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INTRODUCTION

A GUIDE TO THE REPUBLICAN BETTER WAY PLAN

Alex Raskolnikov

ARTICLES

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

Michael J. Graetz

A GUIDE TO THE GOP TAX PLAN – THE WAY TO A BETTER WAY

David A. Weisbach

PROBLEMS WITH DESTINATION-BASED CORPORATE TAXES AND THE RYAN BLUEPRINT

Reuven S. Avi-Yonah
Kimberly Clausing

AN ANALYSIS OF THE HOUSE GOP TAX PLAN

Leonard E. Burman
James R. Nunns
Benjamin R. Page
Jeffrey Rohaly
Joseph Rosenberg

TAX PLANNING UNDER THE DESTINATION BASED CASH FLOW TAX: A GUIDE FOR POLICYMAKERS AND PRACTITIONERS

David S. Miller

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INTRODUCTION

A GUIDE TO THE GUIDE TO THE REPUBLICAN BETTER WAY PLAN

Alex Raskolnikov†

This special Issue of the Columbia Journal of Tax Law is bound to have both an immediate impact and a lasting significance. The immediate impact is assured because the sole focus of this Issue is the tax plan proposed by the Congressional Republicans as part of their broad reform agenda called A Better Way: Our Vision For A Confident America.¹ As this Issue goes to print, the Better Way Plan (or the Plan for short) is being debated in the White House, on Capitol Hill, in the press, in academic circles, think tanks, the U.S. Chamber of Commerce, and all major law and accounting firms, as well as in many other places. For anyone thinking through the implications of the Plan, this Issue is a must read.

At the same time, the contributions in this Issue will provide a lasting benefit to the tax policy community. Even though the intellectual foundations of the tax system proposed in the Plan were laid decades ago, the core ideas underlying the Plan have never before been considered, tested, and scrutinized nearly as rigorously and comprehensively as they are now. Simply put, the level of intellectual capital that is being invested in analyzing the Plan is extraordinary. This Issue combines some of the best applied work on the subject to date. So it will benefit academics, policymakers, and practitioners thinking about the tax systems similar to the one proposed in the Plan for decades to come.

This Issue is a guide to the Plan based on what we know so far, and this Introduction is a guide to the Issue.

Readers familiar with the basics of the Plan and interested in a comprehensive list of questions, concerns, and uncertainties it raises should start with Michael Graetz’s The Known Unknowns of the Business Tax Reforms Proposed in the House Republican Blueprint. The list of unknowns is long and daunting. Some will not be resolved until after the Plan is put in place, for better or worse. Others will need

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† Wilbur H. Friedman Professor of Tax Law, Columbia Law School.

¹ The entire agenda is available at: http://abetterway.speaker.gov.
to be addressed in the legislative drafting process. Even for those, it is far from clear how to answer many critical questions. Why should we expect anything different from an attempt to enact a system that does not exist—and has never existed—anywhere in the world?

Readers who would like to get a firmer grasp of the Plan, its intellectual history, its ideal version, and the deviations from that ideal reflected in the actual proposal cannot do better than reading David Weisbach’s contribution: *A Guide to the GOP Tax Plan—The Way to a Better Way*. As the title suggests, Professor Weisbach offers solutions to some of the problems created by the Plan. He also highlights the areas where finding solutions will be difficult and time consuming. And he points out several unnecessary, complicating, and intellectually incoherent features in the Plan’s current version. One hopes that Professor Weisbach’s cogent critique would convince policymakers to abandon these features.

Reuven Avi-Yonah and Kimberly Clausing also investigate the challenges that the Plan’s enactment will present, but they focus on the international issues. They argue, convincingly, that the Plan will violate the U.S. obligations under the rules of the World Trade Organization. Professor Graetz expresses a similar view, and Professor Weisbach acknowledges the issue. But if you want to read the relevant clauses and parse them as a WTO lawyer might, you should go to Avi-Yonah’s and Clausing’s piece. The other international issue that these authors consider is whether the Plan would violate U.S. income tax treaties, and what are the likely consequences if it does.

