



THE KNOWN UNKNOWNNS OF THE BUSINESS TAX REFORMS PROPOSED IN THE HOUSE REPUBLICAN BLUEPRINT

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**THE KNOWN UNKNOWNNS OF THE
BUSINESS TAX REFORMS PROPOSED IN
THE HOUSE REPUBLICAN'S BLUEPRINT
THANKS TO DONALD RUMSFELD**

- In 2002, referring to Iraq and its relationship to terrorism, Donald Rumsfeld declared “that there are known knowns, there are things we know we know. We also know that there are known-unknowns, that is to say we know there are some things that we do not know, but there are also unknown-unknowns—the ones that we don’t know we don’t know.”

- There was nothing new in what Rumsfeld said, and some thought he was uttering evasive gibberish, but Rumsfeld’s classifications are quite useful. Exploring known unknowns is, for example, much of the work of science.
- Donald Rumsfeld turned out to be a better epistemologist than a defense secretary.

- I shall begin briefly with some known knowns about the House Blueprint’s proposal then turn to known unknowns.

≠ Since both fall into categories of knowns, I am not trying here to be original.

KNOWN KNOWNS

MORE LIKE A VAT THAN A CORPORATE TAX

- The business tax reform proposed in the Blueprint looks very much like a reform of the corporate income tax, but in reality it is closer to a repeal of the corporate income tax and the substitution of a cousin to a value-added tax (VAT).
- The Blueprint does retain some income tax features not found in a VAT; the taxation of net investment income and retention of flow through treatment of partnerships are important examples.
- The fact that the Republican proposal is more like a value-added tax than an income tax is difficult to explain to the public.
- Nevertheless, it is important to understand that the House Republican business tax reform—often referred to as a destination-based cash-flow tax (DBCFT)—is equivalent to a subtraction-method value-added tax with a deduction for wages.
- It is surprisingly easy to move from a corporate income tax to a destination-based cash flow tax and to do so in a way that can be characterized by politicians as a reform of the income tax. All it requires is four basic steps:

KNOWN KNOWNS

TRANSFORMING THE CORPORATE INCOME TAX INTO A DBCFT

- First, substitute expensing of capital assets for amortization and depreciation deductions and eliminate inventory accounting.
- Second, eliminate the interest deduction.
- Third, tax imports by denying any deduction for imported goods or services.
- Fourth, exempt revenues from exports from inclusion in the tax base.

KNOWN KNOWNS

SHIFTING TAX TO WHERE GOODS
AND SERVICES ARE SOLD

- Rather than taxing where goods or services are produced, or where the company producing them is headquartered, as the corporate income tax now does, impose the tax in the jurisdiction where the goods are purchased (or consumed).
- In order to tax goods where they are purchased (or consumed), it is important that imports be subject to tax and that exports be exempt from tax. This is called a border adjustment. The border adjustment in the House Republicans' Blueprint is "economically equivalent to a VAT, but it should not be labeled one," House Ways and Means Committee Chair Kevin Brady, R-Texas, said January 24.

KNOWN KNOWNS

SOLVES INTERNATIONAL CORPORATE TAX PROBLEMS

- This change solves many of the most vexing problems of international taxation of corporate income, problems that have occupied the OECD in its BEPS project for several years without any satisfactory conclusion.
- By imposing tax where goods are sold, where the company is headquartered becomes irrelevant and there is no incentive for U.S. companies to shift ownership to a foreign parent, so called “inversions.”
- The difficult issue of determining inter-company prices in related transactions also is minimized for the U.S. government.

KNOWN KNOWNS

SOLVES INTERNATIONAL
CORPORATE TAX PROBLEMS

- This tax also eliminates tax advantages of shifting income from intellectual property to a lower-rate tax jurisdiction.
- By eliminating the deduction for interest, the tax eliminates the advantage of financing through debt rather than new equity.
- The Blueprint would eliminate the downward pressure on the U.S. corporate income tax rate.

KNOWN KNOWNS

A UNIQUE TAX

- Consumption taxes are used throughout the world.
 - 167 countries have value-added taxes (VATs).
 - The United States has retail sales taxes; but no VAT.
- The DBCFT of the Blueprint does not exist anywhere in the world despite a long history of American economists advocating for such a tax.
- As a result, the DBCFT does not fit well with our international obligations and arrangements.
- Moreover, unlike retail sales taxes or value-added taxes, there is no experience or existing legislative model of best practices to look to in designing the tax.
 - That's why a long list of known unknowns follows. Some of those known unknowns will be resolved by the statute. Others will exist even after a president signs legislation putting a DBCFT into effect.

