the standard destination-basis consumption tax regime. As the Shay-Summers paper and the above comments demonstrate, the unique method of collection and income tax appearance of the consumption tax proposals considered here raise fundamental questions about the underlying principles of well-settled international taxation practices. They demonstrate that changing the form of a consumption tax and the way it is collected,

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12. See generally, Harry Grubert and Scott T. Newlon, *The International Implications of Consumption Tax Proposals*, 48 NAT'L TAX. J. 619 (1995); Reuven Avi-Yonah, *From Income to Consumption Tax: Some International Implications* 33 SAN DIEGO L. REV. 1329 (1996).

13. New Zealand apparently has compiled a "white list" of countries where investments qualify for foreign tax credits or exemption.

14. One can generally design exemption and tax credit systems to have quite similar effects. See HUGH AULT ET AL., *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 380-85, 402-25 (1997) (discussing use of a foreign source income exemption in the United Kingdom, Canada, Germany, the Netherlands, Australia, and France).



without necessarily changing its essential nature or its substance, may unsettle previously accepted international tax practices. By advancing the USA tax and flat tax proposals, proponents have raised the issue whether the routine rules for imposing international taxes on consumption and for allocating revenues from such taxes to the country where the consumption occurs are grounded on firm principles or merely reflect historical practice and longstanding political compromises.

A preliminary analysis of this question suggests that the standard destination basis of a consumption tax can be more easily attributed to historical development than to any current fundamental economic advantages it may have over origin-based consumption taxes, or any reasoned consideration of the appropriate allocation of consumption tax revenues among nations. The Shay-Summers approach began its commentary with an analysis of the retail sales tax. Imposing a retail sales tax without making any international adjustments would allocate the tax on a destination basis. The tax would be collected at the time and place of the retail sale; such transactions normally occur in the jurisdiction where consumption itself will take place. If the tax is on the consumer, the revenue would be collected by the country where the consumption occurs. If the tax base covered all forms of consumption, a destination-based retail sales tax would not affect either choices about what to consume or where to locate production, although it could affect both labor-leisure and savings-consumption tradeoffs. Obviously, imposing a retail sales tax alone would not benefit international trade, but there could be advantages to such a tax if it replaces a tax that harms international trade.

The chief distinction between a credit-method value added tax and a retail sales tax is the time and place of collection. If the collection of such a consumption tax is moved up to earlier stages of production and sale, border adjustments in the form of exemptions for exports and taxes on imports would be necessary to reach results equivalent to those under a retail sales tax. Such border adjustments would allocate the revenues from the tax to the jurisdiction where the retail sale takes place. As with a retail sales tax, the nation where the consumption occurs will collect the revenues from the tax, and international trade would not be affected.

It should not be assumed, however, that the nation of final sale has a better claim to consumption tax revenues than the country where the product was produced and where much of the value has been added. If a Cadillac is produced in the United States, but is purchased and used in Denmark, it is not clear that Denmark, the nation of consumption, has a better claim to the tax revenues than the United States, the nation of production, even if we assume that the tax is borne by Danish consum-

ers. The country where production occurs has, through government expenditures, provided the tangible infrastructure and legal institutions that facilitated production. Collecting a value-added tax in exchange for these benefits seems quite reasonable.

Economic analysis does not offer a clear justification for preferring destination-based over origin-based consumption taxes. Even though it would appear that an origin-based consumption tax might affect the location of production, economists have generally agreed with Shay-Summers that a destination-based consumption tax does not offer any economic advantages over an origin-based consumption tax after taking into account adjustments in exchange rates, prices, and wages.<sup>15</sup> There

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15. See *Flat Taxes: Some Economic Considerations, 1995: Hearings on S. 488 Before the Senate Committee on Finance, 104th CONG. (1995)* (statement of Alan J. Auerbach, Professor of Tax Policy & Public Finance) available in 1995 WL 151912; Professor Alvin Warren has illustrated this argument with the following example:

Suppose that the U.S. has an origin-based VAT of 10 percent with no border adjustments, and that a U.S. consumer product which costs \$100 to produce will sell for \$110, including the tax, whether sold in the U.S. or for export. Assume that a comparable product is produced in country Z and sells for 110Z in the local zed currency. Assume further that the exchange rate between the U.S. dollar and the Z zed is  $1\$ = 1Z$ . Finally, for simplicity, assume that there are no transportation costs for shipping the products.

Under these conditions, consumers in the U.S. and Z will choose between the two products on the assumption that they will sell for identical prices. Consumers in Z have the choice of buying the Z product for 110Z or buying the U.S. product for \$110, which will require 110Z. Similarly, U.S. consumers can buy either product for \$110. A U.S. producer has the choice of selling in the U.S. market for \$110 or exporting for 110Z, which will yield \$110. In either case, the U.S. producer would retain \$100 after payment of U.S. taxes.

