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MARKING UP THE BLUEPRINT

*Lawrence Lokken**

I. INTRODUCTION

Professor David Bradford's paper explains how his X Tax might work in an international context.¹ The X Tax, like its cousin the Hall-Rabushka Flat Tax,² resembles a value-added tax (VAT) (computed by the subtraction method) in that a firm's tax base consists of its revenues from sales of goods and services, reduced by purchases of goods and services from other businesses. But, the X and Flat Taxes differ from a VAT in that they also allow deductions for wages, which are taxable to employees. The aggregate of the tax bases of businesses and employees is thus identical to the base on which a VAT is imposed. Taxing wages to employees, rather than businesses, allows tax liabilities to be adjusted according to the personal circumstances of employees and thus permits progressivity.

The X and Flat Taxes differ principally in their treatment of wage earners. There only are two rates under the Flat Tax.³ The rate is zero on an amount of wages equal to the personal and family allowances (\$16,500 for a married couple filing jointly, plus \$4,500 for each dependent, both figures adjusted for inflation after 1995). For all wages above these allowances, the rate is 19%, which also is the flat rate of the business tax. Under the X Tax, the highest rate on wages also equals the business tax rate. However, the X Tax, unlike the Flat Tax, retains the present earned income credit,⁴ thus effectively

* Lawrence Lokken has held the Hugh H. Culverhouse Eminent Scholar Chair in Taxation at the University of Florida, Levin College of Law, since 1994. He taught previously at New York University School of Law, where he was Editor-in-Chief of the *TAX LAW REVIEW*. Professor Lokken has been a visiting professor at Duke University, the University of Minnesota, and Leiden University, the Netherlands. He is the author of numerous articles and is co-author of *FEDERAL TAXATION OF INCOME, ESTATES & GIFTS* and *FUNDAMENTALS OF INTERNATIONAL TAXATION*, leading treatises in the field. He is a graduate of Augsburg College and the University of Minnesota.

1. David F. Bradford, *Blueprint for International Tax Reform*, 26 *BROOK. J. INT'L L.* 1449 (2001).

2. See ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (2d ed. 1995).

3. *Id.* at 58-60.

4. For the earned income credit, see I.R.C. § 32, discussed in 2 BORIS I.

providing negative rates of tax for low-income families and some individuals. The X Tax also has a zero bracket amount and a set of graduated rates, topping out at the business tax rate. Professor Bradford estimates that with a business tax (and top wage tax) rate of 28%, the X Tax, substituting for the present individual and corporate income taxes, "could approximate the progressivity of the current U.S. income tax system."⁵

As Professor Bradford points out, the X Tax, like the Flat Tax, has the same effect as a VAT, coupled with an array of cash allowances. For example, the Flat Tax could be mimicked by a 19% VAT, supplemented by a cash payment by the government to each family equal to 19% of the family's income, not to exceed 19% of the sum of the personal and family allowances. Because the X Tax would preserve the earned income credit and have more rate brackets, computation of the equivalent cash payments is more complex, but the principle is the same.

I comment on only two aspects of the X Tax: The choice between an origin or destination basis for determining the tax, and some difficulties in the international context of the transition from income taxation to X Taxation.

II. ORIGIN V. DESTINATION BASIS

For cross-border transactions, the X Tax could operate on either an origin basis or a destination basis. On an origin basis, all sales revenues, domestic and foreign, are included in the tax base, and deductions are allowed for all purchases, whether from domestic or foreign suppliers. An origin-based tax encompasses the value of all goods and services produced in the country, regardless of where the goods and services are consumed. On a destination basis, revenues from export sales are excluded, and no deduction is allowed for purchases from foreign suppliers. A destination-based system taxes the value of all goods and services consumed in the country, regardless of where they are produced.

Professor Bradford convincingly demonstrates that the

BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES & GIFTS* ¶ 37.1 (3d ed. 2000).

5. Bradford, *supra* note 1, at 1449.

difference between the two bases is, economically, no difference at all, because exchange rates or prices will adjust to make them equivalent.⁶ If all countries had destination-based X Taxes, the price for a good or service would be grossed *up* in each country by the tax imposed by that country. For example, if country A's tax rate is 25% and country B's is 30% (both rates being applied to a base including the tax), the price for each good and service in country A would be 133% of the pretax price (133%, less 25% thereof, being 100%), while the price in country B would be 143% of the pretax price (143%, less 30% thereof, being 100%).