KNOWN UNKNOWNNS

EFFECTS ON PRICES OF GOODS AND SERVICES,
AND/OR EXCHANGE RATES

- Enactment of the Blueprint would have major effects on some combination of exchange rates and prices, but there is uncertainty about exactly what these effects would be.
- Some economists (including, e.g., Martin Feldstein, Paul Krugman, Alan Auerbach, and Douglas Holtz-Eakin) predict that the value of the dollar will immediately rise by 25 percent relative to other foreign currencies.
 - As a result, no price increases would necessarily follow the enactment of the DBCFT.
- In contrast, economists from financial institutions predict an appreciation of the dollar by about half that magnitude and suggest that it might take several years to occur.

KNOWN UNKNOWNNS

EFFECTS ON PRICES OF GOODS AND SERVICES,
AND/OR EXCHANGE RATES

- These judgments turn on how flexible exchange rates are and how governments might react to the potential depreciation in the values of their currencies.
- These judgments also differ based on different countries' trade relationships with the United States.
- If exchange rates do not rise to fully offset the impact of the DBCFT on trade balances, prices are likely to rise.
 - Historically, when value-added taxes have been introduced prices have risen by an amount equal to about 60 percent of the value-added tax rate, but this has varied. Because of its deduction for wages, the effects on prices of a DBCFT should be smaller than for a VAT. For example, Citigroup's Global Chief Economist Willem H. Buiter concludes his lengthy analysis of this issue by saying:

So, in the spirit of Socrates, we have to say about the exchange rate implications of a BTA: I know I know nothing, but at least I know that. . . . Not only do we not know the magnitude of the exchange rate effect of a BTA, we don't even know the sign or direction.

KNOWN UNKNOWNNS

THE IMPACT OF A POTENTIAL 25 PERCENT RISE IN
THE VALUE OF THE DOLLAR

- The rise in exchange rates, if it occurs, will have a major impact on the values of foreign assets held by U.S. persons and on the value of U.S. assets held by foreigners.
 - Based on the most recent data available, it appears that U.S. holders of foreign assets may lose as much as \$4.9 trillion (20% of \$24.5 trillion), and foreign holders of U.S. assets might gain as much as \$8.1 trillion (25% of \$32.5 trillion).
 - Some of the foreign assets held by U.S. persons and entities are dollar-denominated and that would reduce the size of the losses above.
- A number of foreign countries have issued dollar-denominated sovereign debt and corporations in these countries and elsewhere have issued large amounts of dollar-denominated corporate debt.

KNOWN UNKNOWNNS

THE IMPACT OF A POTENTIAL 25 PERCENT RISE IN THE VALUE OF THE DOLLAR

- Some of these magnitudes follow:

Ratio of Dollar-Denominated Debt to GDP 2015

Country	Govt (%)	NFC (%)	Govt + NFC (%)
Brazil	66.2	50.1	116.3
China	43.9	163.6	207.5
India	69.0	51.0	120.0
Indonesia	27.0	23.9	50.9
S. Korea	37.9	106.0	143.9
Malaysia	54.0	67.9	121.9
Mexico	43.2	24.8	68.0
South Africa	50.1	37.0	87.1
Turkey	37.7	57.0	94.7

Source: Megan Greene, *US Border Adjustment Tax: The Path To Stagflation, Debt And Deflation?*, MANULIFE ASSET MGMT.: MARKET VIEWS AND INSIGHTS (Jan. 26, 2017), <http://www.manulifeam.com/us/Research-and-Insights/Market-Views-And-Insights/US-Border-Adjustment-Tax-The-Path-to-Stagflation-Debt-and-Deflation/>.

KNOWN UNKNOWNNS

THE IMPACT OF A POTENTIAL 25 PERCENT RISE IN THE VALUE OF THE DOLLAR

- Some of these magnitudes follow:

Ratio of Debt to GDP 2015, with 25% Dollar Appreciation

Country	Govt (%)	NFC (%)	Govt + NFC (%)	Increase in debt (%)
Brazil	70.2	58.6	128.8	12.5
China	43.9	198.0	241.9	34.4
India	69.0	63.0	132.0	12.0
Indonesia	30.3	25.9	56.2	5.3
S. Korea	38.6	127.5	166.0	22.1
Malaysia	55.8	76.6	132.3	10.4
Mexico	46.4	28.9	75.3	7.3
South Africa	54.9	42.5	97.3	10.2
Turkey	45.9	58.6	104.4	9.8

Source: Megan Greene, *US Border Adjustment Tax: The Path To Stagflation, Debt And Deflation?*, MANULIFE ASSET MGMT.: MARKET VIEWS AND INSIGHTS (Jan. 26, 2017), <http://www.manulifeam.com/us/Research-and-Insights/Market-Views-And-Insights/US-Border-Adjustment-Tax-The-Path-to-Stagflation-Debt-and-Deflation/>.