What will happen if the U.S. replaces its origin-based VAT with a destination-based VAT that exempts exports and taxes imports? Initially, the Z product appears more expensive to U.S. consumers than the U.S. product, because the Z product will sell for \$121 (the old price of \$110 plus the new 10 percent tax), whereas the U.S. product will still sell for \$110. Similarly, the U.S. product now looks less expensive than the Z product to Z consumers, because the tax rebate means that the U.S. product can now be exported from the U.S. for \$100. The U.S. producer might therefore think it has an advantage in Z, where the comparable local product continues to sell for 110Z. Hence it is often argued that a destination-based VAT would stimulate exports, and that an origin-based VAT would not.

Now consider what happens when the U.S. and Z consumers start to switch from Z products to U.S. products, because the latter appear to be less expensive. That switch would mean that there would be less demand for the Z currency by U.S. nationals (who are reducing their imports of the Z product) and more demand for the U.S. currency by Z nationals (who are increasing their imports of the U.S. product). Given this change in demand, the value of the dollar will rise relative to the zed until there is no longer any advantage to switching from Z products to U.S. products, given the consumers' preferences relating to matters other than price, which preferences are independent of the tax law. In this simple example, the value of the dollar would rise until \$1 could be exchanged for 1.1Z.

U.S. consumers would then have the choice between buying the U.S. product for \$110 (including the tax) or the Z product for \$100 (which would exchange for

are, however, important differences in terms of the revenues that would be raised by a particular country under the two types of taxes. For example, as Alan Auerbach points out, a country which is a net debtor, such as the United States, will receive more revenue under an origin-based consumption tax, and a country which is a net creditor would receive more revenues with a destination-based tax.<sup>16</sup> The financial interests of nations concerning the choices between destination-based and origin-based consumption taxes may diverge. Unlike the case of income taxes, where longstanding political compromises have split tax revenues between source and residence countries, in the consumption tax context, international coordination has generally been achieved by imposing consumption taxes on a destination basis, a practice which has been reinforced by GATT.

The regime of destination-based VATs and other consumption taxes came into place, however, during an era when exchange rates were fixed and did not adjust in response to changes in economic circumstances or fiscal policy. Under a fixed exchange rate regime, imposing a VAT on an origin basis would have disadvantaged nations in terms of business decisions regarding where to locate production facilities. In order to protect its own interests, each nation imposed a value added tax on a destination basis and agreed to destination-based consumption taxes on a multilateral basis. This practice reflected a uniform desire to avoid disadvantaging domestic producers through origin-based taxes.

Of course, if the nation of origin imposes a VAT in that country and the destination nation also imposes a tax on the full retail price, consumption will be taxed twice. Likewise, exports from a destination-based consumption tax country to an origin-based importing nation may not be subject to consumption taxation at all. In contrast to income taxation, however, where such over- or under-taxation affects the allocation of capital, it is not clear that this double or zero consumption taxation of international transactions will have any real economic consequences,

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110Z), plus the 10 percent tax on imports, for a total of \$110. Z consumers would have the choice between buying the Z product for 110Z or the U.S. product for \$100, which would require 110Z. A U.S. producer could sell the U.S. product at home for \$110 (including \$10 in VAT) or abroad for 110Z, which would yield \$100, on which no U.S. tax would be due. In either case, the U.S. producer would retain \$100 after payment of U.S. taxes.

Taking into account the change in exchange rates brought about by the change in relative prices of the U.S. and Z products due to the introduction of border adjustments, the destination-based VAT has no advantage over the origin-based VAT in terms of stimulating exports in this example. One of the U.S. products under discussion exchanges for one of the Z products in both the U.S. and country Z under both taxes. The U.S. producer earns the same amount from a sale at home and a sale abroad under either tax.

16. See Alan J. Auerbach, *supra* note 15.

after currency adjustments. Nevertheless, such a regime will raise substantial political objections.

Indeed, imposing a flat tax on an origin, rather than destination basis, threatens the political viability of the tax itself. For example, if exports, but not imports, were taxed, the full retail sales value of an automobile that was manufactured in the United States and that will be used in the United States, will be included in the flat tax base. Likewise, if a U.S. automobile manufacturer sells automobiles manufactured in the United States to a foreign dealer for use abroad, the manufacturer's sales price would be subject to the U.S. flat tax. But, a U.S. dealer of cars manufactured in a foreign country, such as Japan or Germany, would be taxed in the United States only on the excess of the dealer's sales receipts over the cost of the cars from the foreign manufacturer. In other words, the costs of manufacturing cars abroad for use in the United States would not be included in the U.S. flat tax base; only the dealer's mark-up would be subject to U.S. taxation. In foreign countries, the full value of imports from the United States would be subject to value added taxes while cars exported to the United States would be exempt. In sum, the value of U.S. cars would be subject to two consumption taxes, while foreign cars exported to the United States would largely be exempt from consumption taxation. As previously stated, economists, including the inventors of the flat tax, claim that there would be no adverse economic consequences to U.S. producers from this circumstance because currency exchange rates will compensate for these tax differences. But U.S. automobile manufacturers and other U.S. companies that compete with products from abroad will not readily accept economists' assurances that exchange rates will adjust quickly and effectively.