What if you think that numbers speak louder than words? Then the contribution by the Tax Policy Center experts is for you. Len Burman, Jim Nunns, Ben Page, Jeff Rohaly, and Joe Rosenberg present their estimates of the revenue and distributional effects of the Plan in *An Analysis of the House GOP Tax Plan*. Their analysis includes dynamic scoring estimates generated in collaboration with the Penn Wharton Budget Model. These are not the only estimates available now, and there is little doubt that new estimates will appear in the future. It is worth noting, however, as Martin Sullivan has done in the pages of Tax Notes, that if the past experience is any guide, the official dynamic revenue estimate that may be eventually produced by
the Joint Committee on Taxation is likely to be fairly close to the one offered by the Tax Policy Center.  

Last, but certainly not least, David Miller offers a perspective of a sophisticated tax lawyer. His contribution gives the reader—especially a legislative drafter—a glimpse of what to expect once the tax bar engages with the new rules. The picture is far from rosy. Moreover, the tax planning possibilities that Miller identifies are, no doubt, just a tip of the iceberg. Nor is there any doubt that tax planning around the Plan’s new rules is already underway, even though these rules are only hypothetical at this point. This brings us full circle to Professor Graetz’s main takeaway: enacting a tax system that is literally unprecedented is fraught with risks.

The Plan offers a dramatic reform and raises many difficult questions. This special Issue of the Columbia Journal of Tax Law will serve as an invaluable educational tool for those studying the Plan or working to improve it. It will also serve as a guide for those brave enough for forge ahead.

TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Slide No.</th>
<th>Page No.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>KNOWN KNOWNS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Introduction</td>
<td>4</td>
<td>119</td>
</tr>
<tr>
<td>More Like a VAT Than a Corporate Tax</td>
<td>5</td>
<td>120</td>
</tr>
<tr>
<td>Transforming the Corporate Income Tax into a DBCFT</td>
<td>6</td>
<td>121</td>
</tr>
<tr>
<td>Shifting Tax to Where Goods and Services are Sold</td>
<td>7</td>
<td>122</td>
</tr>
<tr>
<td>Solves International Corporate Tax Problems</td>
<td>8-9</td>
<td>123-124</td>
</tr>
<tr>
<td>A Unique Tax</td>
<td>10</td>
<td>125</td>
</tr>
<tr>
<td><strong>KNOWN UNKNOWNS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Effects on Prices of Goods and Services and/or Exchange Rates</td>
<td>11-12</td>
<td>126-127</td>
</tr>
<tr>
<td>The Impact of a Potential 25 Percent Rise in the Value of the Dollar</td>
<td>13-16</td>
<td>128-131</td>
</tr>
<tr>
<td>The Impact of Exchange Rate Adjustments</td>
<td>17</td>
<td>132</td>
</tr>
<tr>
<td>Potential Price Effects</td>
<td>18-19</td>
<td>133-134</td>
</tr>
<tr>
<td>Potential Effects on Wages</td>
<td>20</td>
<td>135</td>
</tr>
<tr>
<td>Impact on Trade Agreements</td>
<td>21-24</td>
<td>136-9</td>
</tr>
<tr>
<td>Bilateral Income Tax Treaties</td>
<td>25-26</td>
<td>140-141</td>
</tr>
<tr>
<td>A Constitutional Challenge to DBCFT Seems Inevitable</td>
<td>27</td>
<td>142</td>
</tr>
<tr>
<td>The Rate of Tax Matters</td>
<td>28-29</td>
<td>143-144</td>
</tr>
<tr>
<td>Revenue</td>
<td>30</td>
<td>145</td>
</tr>
<tr>
<td>How Will State and Local Governments React</td>
<td>31</td>
<td>146</td>
</tr>
<tr>
<td>Enactment Through the Reconciliation Process</td>
<td>32</td>
<td>147</td>
</tr>
<tr>
<td>Accounting Treatment</td>
<td>33</td>
<td>148</td>
</tr>
<tr>
<td>Burdens of the Tax</td>
<td>34-35</td>
<td>149-150</td>
</tr>
<tr>
<td>Different Kinds of Known Unknowns</td>
<td>36</td>
<td>151</td>
</tr>
<tr>
<td>Losses</td>
<td>37</td>
<td>152</td>
</tr>
<tr>
<td>Mergers</td>
<td>38</td>
<td>153</td>
</tr>
<tr>
<td>Differences in Taxation of Corporations and Flow-Through Entities</td>
<td>39</td>
<td>154</td>
</tr>
<tr>
<td>Enforcement</td>
<td>40</td>
<td>155</td>
</tr>
<tr>
<td>Exemptions</td>
<td>41</td>
<td>156</td>
</tr>
<tr>
<td>Inherently Mobile Industries</td>
<td>42</td>
<td>157</td>
</tr>
<tr>
<td>Financial Transactions</td>
<td>43</td>
<td>158</td>
</tr>
<tr>
<td>Taxation of Financial Institutions</td>
<td>44</td>
<td>159</td>
</tr>
<tr>
<td>Relationship to Individual Taxation</td>
<td>45</td>
<td>160</td>
</tr>
<tr>
<td>Transition</td>
<td>46</td>
<td>161</td>
</tr>
<tr>
<td>Some Alternatives to the DBCFT</td>
<td>47</td>
<td>162</td>
</tr>
<tr>
<td>Appendix: A Bibliography</td>
<td>48</td>
<td>163</td>
</tr>
</tbody>
</table>
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.
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 valued-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:
TRANFORMING 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.
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.
• 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.
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.
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 Unknowns