KNOWN UNKNOWNNS

THE IMPACT OF A POTENTIAL 25 PERCENT RISE IN
THE VALUE OF THE DOLLAR

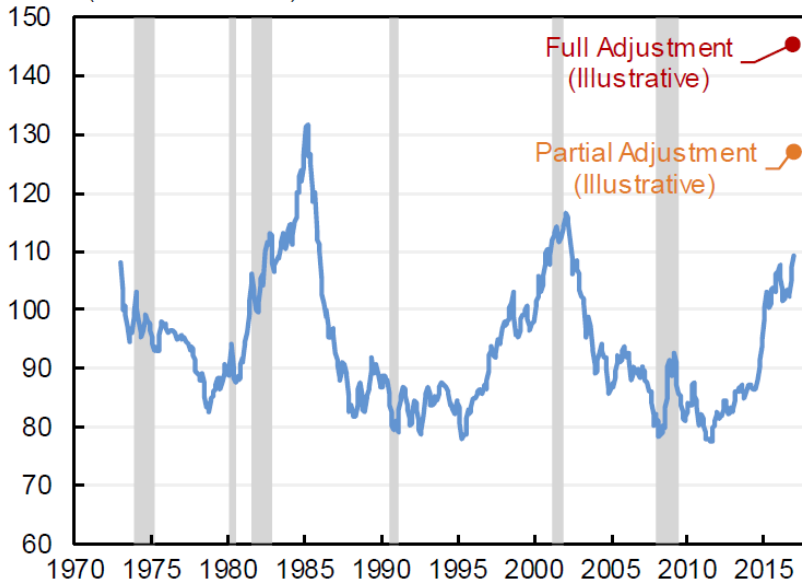
- If the cost of those debts were to increase by 25 percent, as some of the proponents of the DBCFT suggest, this would have a major impact on these countries' ability to repay the debt and on their balance sheets.
- Many of our trading partners, such as these issuers of dollar-denominated debt, will lose while others, such as large holders of U.S. debt, will gain.
- The macroeconomic effects of such a change are uncertain. Some economists have speculated that these effects would be dire, perhaps creating both stagnation in the global economy and inflation.

KNOWN UNKNOWNNS

THE IMPACT OF EXCHANGE RATE ADJUSTMENTS

Real Trade-Weighted Dollar (Major Currency Index)

Index (Mar-1973 = 100)



Note: Shading denotes recession.

Source: Federal Reserve Board; Jason Furman calculations.

KNOWN UNKNOWNNS

POTENTIAL PRICE EFFECTS

- Even if the dollar rises by 25 percent there will be some price effects on dollar-denominated commodities.
 - A number of commodities, e.g., oil and wood pulp, are priced in dollars in world markets.
- A key question is whether the world price of such commodities will fall by 25 percent to reflect the appreciation of the dollar.
 - In some cases, such as oil, this may turn on the response of an international cartel.
 - If world prices do not fall, domestic prices (such as for heating oil or gasoline at the pump) will rise significantly.
 - The domestic price of dollar-denominated commodities will be greater than the world price of those commodities even assuming that currencies adjust fully and the world price falls by 25 percent.
- Markets, especially in currencies and in commodities, are likely to become more volatile as the legislation moves through the legislative process, and speculators anticipate potential changes. Large bets will be made and won or lost on each side of these issues.

KNOWN UNKNOWNNS

POTENTIAL PRICE EFFECTS

- If the dollar does not appreciate by 25 percent, as some predict, prices should rise.
 - The effect on prices will depend on how the Federal Reserve responds.
 - These effects may be different in the immediate future than in the longer term as businesses and other nations attempt to minimize potential losses.
- Retailers who import many of the products they sell and oil refiners, particularly on the east coast, whose capacity allows them to use only imported oil, have been extremely concerned about the potential rise in the after-tax costs of imports and the impact of such a rise on their profit margins and prices.

KNOWN UNKNOWNNS

POTENTIAL EFFECTS ON WAGES

- Some economists have predicted that the enactment of a DBCFT would produce an increase in wages.
 - The extent of such an increase, and its timing, is highly uncertain.
 - The wage subsidy (deduction) is to employers—not to employees.
 - Allowing expensing of capital assets reduces their after-tax cost compared to current law.
- Subsidizing wage payments to employers is not necessarily identical, especially in the short-term, to subsidizing wages of employees.
 - Consider for example two alternatives to the wage deduction: an increase in the earned income tax credit (EITC) or a reduction in the employees' share of payroll taxes. In these cases, the subsidy goes directly into employees' pocketbooks. If the wage benefit is given to employers, employees will benefit only to the extent that wages rise.