Such a gross *up* cannot occur under an origin-based system. For example, if widgets produced in country A are sold in export transactions for \$100 each, widget producers in country B cannot sell their wares for more than \$100 because country A widgets bear no country B tax and thus can be sold in country B for the price at which they are exported from country A. Thus, the after-tax proceeds of country A widget producers is \$75 (\$100, less 25% thereof), while country B producers will net only \$70 (\$100, less 30% tax). However, Professor Bradford shows that this difference will not cause all widget production to shift to country A because exchange rates (or prices if countries A and B use the same currency) will adjust to reflect the differing tax rates.⁷

However, as Professor Bradford notes, various administrative aspects of the X Tax are affected by the choice between destination and origin bases.⁸ These and other administrative aspects of the X Tax, and some very preliminary suggestions for solving problems each alternative raises, are discussed below.

A. *X Taxpayers*

An X Tax law must identify the persons subject to the tax, whether it is imposed on a destination basis or an origin basis, but this issue may be affected by the "destination v. origin" dichotomy. The focus of an origin-based tax is on taxing all value created in the country, and the tax should therefore

6. *See id.*

7. *See id.*

8. *See id.*

apply to all businesses and employees who create such value—that is, all businesses engaged in productive activities in the country and all employees performing services in the country. Whether the firm or employee is a resident of the country should not be relevant. Non-resident firms and employees should be taxed on revenues and wages from domestic business and employment, but residents should not be taxed on revenues and wages from business conducted and services performed outside the country.

Bilateral income tax treaties typically allow a country to tax business profits of a resident of the other country only if the person has a permanent establishment in the taxing country.⁹ A permanent establishment is “a fixed place of business through which the business of an enterprise is wholly or partly carried on.”¹⁰ However, an “agent of independent status” is not considered a permanent establishment of any principal for which the agent acts in the ordinary course of its business.¹¹ For example, if a manufacturing company of country A sells its goods in country B, through a manufacturer’s representative in country B, acting as its agent, the company has no permanent establishment in country B if the agent is independent in the sense that the company does not control the details of the agent’s work and the agent bears the entrepreneurial risk of its business.¹²

Income tax treaties generally allow a country to tax wages earned by residents of the other country for services performed in the taxing country.¹³ However, a resident of one country is exempt from the other country’s tax on wages earned in the

9. See, e.g., OECD Committee on Fiscal Affairs, Model Tax Convention on Income and on Capital, at art. 7.1 (2000) [hereinafter OECD Model]. The United States has income tax treaties, largely based on the OECD Model, with more than 60 countries. Cf. United States Model Income Tax Convention of Sept. 20, 1996, art. 7.1 [hereinafter U.S. Model]. Most other developed countries have significant numbers of such treaties, and some countries have many more than the United States. Most developing countries have fewer tax treaties, and some have none. The OECD Model provisions described in the text are found, with occasional variations in the details, in substantially all income tax treaties.

10. OECD Model, *supra* note 9, at art. 5.1; U.S. Model, *supra* note 9, at art. 5.1.

11. OECD Model, *supra* note 9, at art. 5.6; U.S. Model, *supra* note 9, at art. 5.6.

12. See OECD Model, *supra* note 9, commentary at art. 5, para. 38.

13. OECD Model, *supra* note 9, at art. 15.1; U.S. Model, *supra* note 9, at art. 15.1.

latter country if the person's presence in the taxing country does not exceed 183 days during any 12-month period, the employer is a resident of the other country, and the wages are "not borne by a permanent establishment" of the employer in the taxing country.¹⁴

These treaty restrictions on a country's taxing powers are not consistent with the objective of an origin-based tax to tax all value created in the country, just as they are not consistent with the idea of a country taxing all income from sources within the country. However, the restrictions derive from realities that also would exist under an X Tax. If a foreign company has no permanent establishment in a country, it might have difficulties in complying with the country's tax laws, and perhaps more importantly, the country's revenue authorities would find it hard to enforce compliance. Similarly, if a foreign employee is present in a country on a short-term assignment for a foreign employer, it is not realistic to expect the employee to file a tax return in that country or the employer to withhold the country's tax on the employee's behalf. Because the fundamental limitations on a country's ability to tax foreigners are the same under the X Tax as they are under an income tax, an X Tax law should contain rules similar to these treaty rules. Since the rules are accepted widely throughout the world, their use might facilitate general adoption of X Taxes.