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 UNKNOWNS

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.
THE KNOWN UNKNOWNS OF THE BUSINESS TAX REFORMS PROPOSED

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

<table>
<thead>
<tr>
<th>Country</th>
<th>Govt (%)</th>
<th>NFC (%)</th>
<th>Govt + NFC (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>66.2</td>
<td>50.1</td>
<td>116.3</td>
</tr>
<tr>
<td>China</td>
<td>43.9</td>
<td>163.6</td>
<td>207.5</td>
</tr>
<tr>
<td>India</td>
<td>69.0</td>
<td>51.0</td>
<td>120.0</td>
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<tr>
<td>Malaysia</td>
<td>54.0</td>
<td>67.9</td>
<td>121.9</td>
</tr>
<tr>
<td>Mexico</td>
<td>43.2</td>
<td>24.8</td>
<td>68.0</td>
</tr>
<tr>
<td>South Africa</td>
<td>50.1</td>
<td>37.0</td>
<td>87.1</td>
</tr>
<tr>
<td>Turkey</td>
<td>37.7</td>
<td>57.0</td>
<td>94.7</td>
</tr>
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</table>


## 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

<table>
<thead>
<tr>
<th>Country</th>
<th>Govt (%)</th>
<th>NFC (%)</th>
<th>Govt + NFC (%)</th>
<th>Increase in debt (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>70.2</td>
<td>58.6</td>
<td>128.8</td>
<td>12.5</td>
</tr>
<tr>
<td>China</td>
<td>43.9</td>
<td>198.0</td>
<td>241.9</td>
<td>34.4</td>
</tr>
<tr>
<td>India</td>
<td>69.0</td>
<td>63.0</td>
<td>132.0</td>
<td>12.0</td>
</tr>
<tr>
<td>Indonesia</td>
<td>30.3</td>
<td>25.9</td>
<td>56.2</td>
<td>5.3</td>
</tr>
<tr>
<td>S. Korea</td>
<td>38.6</td>
<td>127.5</td>
<td>166.0</td>
<td>22.1</td>
</tr>
<tr>
<td>Malaysia</td>
<td>55.8</td>
<td>76.6</td>
<td>132.3</td>
<td>10.4</td>
</tr>
<tr>
<td>Mexico</td>
<td>46.4</td>
<td>28.9</td>
<td>75.3</td>
<td>7.3</td>
</tr>
<tr>
<td>South Africa</td>
<td>54.9</td>
<td>42.5</td>
<td>97.3</td>
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</tr>
<tr>
<td>Turkey</td>
<td>45.9</td>
<td>58.6</td>
<td>104.4</td>
<td>9.8</td>
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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.
THE IMPACT OF EXCHANGE RATE ADJUSTMENTS