Domestic businesses undoubtedly will resist rules that would impose a U.S. tax on the full retail price of products manufactured in the United States, but would tax only the dealer markup of products manufactured abroad. They will view such a tax as fundamentally unfair to U.S. businesses and perhaps as entailing a serious competitive disadvantage to U.S. manufacturers. This could be an important, perhaps even a decisive, issue. U.S. businesses vehemently—and effectively—opposed President Clinton's 1993 proposed energy tax because of the potential disadvantages to domestic versus foreign products. Such opposition could prove the death knell of the flat tax.

The willingness of flat tax proponents to advocate an origin-based consumption tax is also inconsistent with the political judgment of Senators Nunn and Domenici, who regard the imposition of the business-level USA tax on a destination basis as an important political advantage, and who also have attempted to convert the employers' payroll tax from

an origin to a destination basis by allowing businesses to credit the employers' payroll tax against their subtraction-method VAT.

With regard to the individual-level USA tax, Senators Nunn and Domenici recognize that imposing progressive tax rates on an individual's total consumption, implies a tax on an individual's consumption wherever it occurs. Only the residence country will have the capacity to know the total worldwide consumption of its residents and citizens. The source country will have incomplete information since it can know only the amount of consumption by nonresidents within its borders. This is why the USA tax would tax consumption by U.S. citizens or residents on a worldwide basis. In proposing this, Senators Nunn and Domenici have added residence to the usual consumption tax options of origin and destination. Under this scheme, a product manufactured in China and consumed in Europe by a U.S. citizen or resident will be taxed by the United States under the individual-level USA tax. In this instance, if no credit is allowed for the foreign consumption taxes, U.S. residents consuming abroad rather than at home will be economically disadvantaged and no offsetting adjustment in currency values seems likely to compensate for the disadvantages.

The ability-to-pay emphasis of the individual-level USA tax, which argues for taxation of worldwide consumption by the residence country, would not be contradicted by allowing a foreign tax credit for consumption taxes actually imposed by other nations, or by exempting foreign consumption that is taxed by the destination country in a manner similar to how it would be taxed in the nation of residence (an exemption with progression). The Nunn-Domenici foreign tax credit is mysterious, however. If Senators Nunn and Domenici are concerned that consumption abroad will be taxed twice—which could be caused by other countries' imposition of a destination basis VAT, for example—a credit against the USA tax for foreign consumption taxes would be appropriate. But why allow a foreign tax credit for foreign income taxes against a U.S. consumption tax? The credit would undermine the longstanding U.S. position that allows only foreign income taxes to be credited against U.S. income taxes. Are we on the threshold of cross-crediting income and consumption taxes depending on their form?<sup>17</sup>

Finally, there are distinct tax enforcement issues that arise when dealing with the taxation of international income or consumption. An easy way to stumble into zero taxation is to allocate a tax claim to a country that cannot collect it. For example, it is critical under the individual-level USA tax to avoid a regime where deductions are allowed

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17. Charles E. McLure & George R. Zodrow, *The Economic Case for Foreign Tax Credits for Cash Flow Taxes* (1995) (unpublished paper).

for investments in one nation, but where disinvestments and consumption may occur in another nation free of tax.<sup>18</sup> Enforcement advantages have sometimes been offered as a justification for taxing income at source, but these advantages seem to offer little guidance in choosing between origin- and destination-based value added taxes.<sup>19</sup>

## V. CONCLUSION

The USA and flat tax proposals make clear that the international tax consequences of both income and consumption taxes tend to turn on whether the tax is collected from businesses or from individuals. In the income tax arena, longstanding practices have produced a division of revenues between countries of source and countries of residence, depending on whether income tax is collected from businesses or individuals. Along with many other countries, the United States allows foreign tax credits for income taxes of other countries; those nations who do not allow foreign tax credits typically exempt foreign source income. We regularly negotiate income tax treaties based on a U.S. model tax treaty, while other nations negotiate their income tax treaties based on the closely related OECD model tax treaty. These rules are routinely described as generally allocating revenues from business income taxes to the country of source and taxes on passive income to the country of residence. This allocation has been referred to as the 1920s compromise, since its basic outline has been around since the 1921 Tax Act and the model international tax treaties promulgated by the League of Nations nearly seventy years ago.<sup>20</sup>

Even if the flat tax and USA tax proposals are ultimately relegated to the legislative waste bin, this longstanding income tax compromise is becoming unraveled as a result of the integration of corporate and individual income taxes throughout most of the industrialized world.<sup>21</sup> Analysis of corporate tax integration has shown three integration methods that are fundamentally equivalent: 1) allowing a corporate income tax deduction for corporate dividends, 2) allowing individual shareholders to exclude dividends from income, and 3) converting all or part of the corporate income tax into a withholding tax on dividends and allowing shareholders a credit for the corporate taxes that have been

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18. Klaus Vogel, *Reflections on the Future of the OECD Model Convention and Commentary*, 50 BULL. FOR INT'L FISCAL DOCUMENTATION 527, 528 (1996).