KNOWN UNKNOWNNS

IMPACT ON TRADE AGREEMENTS

- Under our trade agreements, value-added taxes may be adjusted at the border for imports and exports. These agreements include the WTO agreements with 163 other countries.

- It is quite certain that the DBCFT of the Blueprint would be held to be in violation of our international trade agreements by the WTO.
 - Article III of the GATT requires no worse treatment of an imported good by a tax than that imposed on a domestic product.
 - A value-added tax or a retail sales tax complies with this article.
 - Because of the deduction for domestic wages and the absence of any similar deduction for the wage component of imported products, the cash-flow tax would burden the entire value-added of imported products, but not the labor component of value-added in domestic products. If wages were included in the tax base as they are with value added taxes, no violation of Article 3 should be found.

KNOWN UNKNOWNNS

IMPACT ON TRADE AGREEMENTS

- Annex 1 of the GATT prohibits export subsidies.
 - The deduction for wages in the DBCFT combined with the exclusion of revenues from the sales of exported goods or services means that the DBCFT advantages exports over domestic consumption in violation of trade agreements.
 - Again, the problem is that wages are deducted from cash flow in computing the DBCFT in contrast to VATs where wages are included in the tax base.
- Because of the flow-through treatment of partnerships with taxation to individual owners and the taxation of net investment income, the DBCFT may be characterized by the WTO as a direct tax. Border adjustments of direct taxes violate the WTO.
- These violations of our trade agreements are not overcome by the fact that a different combination of taxes with similar economic effects could pass WTO scrutiny.
 - As Alan Auerbach and Douglas Holtz-Eakin have demonstrated, an economic equivalent of the DBCFT could be achieved by a combination of a value-added tax or retail sales tax, and a reduction in payroll taxes or a wage subsidy.
 - The lawyers who will resolve any dispute in the WTO will regard such a potential economic equivalence as irrelevant.
- Including wages in the tax base and using the tax revenues from that change to reduce payroll taxes or to eliminate those taxes for many employees, for example, could solve this problem.

KNOWN UNKNOWNNS

IMPACT ON TRADE AGREEMENTS

- What will be the timing of a WTO finding that a DBCFT violates our trade agreements?
 - In recent years, WTO determinations have taken anywhere from three to seven years.
 - The EU has already begun preparing a case against the U.S. in case the DBCFT is enacted.
 - Individual countries may respond more quickly than the WTO.
- What will be the remedy for a violation of our trade agreements?
 - An adverse finding by the WTO will likely lead to the imposition of countervailing duties on U.S. products – estimated at \$220 billion on imports from the U.S.
 - These countervailing duties would be imposed prospectively, but there is much discretion as to what products these duties might apply to.
 - Individual countries may impose countervailing duties: estimates suggest more than \$40 billion by China and the E.U., \$25-30 billion by Canada and Mexico, and \$13 billion by Japan.
 - France, for example, might be inclined to impose large countervailing duties on Boeing airplanes to advantage Airbus.

KNOWN UNKNOWNNS

IMPACT ON TRADE AGREEMENTS

- How will the U.S. respond to an adverse decision by the WTO?
 - President Trump during his campaign labeled the WTO a “disaster.”
 - The Trump administration’s response might be to walk away from our trade agreements.
 - What impact would this have on international trade and supply chains?
 - Negotiating or re-negotiating bilateral trade agreements with 163 countries would take considerable time, and success is hardly foreordained.
- An important question is how the uncertainties of this potential disruption to international trade arrangements will affect business decisions and behavior by U.S. companies.
 - Will they refrain from making substantial changes to international supply networks until these issues are resolved.
 - If so, one should be cautious about claims of large increases in jobs, investments, and economic growth in the United States.

KNOWN UNKNOWNNS

BILATERAL INCOME TAX TREATIES

- The Blueprint raises substantial questions with respect to U.S. bilateral income tax treaties.
 - The U.S. has treaties with 68 countries.
- First, do the rules of the treaties apply to this tax?
 - The income tax treaties apply to “substantially similar taxes subsequently enacted.”
 - The DBCFT is closer to a tax on consumption than to a tax on income, and depending on how Congress chooses to draft legislation, the DBCFT may be outside the treaties’ scope.
- If on the other hand, the tax is treated as an income tax—or drafted as an income tax—there are a number of ways in which it would violate our income tax treaties.
 - These include the taxation of imports to sellers where there is no “permanent establishment” in the United States, potential discrimination against foreign multinational corporations; for example, in the treatment of royalties, and perhaps in the treatment of inter-company transfer prices.