Real Trade-Weighted Dollar (Major Currency Index)
Index (Mar-1973 = 100)

- Full Adjustment (Illustrative)
- Partial Adjustment (Illustrative)

Note: Shading denotes recession.
Source: Federal Reserve Board; Jason Furman calculations.
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.
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.
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.
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.
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.
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.
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.
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.
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.
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.
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.
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.
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 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.
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.
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.
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?
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.
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.
• 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.
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 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 unknowns

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 UNKNOWNS**

**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?
**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 UNKNOWNS

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 UNKNOWNS

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?
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?
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?
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?
• 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?
• 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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A GUIDE TO THE GOP TAX PLAN –
THE WAY TO A BETTER WAY

David A. Weisbach*

Executive Summary

The tax reform plan – A Better Way – put forward by the chairman of the House Ways and Means Committee Kevin Brady and the Speaker of the House, Paul Ryan would be the most substantial tax reform in the United States since the enactment of the income tax in 1913. At the corporate level, the reform would allow immediate expensing of investments, deny deductions for net interest expense, and eliminate the taxation of income from sales in foreign countries while taxing the full value of imports (together shifting the tax base to a destination basis). At the individual level, the system would tax capital income including interest, dividends, and capital gains at half the rate that wages and salaries are taxed. It would also repeal the estate and generation skipping taxes. These changes would go a long way toward shifting the tax system to taxing consumption rather than income.

This paper considers the implementation of the House GOP tax plan and addresses issues that will need to be resolved if the plan is to work as intended. The plan is based on, and builds off of, a long history of thinking about consumption taxes. To understand the basic choices made in the plan, it is helpful to understand this history and how consumption taxes work in general.

The paper provides a nutshell version of this history. It shows that the plan is essentially the same as the proposal put forward by the tax reform panel convened by President Bush in 2005 known as the

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Growth and Investment Tax. That plan, in turn, was a modification of two similar consumption tax proposals, the Flat Tax and a closely related plan known as the X-tax. And these proposals are modifications of the standard VAT used throughout the world. Understanding how VATs work and the issues they raise, as well as the reason for the various evolutions in the proposals allows us to understand the central issues that will arise in implementing the Brady plan.

After summarizing this history, the paper turns to the issues that will need to be resolved to implement the plan, focusing on eight sets of issues: (i) the design of the business tax; (ii) the relative tax rates for corporations, partnerships, labor income, and the capital income of individuals; (iii) international tax issues; (iv) the taxation of financial instruments and institutions; (v) the taxation of corporate transactions such as mergers and acquisitions; (vi) deferral and the functioning of the individual-level tax on capital income; (vii) issues relating to the individual tax base such as the mortgage interest deduction; and (viii) problems of transition.