The objective of a destination-based tax—to tax all goods and services consumed in the country once and only once—requires more emphasis on coordination. The exclusion for export sales must not be allowed for a sale to another business subject to the tax because the latter firm will take a deduction for the purchase price. Similarly, a business should not be denied a deduction for a purchase from an X Taxpayer because the latter must include the purchase price in its taxable revenues.

The treaty rules described earlier provide a good starting point for defining the taxpayers subject to a destination-based tax. The objective of taxing all consumption within the country does not, even in theory, require taxing foreign businesses without local permanent establishments or foreign employees

14. OECD Model, *supra* note 9, at art. 15.2; U.S. Model, *supra* note 9, at art. 15.2.

briefly present in the country for foreign employers.

B. Defining the Tax Base

Whether the tax operates on a destination or origin basis, allocation issues arise for firms doing business in two or more countries. Income tax treaties suggest an approach to this issue. Under a typical income tax treaty, if a resident of one of the countries has a permanent establishment in the other country, the latter can tax the person's business profits only to the extent they are attributable to the permanent establishment.¹⁵ The profits attributable to a permanent establishment are determined as though the permanent establishment were a separate entity dealing at arm's length with other units of the taxpayer's business.¹⁶ For example, if *X Corp.* produces goods in country *A*, and sells them through a permanent establishment in country *B*, the income of the country *B* permanent establishment is determined as though it purchased the goods at an arm's length price from *X's* manufacturing arm. Deductions are allowed only for expenses "incurred for the purposes of the permanent establishment"¹⁷

Under the *X Tax*, these rules should apply to domestic firms as well as foreign firms. If a resident has a permanent establishment in a foreign country, the permanent establishment should be treated as a separate foreign firm in determining tax in the resident's home country. In the example, if *X* is organized and managed in country *A*, the division of revenues and costs resulting from the hypothetical arm's length sale should be used in determining the tax base in country *A* as well as country *B*.¹⁸

Also, whether tax is destination-based or origin-based, a resident should be exempted from the wage tax with respect to services performed abroad only if the wages are taxed by another country. Assume a resident of country *A* spends three

15. OECD Model, *supra* note 9, at art. 7.1; U.S. Model, *supra* note 9, at art. 7.1.

16. OECD Model, *supra* note 9, at art. 7.2; U.S. Model, *supra* note 9, at art. 7.2.

17. OECD Model, *supra* note 9, at art. 7.3; U.S. Model, *supra* note 9, at art. 7.3.

18. This division generally is relevant only if the tax is applied on an origin basis.

months working for her employer, a country A company, in country B, and the 183-day rule described above is found in the tax laws of both countries. The employee's wages for this period should be subject to country A tax since country B has relinquished taxing jurisdiction. Considerations favoring the 183-day rule provide no justification for exempting the wages in both countries. Similarly, the employer should be allowed to deduct the wages in determining its country A tax.

Under an origin-based tax, value added by activities outside all countries probably is not taxed by any country. Assume X Corp. produces goods in country A and sells them for \$100 to Y Corp. under a contract requiring X to put the goods on board a common carrier for shipment to Y's warehouse in country B. Y pays the common carrier (Z Corp., a country C entity) \$10 to transport the goods. If all countries tax on an origin basis, X has revenues of \$100 for country A purposes, and Y deducts \$110 (\$100 cost, plus \$10 shipping) in computing its country B tax. If Z has permanent establishments in countries A and B, some portion of its shipping fee of \$10 is attributable to each of these countries, and some of the fee may be earned by administrative activities of Z in country C. However, much of the fee may be earned by activities outside of all of these countries, and if the goal of the origin basis is for each country's tax to reach value created in that country, this portion should not be taxed by any country. If the countries tax on a destination basis, in contrast, the entire value of the goods is taxed by country B, where the goods are consumed.