KNOWN UNKNOWNNS

BILATERAL INCOME TAX TREATIES

- If applicable, the most recent U.S. treaties provide for mandatory arbitration.
 - The U.S. is likely to lose.
- The great unknown—regardless of whether the DBCFT is inside or outside the scope of our bilateral income tax treaties—is how will other countries respond?
 - For example, if a U.S. multinational licenses its intellectual property for use abroad in exchange for payment of royalties from abroad, those royalties will not be subject to U.S. taxation under the DBCFT because they will be treated as revenue from an export.
 - Under current law, however, those royalties are deductible in computing income tax in the foreign country.
 - Based on recent experience in the OECD and the EU, many foreign countries would likely respond by trying to grab the revenue that the U.S. is giving up.
 - They might, for example, deny deductions for royalties paid to the U.S. or impose withholding taxes, or even deny deductions for imported goods or services from the U.S.

KNOWN UNKNOWNNS

A CONSTITUTIONAL CHALLENGE TO THE
DBCFT SEEMS INEVITABLE

- The Blueprint denies any deductions for imports, including imports that constitute costs of goods sold.
- In the 1918 case Doyle v. Mitchell Bros. Co., the Supreme Court distinguished gross receipts from gross income and implied that a reduction of gross receipts by the costs of goods sold might be implicit in the definition of “income” under the 16th Amendment. (*See also*, Roswell Magill, Taxable Income, Chapter 9 (rev. ed. 1945); Sullenger v. Commissioner, 11 T.C. 1076 (1948).
- The 1982 Senate Report – discussing the addition of Section 280E to the Internal Revenue Code, disallowing business expense deductions but not costs of goods sold to businesses selling drugs illegal under federal law – stated: “To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by the provision of the bill.”
- The IRS has made similar statements in Office of Chief Counsel Memorandum No. 201504011, January 23, 2015.
- Constitutional challenges to the denial of deductions for costs of goods sold relating to imports may or may not succeed, but are certain to occur because of the resemblances of the DBCFT to an income tax.
- This will create uncertainty about the validity of the denial of deductions for imports by the DBCFT.
- A retail sales tax or VAT could tax all domestic purchases (or consumption) without raising any constitutional issues.

KNOWN UNKNOWNNS

THE RATE OF TAX MATTERS

- Some proponents and opponents of the DBCFT have claimed that the rate at which the DBCFT is imposed does not matter.
 - It is true, as the proponents assert, that the rate of this border-adjusted tax will have no effect in stimulating the kinds of tax-planning activities that turn on rates of corporate income taxes.
 - High corporate income tax rates attract deductions, such as for interest or royalties, and low corporate income tax rates attract income. This is one reason that having the highest corporate rate in the developed world currently disadvantages the United States.
 - Differences in corporate income tax rates stimulate transfer pricing and other tax planning gambits.
 - Likewise, high corporate income tax rates discourage the location of corporate headquarters.
 - The rate of a DBCFT does not affect these kinds of transactions.
- But this does not mean that the DBCFT rate does not matter.
 - The level of the tax rate might affect compliance with the tax and will affect tax planning (e.g., “compensation” to partners vs. “profits”).
 - The size of exchange rate adjustments and/or price effects resulting from the enactment of a DBCFT turns on the rate at which the DBCFT is imposed.
 - Because the House Blueprint tax would be imposed at a 20 percent (tax-inclusive) rate, the combination of exchange rate adjustments and/or price adjustments would be equal to 25 percent.
 - If wages were included in the tax base, as they are with VATs and retail sales taxes, a rate of about 6.3 percent or less could raise revenues equivalent to the House Blueprint’s 20 percent DBCFT.

KNOWN UNKNOWNNS

THE RATE OF TAX MATTERS

- The 2005 tax reform panel of President George W. Bush recommended a DBCFT (which they called a growth and investment tax) at a 30 percent rate because it did not count the revenue from border adjustments because of concerns that they violate the WTO and therefore would not be sustainable.
- At a 30 percent rate, the necessary exchange rate and / or price effects would exceed 40 percent. The higher the rate, the greater the costs reported on companies' financial statements.

KNOWN UNKNOWNNS

REVENUE

- A principal political advantage of a border-adjusted tax is that it will produce revenue as long as our trade balance in goods and services is negative.
 - The excess of imports minus exports multiplied by the rate of tax would produce revenues for the Treasury in any given year.
- Over a ten-year budget window, our trade imbalances may produce more than \$1 trillion at a 20 percent tax rate.
 - “Dynamic scoring” will push that number higher in the congressional process.
 - These two factors help pay for a 20 percent DBCFT rate rather than our current 35 percent corporate income tax rate based on Congressional budget scorekeeping conventions.
 - How will anticipated exchange rate adjustments that lower would lower the prices of imports affect the revenue estimates over the budget period?
- It is widely agreed among economists that the revenues to the federal government will be negative in present value. Alan Viard describes “the border adjustment money” as a “disguised form of borrowing.” Jason Furman estimates a long-term increase in deficits of 0.4 to 0.7 percent of GDP.
- According to CBO, a broad-base VAT at a 2 ½ percent rate would raise revenues in the budget period similar to the border adjustments of the 20 percent DBCFT.