Some of the problems in the current draft of the Brady plan, such as inconsistencies in the design of the corporate tax, are easily fixed. Some problems, such as the treatment of pass-through entities and the taxation of major corporate transactions, can be improved with modest substantive changes. Others, such as the taxation of financial institutions, will require substantial effort to get right, but approximate solutions exist. Finally, some issues, such as the taxation of capital income at the individual level, will not be readily fixed. The basic structure of the plan may not be workable for these issues and resolution of these issues might require structural changes to the plan. Overall, I believe that a system following the contours of the House GOP tax plan can be made to work, but solving the implementation problems will take time, effort, and compromises.
I. INTRODUCTION ................................................................. 174
II. DESCRIPTION OF THE PROPOSAL .......................... 176
   A. Business Level Tax .................................................. 177
   B. International Tax Rules ........................................... 178
   C. Other Entities ........................................................ 179
   D. Individual Level Taxation ....................................... 179
   E. Estate and Gift Taxation ......................................... 180
   F. Revenue and Distribution ....................................... 180
III. HOW DID WE GET HERE? .............................................. 181
   A. Consumption Tax Basics ........................................ 181
   B. The Cash-Flow or Subtraction-Method VAT ............... 184
   C. Destination v. Origin Basis ..................................... 187
   D. The Flat Tax and the X-tax .................................... 191
   E. Destination-based X-tax ....................................... 193
   F. The Growth and Investment Tax Plan ....................... 194
   G. The Brady Plan ....................................................... 195
IV. ISSUES AND PROBLEMS WITH THE BRADY PLAN .... 195
   A. Design of the Business Tax ..................................... 196
   B. Tax Rates ............................................................ 203
   C. International Issues ............................................... 206
   D. Financial Flows ..................................................... 215
   E. Corporate Transactions .......................................... 217
   F. Deferral .................................................................... 220
   G. Other Individual Tax Provisions .............................. 222
   H. Transition ............................................................... 223
V. CONCLUSIONS .............................................................. 227
I. INTRODUCTION

The tax reform plan put forth by the Chairman of the Ways and Means Committee, Representative Kevin Brady (R-TX) and the Speaker of the House, Paul Ryan (R-WI), if enacted, would be the most substantial tax reform since the original enactment of the income tax in 1913, far exceeding the 1986 reform.\(^1\) Known as “A Better Way,” the plan (which I will call the Brady plan for short) would shift the corporate tax from a tax on income toward a tax on consumption, from a worldwide system to a territorial system on what is called a “destination basis,” and from a system that allows a deduction for interest expense to a system that at least to some extent ignores financial flows.\(^2\) At the individual level, the plan would tax capital income, including interest, dividends, and capital gains, at half of the tax rate on wage income, greatly reducing the tax on capital. Combined, the changes to the corporate tax and the individual tax would transform the tax system, shifting strongly toward a consumption base and away from an income base.

Although it would be a dramatic change from current law, the plan is based on a long line of academic study. It is also based on numerous proposals put forward in the past including a relatively detailed proposal by the tax reform commission created by President Bush in 2005.\(^3\) And it has similarities to consumption tax systems currently in use elsewhere in the world. We know a reasonable amount about how the system should work.

Nevertheless, nothing quite like this has ever been tried in the United States or any other developed country. It would be a massive break from the past. To implement the proposal, we would have to resolve numerous issues, some of which are barely mentioned in the current description of the plan and many of which are not mentioned at all.

\(^1\) A possible rival is the addition of withholding under the income tax during World War II, which effectively converted the income tax from a tax on a small minority of wealthy individuals to a tax on most of the population. A second possible rival would be the gradual expansion of the payroll tax to be the dominant tax paid by a large portion of the population.

\(^2\) The most recent description of the plan can be found at *A Better Way* (June 24, 2016), http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf [perma.cc/9Z2N-NE2J].

My goal in this paper is to provide a guide to the plan, focusing on how the tax system would be implemented rather than the economic and distributional effects. I start by describing the broad contours of the plan based on what is currently publicly available. As noted, the proposal is based on a long history of study of consumption taxation. To understand the structure and reasons for the choices made in the proposal, I next provide an encapsulated version of the history of thinking about consumption taxes, and show how the plan relates to, and is built off of, prior proposals. In particular, the Brady plan is essentially the same as the “Growth and Investment Plan” proposed by President Bush’s tax reform commission. That plan itself was built off of a prior proposal by David Bradford known as the X-tax, and a plan by Robert Hall and Alvin Rabushka, known as the Flat Tax. These plans in turn are modifications of a VAT, which is the standard form of consumption taxation used by nations around the world.