C. Export Sales and Import Purchases

A destination-based X Tax must have rules distinguishing excludable export sales from includable domestic sales and non-deductible import purchases from deductible domestic purchases. These rules should be tied closely to those defining the taxpayers subject to the tax. The exclusion generally should be allowed only for sales to firms that are not subject to the country's tax, and the deduction for purchases should be denied only for purchases from firms that are not subject to the tax with respect to the sales.

Under the permanent establishment principle described above, a taxpayer's transfer to its foreign permanent establishment should be treated as an export sale, whether the taxpay-

er is a resident or is a foreign firm making the transfer from a domestic permanent establishment. For example, if *X Corp.* produces goods in country *A*, ships them to country *B*, and sells them through a permanent establishment it has in country *B*, *X's* country *A* tax should be computed as though it made an export sale of the goods, and none of the revenues from selling the goods in country *B* should be included in the country *A* tax base. Conversely, goods and services received by a domestic permanent establishment from a foreign permanent establishment of the same taxpayer should be considered non-deductible imports. In the example, the goods should be considered acquired by the country *B* permanent establishment by an import purchase, and none of *X's* production or shipping costs should be deductible in determining country *B* tax.

Additional rules are needed for cross-border sales to consumers since, in this case, the buyer's status provides no clues as to whether a sale is an export. A firm selling goods to a retail customer should be allowed the export exclusion only if it owns goods as they physically leave the country or transfers ownership in a transaction by which the goods are exported. For example, if a jeweler in country *A* sells a ring to a resident of country *B* and the customer takes delivery at the jeweler's shop in country *A*, the sales price should not be excludable because removal of the ring from country *A* is not part of the sales transaction.

For services, the objective should be to apply the exclusion to reach results analogous to those for transactions in goods. Generally, the exclusion should be allowed only if the benefits of the services are enjoyed outside of the country. However, in many cases, the place at which services are utilized is not easily identified. If a resident of country *B* has heart surgery at a hospital in country *A*, performed by a country *A* surgeon, does the patient enjoy the benefits of the surgeon's and hospital's services in country *A* or country *B*? If a resident of country *A* places a telephone call to a resident of country *B*, the benefits of the telephone company's services are probably enjoyed in both countries *A* and *B*, but how should the revenues be allocated between the two countries? Such questions probably should be answered by a series of arbitrary rules. For example, revenues from a telephone company's services in a call between two countries could be allocated one half to each country. Other cases could be governed by rules presuming all

services to be utilized in the country in which they are performed and considering the presumption rebutted only by a showing that no substantial benefit from a service was had in the country in which the service was performed.

These definitional issues do not arise under an origin-based tax, under which a firm's tax base includes all sales revenues, whether the purchaser is domestic or foreign, and is allowed deductions for all purchases, domestic and foreign.

D. Administering Border Adjustments

Under a destination-based tax, there must be mechanisms for ensuring that the export exclusion is not claimed for domestic sales and that businesses do not deduct costs of import purchases. The monitoring of exclusion claims can be facilitated by a rule that all of a firm's revenues are deemed to be from domestic sales of goods and services, excepting only those for which an exclusion is documented as prescribed by law. For export sales of goods, the needed documentation could consist of shipping or other documents showing that the goods have left the country. For services, the documentation could consist of a contract showing that the purchaser utilizes the services outside the country. To monitor the denial of deductions for import purchases, an X Tax law might borrow from value added and retail sales tax systems: (1) requiring every business subject to the X Tax to obtain a registration number from the tax administration and to disclose this number to all businesses to which it sells goods or services; and, (2) allowing a business to deduct only the costs of purchases from businesses that have disclosed their registration numbers to the taxpayer.

This monitoring issue does not arise under an origin-based tax since the base of such a tax includes all sales revenues, including revenues from export sales, and deductions are allowed for all purchases, including import purchases.

E. Transfer Pricing

Under an origin-based tax, prices must be established for cross-border transactions between related businesses. Assume *P* Corp. produces widgets in country *A* and sells them to its wholly-owned subsidiary, *S* Corp., which imports them into country *B* for sale in that country. If countries *A* and *B* tax on an origin basis, the price in this transaction affects tax liabili-

ties in both countries because *P* must include the price in its country *A* tax base and *S* is allowed a deduction for the price for country *B* tax purposes. Similarly, if *P* sells goods produced in country *A* through a permanent establishment in country *C*, a transfer price must be constructed for the transfer of the goods between permanent establishments because the value of the goods as they leave country *A* is included in *P*'s country *A* tax base; while this value is a cost of the country *C* permanent establishment for purposes of determining country *C* tax.