KNOWN UNKNOWNNS

HOW WILL STATE AND LOCAL
GOVERNMENTS REACT?

- Most states and many local governments in the United States already impose their own border-adjusted taxes—retail sales taxes.
- Most state governments also impose corporate income taxes.
 - These taxes typically use the federal corporate income tax as the basis (or at least the starting point) for their corporate taxes.
 - Many states use their own depreciation schedules and might resist expensing for budget reasons.
- How will state and local governments respond to the elimination of the federal corporate income tax and its replacement with a DBCFT?
- Absent specific congressional authorization, a state-level, border-adjusted DBCFT might violate the Commerce Clause of the Constitution.

KNOWN UNKNOWNNS

ENACTMENT THROUGH THE RECONCILIATION PROCESS

- Major tax reforms have historically been enacted on a bipartisan basis and as a result have been stable over time.
- Republicans intend to enact this tax reform through the budget reconciliation process.
 - Needing only 51 votes to pass budget reconciliation legislation, it becomes possible to enact a major tax reform with only Republican votes in the House and Senate.
- Under Senate rules (“The Byrd Rule”) if reconciliation legislation loses revenue in years beyond the budget period, it is subject to a point of order, which can be overruled only with 60 or more votes.
- If a DBCFT is enacted with only Republican votes, will Democrats, when they reassume power, repeal and replace this tax?
 - Replacement here is much easier than with Obamacare. All one needs to do is replace expensing with depreciation rules, revise tax rates, eliminate border adjustments, and perhaps impose a minimum income tax on global income.

KNOWN UNKNOWNNS

ACCOUNTING TREATMENT

- Because this tax is unique, its treatment for financial accounting purposes is uncertain.
- The tax may be treated like a VAT and reduce corporations' revenues.
- Alternatively, this tax may be treated like an income tax and therefore be treated as a business expense, perhaps with permanent and timing adjustments.
- Who will decide this issue?
 - FASB (with the SEC) is most likely.
 - Congress could decide (with committees other than the House Ways and Means and Senate Finance Committee).
- How will this transformation of the U.S. tax system affect existing deferred tax assets and liabilities on financial statements?
- How will exchange rate adjustments affect balance sheets?

KNOWN UNKNOWNNS

BURDENS OF THE TAX

- In the near term, a DBCFT will burden different people depending on how much exchange rates adjust or prices rise.
- U.S. holders of foreign assets lose and foreign holders of U.S. assets win if the value of the dollar rises.
- Foreign borrowers in dollar-denominated debt lose if the value of the dollar rises.
- Consumers who pay more for goods and services lose if prices of those goods and services rise (unless wages rise to the same extent).
- Profits of companies that export may increase (and profits of companies that import may decrease) to the benefit (or detriment) of their shareholders.
- Generous transition rules will tend to benefit corporate equity owners.
- Over the longer term, the burdens of this tax will be different.

KNOWN UNKNOWNNS

BURDENS OF THE TAX

- In the most comprehensive analysis of a DBCFT to date, the economists Alan Auerbach, Michael Devereux, and Mick Keen claim:

Given the equivalence between a DBCFT and a VAT combined with a labour tax cut, the incidence of the tax would be on domestic residents financing consumption other than from wages, including from profit subject to the DBCFT. In that respect, the DBCFT would be more progressive than a single rate VAT, and possibly more so than existing corporate taxes.
- Allowing expensing of capital assets is viewed by economists as exempting from tax the “normal rate of return on capital.”
- Compared to a corporate income tax, which allows deductions for wages but requires recovery of capital costs over time, expensing should reduce the cost of capital.
- Disallowing deductions for interest expense increases the cost of capital compared to a corporate income tax.
- The Blueprint replaces a 35 percent corporate income tax with a 20 percent DBCFT.
- The border adjustment and wage deductions eliminate the burdens on domestic wages. Why should a consumption tax exempt consumption financed out of very high labor income?
- Do changes in prices change these results?
- It is not clear how the Joint Committee on Taxation – which typically produces distributional tables showing how changes in revenue affect the distribution of the tax burden and its after-tax income – will distribute the House Blueprint.