After showing how the Brady plan fits into this history, I examine the issues that will need to be resolved if the plan is to be implemented. I focus on eight sets of issues: (i) the design of the business tax; (ii) the relationship between the tax rates for corporations, partnerships, labor income, and the capital income of individuals; (iii) international tax issues; (iv) the taxation of financial instruments and institutions; (v) the taxation of corporate transactions such as mergers and acquisitions; (vi) deferral and the functioning of the individual-level tax on capital income; (vii) issues relating to the

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5 The discussion is based largely on two of my prior publications on this topic, David A. Weisbach, Ironing Out the Flat Tax, 52 STANFORD L. REV. 599 (2000), and David A. Weisbach, Does the X-Tax Mark the Spot?, 56 SMU L. REV. 201–238 (2003).

6 Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System, supra note 3.


individual tax base such as the mortgage interest deduction; and (viii) problems of transition.

Some of the problems I discuss can be readily fixed, but many of the issues that need to be resolved are complex and defy easy solutions. Some aspects of the plan may require substantial revision or a completely different approach to be workable. A central problem with the plan is that it tries to straddle the line between an income tax and a consumption tax, inconsistently taking elements of both. In some cases, this generates inconsistent taxation of different types of investments and unnecessary complexity. In other cases, the mix is entirely unworkable. Solving these problems by shifting to a pure consumption tax, however, would put the United States in new territory: no developed country has tried to have a pure consumption base for its tax system.

Although there is a strong impetus to pass a tax reform plan quickly, finding reasonable and durable solutions to many of the issues will take time. This is particularly so because consumption tax approaches to tax issues are very different than income tax approaches, and there is little expertise in the United States on how to approach taxes when the base is consumption. It is easy to make mistakes by relying on an understanding of how income taxes work. For example, deferral is one of the central problems in designing an income tax, but is largely irrelevant in a consumption tax. Income tax concepts like basis, inventory, and capitalization of expenses no longer apply. Legislative drafters, experienced in income tax design, will have to work hard to avoid importing income tax concepts into a consumption tax. Doing so quickly and, possibly, on a partisan basis if tax reform is passed as part of budget reconciliation, will be difficult. Nevertheless, I will conclude that with work, a plan following the basic contours of the Brady plan can be implemented and, if the right choices are made, may, in many areas, be substantially simpler than current law.

II. DESCRIPTION OF THE PROPOSAL

The following is a summary of the proposal taken from the June 24, 2016 description of the plan found in the Ways & Means Committee website. The description on the website is just a rough outline and has many ambiguities. It is likely that in some places my interpretation is incorrect. Moreover, many elements will be changed as the plan is developed in more detail.

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9 Supra note 2.
A. Business Level Tax

Corporations. The plan makes four key changes to the corporate tax:

- The cost of capital expenditures (other than land) would be immediately deductible instead of recovered over time through depreciation deductions.
- Net interest expense would not be deductible. In effect, interest expense would be treated similarly to dividends, reducing the disparity between debt and equity. Non-deductible interest expense can be carried forward and used against interest income in future years.
- The tax would be territorial, which means that it would apply only to income from domestic activities. Accumulated foreign earnings at the time of the tax, however, would be subject to a one-time tax of 8.75% for cash holdings and 3.5% for other assets, without regard to whether they are repatriated. This transition tax would be payable over an eight-year period.
- The tax would be destination-based, which means that sales in foreign countries would not be taxed and imports from foreign countries would not be deductible (or give rise to basis).