A company doing business in countries with differing tax rates has an incentive to tilt the pricing of inter-company transfers to decrease the tax base in high tax countries and increase the tax base in low tax countries. For example, if countries *A* and *B* both have X Taxes determined on an origin basis, but the tax rate is 30% in country *A* and 20% in country *B*, *P* Corp. and *S* Corp. can reduce their aggregate tax burden by setting a low price for the goods *P* sells to *S*, thereby minimizing the amount taxed by country *A* at 30% and maximizing the amount taxed by country *B* at 10%.

Given this incentive and evidence that many companies yield liberally to its temptations, tax administrations have seen a need to monitor transfer prices. They have, however, experienced considerable difficulty in doing so. The general standard is that the price for a transaction between related businesses should be the price that unrelated persons dealing at arm's length would agree upon for the transaction.¹⁹ This standard is applied easily to sales of fungible goods, for which the arm's length price is an established market price, adjusted for the particular circumstances of the transaction. However, application of the standard generally is difficult in any case involving intellectual property, whether the transfer is of intellectual property, or a right to use the property, or of goods produced or marketed with intellectual property. Intellectual property is, by its nature, unique. Unless a company transfers the same property or goods in substantially similar transactions to both related and unrelated persons, a consequence of this uniqueness is that there is no closely parallel market transaction to provide a guide for determining an arm's length

19. See, e.g., Treas. Reg. § 1.482-1(b)(1) (1986); OECD Model, *supra* note 9, at art. 9.1.

price for the company's transactions.

The recent history of transfer pricing in the United States is, briefly, as follows: During the 1980s, increasing vigilance by the Internal Revenue Service ("IRS") in monitoring transfer prices led to highly complex litigation with taxpayers that threatened to swamp the Tax Court and yielded disappointing results for the Service.²⁰ In 1990, Congress enacted stiff penalties for companies caught using transfer prices differing substantially from the arm's length prices finally determined.²¹ In 1994, the Treasury restated its transfer pricing regulations as a lengthy and complex set of rules with many innovations designed to reduce the indeterminacy often experienced by companies and the IRS in transfer pricing matters.²² Tax administrators in other countries have been struggling with similar problems. In 1995, the Organisation for Economic Cooperation and Development ("OECD") restated its transfer pricing guidelines, eschewing the extreme complexity of the U.S. regulations but recognizing that for an issue of such complexity, simplicity in legal approach is not consistent with sound tax administration.²³

Probably, the most successful approach to the transfer pricing problem has been the development of Advance Pricing Agreements (APAs). These are agreements between taxpayers and the tax authorities of one or more countries specifying concrete procedures for determining prices for the taxpayer's goods and services.²⁴ The APA process is expensive, requiring taxpayers to obtain and tax authorities to evaluate elaborate

20. For example, for the first half of 1991, the U.S. Tax Court officially published opinions in about 50 cases. Of the 921 pages of these opinions, the opinion in one transfer pricing case consumed 184 pages. *Sundstrand Corp. & Subsidiaries v. Comm.*, 96 T.C. 226 (1991). The court found that the IRS's principal approach in the case was an abuse of discretion, but it adjusted the taxpayer's transfer pricing some.

21. I.R.C. § 6662(e), discussed in BORIS I. BITTKER & LAWRENCE LOKKEN, *FUNDAMENTALS OF INTERNATIONAL TAXATION* ¶ 79.15 (2d ed. 2001) [hereinafter BITTKER & LOKKEN, *FUNDAMENTALS*].

22. Treas. Reg. §§ 1.482-1 through 1.482-8 (1986). In a June 2000 printing of the regulations by CCH, Inc., the regulations are 81 double-column pages of fairly small type. See BITTKER & LOKKEN, *FUNDAMENTALS*, *supra* note 21, at ch. 79 (basic description of regulations; approximately 130 pages).

23. OECD, *TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS* (1995).

24. For the U.S. APA practice, see BITTKER & LOKKEN, *FUNDAMENTALS*, *supra* note 21, ¶ 79.14.

economic studies, but at least for larger companies, the process is generally cheaper than the alternative—litigation.