KNOWN UNKNOWNNS

DIFFERENT KINDS OF KNOWN UNKNOWNNS

- The issues and questions raised by the preceding slides will be resolved based on a series of government, business, and international institutions' behavior subsequent to enactment.
- The issues that follow will be resolved in the process of drafting this legislation.
 - Their economic impact, however, will turn on the subsequent behavior of businesses, governments, and international institutions.

KNOWN UNKNOWNNS

LOSSES

- Under a value-added tax, whenever inputs exceed outputs, the tax reduction on the excess is refunded.
- Although economists have long urged refunds of the income tax rate on losses, income taxes are not refunded. And the income tax limits the use of losses through mergers.
- Because of the exclusion of export sales from income, including payments associated with intellectual property used abroad, losses will be more prevalent under a DBCFT than under the existing corporate income tax.
- Because of the deduction for wages, losses will be greater under the DBCFT than under at VAT.
 - For businesses that are primarily exporters, losses will occur year after year, perhaps with no years of positive taxes.
 - Providing interest on loss carry forwards may not solve their problem.
- A great variety of transactions designed to enable businesses to utilize their losses seem likely to emerge.
 - These include the potential for transferring losses to others through leasing transactions or mergers and acquisitions designed to match income with losses.
 - Tax planners are certain to engage in numerous, and perhaps novel, transactions to monetize losses.
 - It is unknown how generous the ability to use losses will be under a DBCFT.

KNOWN UNKNOWNNS

MERGERS

- How will mergers or transfers of substantial business assets be treated?
 - With respect to normal business transactions, purchases and sales of real assets will be treated differently from purchase and sales of financial assets.
 - When a line of business is sold, will sales of assets be treated similarly to sales of stock?
 - Will companies be able to elect stock or asset treatment to minimize taxes?
- Will the sale and purchase of a line of business be excluded from this tax as is usually the case in value-added taxes? If so, how will such sales be defined?

KNOWN UNKNOWNNS

DIFFERENCES IN TAXATION OF CORPORATIONS
AND FLOW-THROUGH ENTITIES

- The House Blueprint provides for different rates of tax on corporations (20%) than on partnerships and other flow-through entities (25%).
- Different tax rates depending on how a business is organized do not exist in consumption taxes elsewhere, including retail sales taxes or VATs.
- Such a rate differential will create incentives to locate deductions in flow-through business entities and taxable receipts with corporate entities. And to locate exports in flow-through entities, imports in corporations.
- How will the deduction for wages apply to partnerships and other flow-through entities?
 - Will a rule requiring “reasonable compensation” be included? Will “special allocations” by partnerships of losses, for example, continue to be allowed? Will any deduction be allowed for wages of employees abroad?
- What opportunities will occur for tax planning through complex structures that include both partnerships and corporations under the same ownership?
- Will any tax be imposed on foreign-owned entities that do business in the United States but do not sell their products here?

KNOWN UNKNOWNNS

ENFORCEMENT

- Value added taxes are typically of the credit-invoice type and rely on invoices showing taxes paid for their enforcement. Credits are allowed only for taxes previously paid.
- The DBCFT is an accounts-based tax and the extent to which payment of tax by sellers will be required for deductions by purchasers is uncertain.
 - Will the allowance of a deduction under the Blueprint require a document showing how the item was treated and whether tax was paid at the previous stage of production?
- VATs rely on customs authorities to enforce the tax on imported goods.
 - The role, if any, of customs under the DBCFT is uncertain.
 - In the absence of customs enforcement, Europe has experienced significant missing-trader fraud.
 - In the absence of customs enforcement, many of the problems of taxing services under VATs will also occur in taxing goods under a DBCFT.
- VATs typically require registration of businesses, including foreign businesses, for enforcement. Will registration be required under the DBCFT?
- Taxation of services, especially imported services, has been troublesome under VATs.
 - Will VAT rules, which typically rely on the location or residence of customers, be used in the DBCFT?

KNOWN UNKNOWNNS

EXEMPTIONS

- Will there be any exemption or special treatment for small businesses?
 - Value-added taxes typically have exemptions for small businesses, sometimes quite large exemptions.
 - Similar exemptions might create substantial difficulties under a DBCFT. It has already been suggested that a deduction be allowed for interest expenses of small businesses.
- How will purchases and sales of tax-exempt organizations and state and local governments be treated?
 - This question has been difficult and controversial in designing VATs.
- Will there be any special treatment of goods that are not produced in the United States? Importers of chocolate, coffee, bananas, and spices, for example, have requested exemptions.
- Will there be exemptions or special rates for particular industries, e.g., agriculture, real estate, housing?
- The Blueprint seems to disallow immediate deduction of capital expenditures on inventories and on land. Why? How will sales of these assets be treated?

KNOWN UNKNOWNNS

INHERENTLY MOBILE INDUSTRIES, ETC.