The plan would also eliminate most special deductions and credits currently allowed to corporations such as the domestic production deduction. It would, however, retain a version of the R&D credit. The tax on this base would be 20%.

The plan describes these changes as moving the system towards what is called a cash-flow consumption tax. In a cash-flow consumption tax, firms deduct outflows and include inflows rather than using the usual income tax concepts such as basis, realization, capitalization, and the like. As will be discussed, it is a tax on consumption rather than income.

There are, however, a number of statements in the plan that are inconsistent with cash-flow taxation. In particular, the plan says that it will keep inventory accounting. Inventory accounting would not be necessary in a cash-flow system because the cost of assets is deducted when purchased or created. The plan also does not allow a deduction for purchases of land, so that expenditures on land are treated differently than other expenditures. In a cash-flow system, all (non-financial) expenditures would be deductible.

Cash-flow consumption taxes are also usually what is called R-based, which means that they ignore financial flows such as borrowing and lending. They tax only real flows, hence the R. An alternative is
what is called R+F based, which means that the system taxes all real and all financial flows (other than with respect to stock) on a cash-flow basis.\footnote{The R+F base was first described by the Meade Commission. \textit{The Structure and Reform of Direct Taxation}, \textsc{Inst. for Fiscal Studies} (1978).} The Brady plan, as described, is consistent with neither of these approaches. In particular, it taxes net interest income but denies a deduction for net interest expense. In an R-based system, interest income would not be taxed. In an R+F system, interest expense (and the principal of loans) would be deductible. Moreover, the plan is silent on other financial flows, such as gains and losses from the sale of securities and derivative instruments.

It is not clear whether these deviations from an R-based cash-flow tax are mistakes or are on purpose. The description of the plan gives no explanation. In Part IV.A., I will discuss the problems these deviations from an R-based cash flow system create.

\textit{Pass-through entities}. The plan keeps the current law tax rules for pass-through entities. This means that the tax rules for partnerships under subchapter K and for closely-held corporations under subchapter S would remain. The tax base\footnote{Throughout, rather than using “income” I use “tax base”. If the reform shifts the tax system to a consumption tax, the tax base would not be income, and it is misleading to say that a business computes its income on a cash-flow basis. Instead, I will say that a firm computes its tax base, or where grammatically simpler, its earnings.} for these entities has the same features as the corporate tax base: immediate deduction for capital expenditures, no deduction for net interest expense, territorial taxation, and destination-based cash flow determination.

Once a pass-through entity computes its tax base and allocates it to its owners, the owners report their amounts on their personal returns. The tax rate for the active earnings of pass-through entities is capped at 25% which means that the applicable rate is the lesser of the owner’s marginal tax rate and 25\%.\footnote{An alternative interpretation of the language in the plan, suggested to me by Steve Shay, is that pass-through income is taxed at a flat 25\% rate. It is not clear which interpretation is correct.} Because this rate cap applies only to active earnings, passive income of pass-through entities (which is not defined) would presumably be taxed at the owner’s marginal tax rate, not capped at 25\%.

B. \textit{International Tax Rules}

As mentioned, the tax would be destination based, which means that exports would not be taxed and imports would be subject to tax. In practice, what this means is that a U.S. company that sells a
good in a foreign country would not include the proceeds in its tax base. Conversely, a U.S. company that imports a good would not be able to deduct the cost of the good so that when the good is sold in the United States, its full value is included in its tax base and taxed (as opposed to just the value added in the United States).

The plan is also territorial, which means that U.S. corporations are not taxed on income earned in other countries. Because sales in other countries and active income earned in other countries are not taxed, most tax rules governing outbound transactions would be repealed. The plan indicates that the foreign personal holding company rules would remain.

The plan does not mention which rules governing inbound investments would remain. For example, the plan does not say whether it would retain the withholding rules for dividend payments made to foreigners or the branch profits rules. Similarly, the plan does not say which source rules would be retained or how they would be modified.