The transfer pricing problem disappears for countries adopting an X Tax on a destination basis. Since under a destination-based tax the price received in an export sale is excluded from the tax base and the price paid in an import purchase is not deductible, the fairness of the price for the transaction is not relevant to any tax determination in either the exporting country or the importing country.

F. Cross-Border Consumers

Consumers who travel and shop across borders complicate administration of a destination-based X Tax. For example, if individual *X*, a resident of country *A*, returns from a trip to country *B* with goods purchased in country *B*, the general principle of the destination basis—to tax goods and services consumed in the country—requires that country *B* treat the sale to *X* as an exempt export sale and that country *A* tax be imposed on her purchase. Similarly, if *X* orders goods from a mail order firm in country *B*, the firm's revenue on the sale should be excluded from its country *B* tax base, and *X* should be required to pay country *A* tax on the goods. In both of these cases, the country *A* tax should be at the flat business-tax rate, not the graduated wage-tax rates, because it is a surrogate for the business tax that would have been imposed if the goods had been imported into country *A* by a firm and *X* had purchased the goods from the firm.

In cases such as these, border adjustments can be made by customs authorities as the goods leave country *A* and arrive in country *B*. For example, when *X* returns from her trip to country *B* with goods purchased there, country *B* tax on the purchases can be refunded to her as she leaves the country, and country *A* tax can be imposed as she enters that country.

In other cases, border adjustments are less feasible. If *X* travels to country *B* to have her hair done, the value of this service should, in principle, be taxed by country *A*, not country *B*. Country *A*, not country *B*, is also the proper country to tax if *X* purchases software, a book, or music from a country *B* supplier, placing the order, making payment, and taking delivery over the Internet. In cases such as these, existing systems provide no means for reliably effectuating border adjustments.

One can imagine an international cooperative system under which a supplier could treat a transaction with a non-resident consumer as an export sale if (1) the consumer presents an encoded taxpayer identification card from tax authorities of her residence country and (2) the supplier transmits data on the card and details of the transaction to the country *B* tax authorities, which would relay the data to tax authorities of the residence country, which would bill the consumer for tax. Although this system is no more complex than an ordinary credit card transaction, it would require a level of cooperation and technological sophistication that has never been known in international taxation. The requirements that the consumer present a taxpayer identification card to the supplier and that the supplier transmit the needed data to the tax authorities effectively would allow either the consumer or the supplier to opt out of the system. Nevertheless, the system may be seen as overly intrusive into private financial matters, and the international cooperation needed to effectuate the system may be seen as an excessive imposition on national sovereignty.

An alternative to such a system would be one requiring suppliers to collect tax for the purchaser's country of residence. For example, if a resident of country *A* purchases music over the Internet from a supplier in country *B*, the supplier, pursuant to an international agreement to which countries *A* and *B* are parties, could be allowed to treat the transaction as an export sale for purposes of the country *B* tax, but would be required to pay tax on the selling price at country *A*'s *X* Tax rate. Rather than requiring the country *B* seller to report the transaction to country *A*, the agreement could provide for the seller to report the transaction on its *X* Tax return to country *B* and pay the tax to the country *B* tax authorities, which would settle up with country *A*.

Without international cooperation, many types of transactions, particularly Internet transactions, would tend to migrate into tax havens in a destination-based *X* Tax world. Assume *X* Corp., which does business only in country *B*, develops software and makes an exclusive license of the software to *Z* Corp, which does business only in country *H*, a tax haven; *Z* sells copies of the software to consumers resident in country *A*. If countries *A* and *B* have destination-based *X* Taxes and country *H* has no *X* Tax, country *B* collects no tax because *X*'s transfer to *H* is an exempt export sale, and country *H* collects no tax

because it has no tax, and tax is collected only if country *A* is able to extract payment from its consumers. Although country *A* is the proper country to tax in this situation, its ability to learn of the transaction is limited.

Tax haven countries are not likely to participate in an international enforcement regime, even if a regime along the lines suggested above is developed. However, other countries are not defenseless against tax havens. In the last example, countries *A* and *B* could agree to deny the export exclusion under their laws for transfers to country *H*.