- How will industries that necessarily operate across borders be treated?
 - These industries include communications suppliers, e.g., telephone and internet companies. Questions also arise involving international transportation companies, e.g., FedEx, UPS, MAERSK.
- Will border adjustments turn on the residence of the buyer?
- Will transportation companies (or credit card companies) be required to collect taxes on imports to consumers?
- How will advertising that reaches both domestic and foreign customers be treated?
- How will Puerto Rico – which is within U.S. customs jurisdiction – be treated?

KNOWN UNKNOWNNS

FINANCIAL TRANSACTIONS

- The Blueprint disallows deductions for interest expenses in excess of interest income.
- How will interest equivalents, such as rents from net leases, be treated?
 - Lease transactions are important in the automobile industry, the airline industry, and the real-estate industry, for example.
 - This question has been difficult under the income tax, even though both rent and interest expenses are deductible.
- What will be the treatment of non-financial corporations who earn financial income abroad?
 - Will the personal holding company rules of subpart F be retained?
- How will interest equivalents in financial instruments, such as swaps and forward contracts, be treated?
- The Blueprint distinguishes transactions in real assets from transactions in financial assets. How will business hedges of inventories and other business assets be treated?

KNOWN UNKNOWNNS

TAXATION OF FINANCIAL INSTITUTIONS

- The Blueprint expressly put aside the treatment of financial institutions under the DBCFT.
 - There are many different kinds of financial institutions: for example, banks, insurance companies, hedge funds, private equity.
 - These institutions provide many different kinds of financial services, including merger and acquisition services, insurance and re-insurance services, checking and savings accounts, etc. Will each of these services be treated similarly?
 - Will financial services provided to businesses simply be ignored?
- Many industrial companies provide financing of their own products.
 - For example, GE finances its sales of airplane engines and medical equipment; there are many others.
 - Will these lines of businesses be taxed as financial institutions? Does it matter whether they provide financing in the form of loans or leases?
- Value-added taxes have long struggled, without great success, in fashioning tax rules for financial institutions.
 - Will only services provided to consumers be taxed? Or will there be some tax on transactions between financial institutions and other businesses.
- Will financial transactions or transactions of financial institutions be border-adjusted?
 - How will this be accomplished? Will fees for foreign mergers be ignored as exports?

KNOWN UNKNOWNNS

RELATIONSHIP TO INDIVIDUAL TAXATION

- Will the corporation (or partnership) become a tax shelter opportunity for individuals?
 - Under the Blueprint, taxes on investment income can be deferred indefinitely at the business level (or, if investment income is taxed, subject to a lower rate).
 - Should the step-up in basis (section 1014) be repealed to limit tax avoidance?
- The Blueprint taxes dividends to individuals.
 - How will dividends be defined?
 - For example, will earnings and profits (E&P) be required?
 - If so, will the depreciation and other E&P rules of current law be retained?
 - If not, will all distributions, including returns of capital, be taxed to individuals as dividends?

KNOWN UNKNOWNNS

TRANSITION

- What rate of tax will be imposed on existing foreign assets held by USMNCs abroad?
 - Will there be a distinction between cash (and cash equivalents) and other assets such as plant and equipment?
 - Will potential exchange rate adjustments be taken into account in devising the tax?

- How will pre-enactment transactions be treated?
 - Pre-enactment assets: recovery of remaining basis?
 - Pre-enactment loans: ongoing deductions of interest?
 - Pre-enactment net operating losses: ongoing allowances against the DBCFT?
 - Pre-enactment credits: ongoing carry-forwards?
 - Treatment of pre-enactment contracts?
 - Any distinction based on whether contracts are dollar-denominated?
 - Any rules for unwinding existing arrangements?

- Phase-in of DBCFT rules and rate?

KNOWN UNKNOWNNS

SOME ALTERNATIVES TO THE DBCFT

- Enact a low-rate corporate income tax or cash flow tax without border adjustments.
 - Perhaps revise transfer pricing rules to allocate more income to the destination country (especially income from IP).
 - Allocate residual profits (after allowing a fixed rate of return on manufacturing, research and development, and financing) to the countries where sales occur.
- Or finance a 15 percent corporate tax rate and payroll tax relief with a 5 percent retail sales tax or VAT.
- Or eliminate the DBCFT wage deduction, lower the tax rate by up to two-thirds, provide payroll tax relief to employees and employers.
- Or as a revenue and distributionally neutral alternative: Enact a 12.9 percent (tax-exclusive) rate VAT, provide payroll tax relief, provide VAT offsets to low and moderate income families, exempt 150 million families from the income tax through a \$100,000 family exemption and reduce the corporate income tax rate to 15 percent.

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