19. Michael J. Graetz & Michael O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021 (1997) [hereinafter *Original Intent*].

20. *Id.*

21. See, e.g., REPORT OF THE COMMITTEE OF INDEPENDENT EXPERTS ON COMPANY TAXATION, (Ruding Report) (Brussels, 1992).

paid with respect to the dividends they receive.<sup>22</sup> Despite their economic equivalence, however, these proposals differ significantly in whether the tax collected is a business level or individual level tax. As suggested, longstanding international income tax practice would presumptively allocate these revenues differently among source and residence countries depending upon whether the relief from double taxation of corporate source income occurs at the individual or business level.

International taxation of both consumption and income taxes should not turn so crucially on the form of these taxes. There may be very good domestic tax policy reasons for preferring that a tax be collected from businesses or from individuals. As the foregoing discussion suggests, individualizing a consumption tax, as both the USA tax and flat tax do, makes achieving their proponents' policy goals concerning the distribution of these taxes easier. On the other hand, collecting a tax from businesses eases the costs of tax compliance by individuals; the Treasury Department offered this as a principal reason why it preferred a dividend exclusion or comprehensive business income tax to a shareholder tax credit.<sup>23</sup> But by demonstrating the importance of form over substance, both of the consumption tax proposals, which are the subject of this conference, and the various proposals for integration of the corporate and individual income taxes, call into question the basis for longstanding international income and consumption tax practices. Unfortunately, so far at least, the principles that form the foundations for both international income and consumption tax practices do not offer modern policymakers clear guidance.<sup>24</sup>

In sum, looking to the standard tax policy analyses of international tax issues does not offer a clear principled preference for destination-based taxes over origin-based consumption taxes. Indeed, the USA tax has advanced a third possible claimant to consumption tax revenues: the nation of residence. In principle, the countries of origin, destination and residence all have reasonable bases to claim the revenues from consumption taxation. I am reminded of the prescient observation of Thomas Sewall Adams, the individual most responsible for the current shape of the U.S. international tax regime: "Prove to Jurisdiction A that a given tax, X, logically belongs to Jurisdiction B, and—if self-interest

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22. See TAXING BUSINESS INCOME ONCE, REPORT OF THE DEPARTMENT OF THE TREASURY ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS (1992). See also *Original Intent*, supra note 19. Integration at the individual or business level may produce some differences relating to the imposition of progressive rates and this may affect some analysts' judgment about the appropriate allocation between residence and source countries.

23. See TAXING BUSINESS INCOME ONCE, REPORT OF THE DEPARTMENT OF THE TREASURY ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS (1992).

24. See, e.g., *Original Intent*, supra note 19.

so dictates—A, in the long run, will develop some subtle modification of tax X which the accepted theory of jurisdiction assigns to A.”<sup>25</sup>

As a practical matter, it is impossible for a residence country to protect its residents and citizens against double taxation of international income without conceding a primary claim of taxation to the country of source. This was the original justification for the U.S. foreign tax credit.<sup>26</sup> Going beyond that requires international negotiations and coordination, bilateral or multinational agreement on principles for the division of tax revenues. In the income tax area, this has occurred through a bilateral tax treaty process in light of the OECD model. In the consumption tax context, international coordination has occurred by multilateral agreement (GATT) to impose a standard form consumption tax on a destination basis.

Given these well settled international practices, one has to ask whether a belief in American exceptionalism requires the United States to adopt a form of consumption tax untried elsewhere in the world instead of moving toward a standard form of value added tax or retail sales tax. The practical and political international advantages of the standard form should by now be obvious. A contrary answer to the foregoing question seems appropriate to me only if personalizing the consumption tax, as both the flat tax and the USA tax do, fully satisfies the American people’s concerns about the distributional fairness of replacing the income tax system with a retail sales or value added tax.<sup>27</sup>

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25. *Id.*, quoting from Thomas Sewall Adams, *Interstate and International Double Taxation* 125, in *LECTURES ON TAXATION* (R. McGill ed., 1932).

26. *Id.*

27. For an elaboration of this argument, see MICHAEL J. GRAETZ, *THE DECLINE (AND FALL?) OF THE INCOME TAX*, chapters 13, 14 and 15 (1997).