Problems such as these are much less significant under an origin-based tax. For example, if countries *A* and *B* apply the *X* Tax on an origin basis, the payments received by *X* under the license of its software to *Z* are taxed by country *B*, and the prices paid by country *A* consumers to *Z* escape tax only to the extent of the value added by *Z*.

G. Foreign Consumption

Under a destination-based tax, consumption occurring outside the consumers' countries of residence should not be considered cross-border transactions. For example, if individual *X*, a country *A* resident, travels to country *B*, where she stays in a nice hotel, eats in fine restaurants, and attends the opera, these items should be treated as consumption in country *B*, not imports into country *A*. Since the basic principle of the destination basis is that a country taxes all consumption occurring within its borders, country *B* should not be expected to forgo tax on the transactions. If country *A* taxes them as imports, the country *A* tax is a second tax on each item of consumption. Taxing some consumption twice penalizes consumers who consume in this way without advancing any policy goal.

It necessarily follows that if *X* emigrates to country *B*, country *A* should have no further claim to tax her consumption, except to the extent it occurs in country *A*. That *X* may have accumulated a substantial fortune while residing in country *A* and that she may pay for her consumption as a resident of country *B* with income from investments in country *A* is not relevant to country *A*'s tax jurisdiction under a destination-based tax.

H. Business Tax Refunds

An X Tax law should include provisions for tax refunds to businesses whose deductions exceed includable revenues, especially if the tax is destination-based. Assume *P* Corp. produces goods in country *A* and sells one half of them domestically and one half in export transactions; its annual sales are \$1,000, and its annual costs for wages, materials, supplies, and other imports are \$900. If country *A* has a destination-based X Tax, *P*'s deductions (\$900) exceed its includable revenues (one half of \$1,000) by \$400 every year. Since *P*'s employees and suppliers have paid tax on all of the input costs, lack of any provision for *P*'s excess deductions would be inconsistent with an essential feature of the destination basis—not taxing exported goods and services. The law is faithful to this feature only if it allows to *P* an annual refund equal to \$400 times the tax rate.

Under an origin-based tax, business losses may be either real economic losses or losses resulting from timing. For example, if a firm increases its inventory during a taxable period or makes equipment purchases during the period exceeding economic depreciation on its equipment, its X Tax base for the period may be a negative number, even if the firm is quite profitable. For example, if *P* Corp., which for a normal year has sales revenues of \$1,000 and costs of \$900, spends \$2,000 during a particular year to replace all of its manufacturing equipment, the deduction for the equipment purchase, added to other deductible costs, substantially exceeds revenues for the year, even though *P* may be as profitable for that year as any other.

Under the Flat Tax, which is origin-based, business losses can be carried forward indefinitely, but refunds are not allowed based on losses.²⁵ This treatment of losses is appropriate if the objective of the origin basis is to tax all value created in the country, but it is not consistent with any conception of the tax as a consumption tax. In the example, all of *P*'s costs represent value created in the country, but its loss represents value created but not consumed.

25. See HALL & RABUSHKA, *supra* note 2, at 118.

III. GETTING THERE FROM HERE

Internationally, a transition from the present, when all major developed countries and most developing countries have income taxes, to an X Tax world could be quite bumpy. Assume country A substitutes the X Tax for its income tax, while country B retains its income tax. The change may make country A very attractive as an investment destination for country B residents. Income from country B investments in country A will no longer bear source-based income taxes. If country B taxes its residents on worldwide income, with a credit for foreign income taxes, the tax liability of country B investors in country A may not be reduced by the repeal of country A's income tax. However, withholding taxes imposed at the source ensures that some tax is collected, even if an investor fails to report income to her home country. Also, as country A repeals its income tax, it presumably also will repeal its system requiring payors of income to report the payments to country A's tax authorities. Information collected by such reporting often is exchanged among countries under income tax treaties.²⁶ Thus, country B residents, not inclined to be fully compliant with country B income tax laws, will find country A to be a very attractive investment destination. As a consequence, policymakers in country B will feel considerable pressure to move to the X Tax—even if they do not believe the change is good policy—in order to have a tax not fatally subject to evasion.

These consequences would be avoided if countries A and B agreed to change simultaneously to the X Tax. However, such an agreement is without precedent in international taxation.

26. See OECD Model, *supra* note 9, at art. 26; U.S. Model, *supra* note 9, at art. 26.