C. Other Entities

The plan does not say how other entities, such as banks, regulated investment companies, insurance companies, real estate investment trusts, REMICs, and other entities will be taxed. The plan does not mention tax-exempt entities, and I assume that means no changes would be made to their treatment. The plan does not mention the Unrelated Business Income Tax, although this would likely be reformed to match the new business tax rules.

D. Individual Level Taxation

To a great extent, the taxation of individuals under the plan is similar to their taxation under current law. The basic intent seems to be to simplify the ornate structure of taxation that has built up over the years.

In particular, the plan would tax wage or labor income at progressive rates, with three brackets, 12%, 25%, and 33%. It would have a large standard deduction, in the range of $24,000 for a married couple, and a combined child credit and personal exemption of $1,500. The AMT would be repealed. The plan does not mention payroll taxes, which, I assume, remain as is.

Many of the features of the tax system for individuals found in current law would remain roughly as is, with unspecified simplifications. For example, the plan says that it will preserve “a” mortgage interest deduction, and that the Committee on Ways and Means will evaluate options to make it more effective and efficient.
Similar language is used for the deduction for charitable donations, the exclusion for employer provided health care, the various education tax benefits, and the various retirement savings provisions found in current law. With the exception of the mortgage interest deduction and the deduction for charitable donations, all itemized deductions would be repealed (which means that the plan would repeal the state and local tax deduction). The Earned Income Tax Credit would remain. Presumably, the rules defining the scope of taxable compensation, such as the fringe benefit rules, would remain.

The most important difference from current law for individuals is that all income from capital, including interest, dividends, and capital gains would be taxed at half the rate applicable to labor income. This change would reduce the highest tax rate on dividends and capitals from 25% (the 20% statutory rate plus the 3.8% surtax on net investment income plus the Pease surtax) under current law to 16.5% and the highest tax rate on interest income from 44.6% to 16.5% (a 63% cut). While business taxes are territorial, I assume that the individual capital income tax is not. That is, I assume that dividends, interest, and capital gains, regardless of the source, would be taxed.

E. Estate and Gift Taxation

The plan would repeal the estate tax and the generation skipping taxes. It is silent on the gift tax, which I take to mean that the gift tax would be retained. It does not mention whether it would retain stepped-up basis at death.

F. Revenue and Distribution

The description of the plan does not include a revenue estimate or distributional tables. It is not clear whether estimates were used to arrive at the tax rates stated in the plan. If not, the stated tax rates may have to change, possibly significantly, to reach appropriate targets. In particular, the Tax Policy Center estimates that the plan lowers tax receipts by about $3.1 trillion over ten years on a static basis and $3 trillion on a dynamic basis. The Tax Foundation’s static estimate is that the plan would lose $2.4 trillion over ten years, which is roughly

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13 The Tax Policy Center analysis made the opposite assumption, that the gift tax will be repealed. See Burman et al., supra note 4 at 264.

14 Burman et al., supra note 4, at 273 also estimate that the plan would be highly regressive. In its first year of operation (which they assume is 2017), the top 0.1 percent of taxpayers would receive a tax cut of about 16.9 percent of their after-tax income. Households in the middle fifth of the income distribution would receive cuts of about 0.5 percent of their after-tax income. The poorest fifth would have tax cuts of 0.4 percent.
in the same ballpark, although their dynamic estimate is that the plan would lose only $191 billion, which is effectively revenue neutral.\footnote{Kyle Pomerleau, Details and Analysis of the 2016 House Republican Tax Reform Plan, TAX FOUND. (July 5, 2016), http://taxfoundation.org/details-and-analysis-2016-house-republican-tax-reform-plan/ [perma.cc/88UK-5CGK].}

These estimates need to be taken as provisional because so many of the details of the plan remain unspecified. For example, the plan does not state how existing basis will be treated once the corporate tax shifts to an expensing system. Many of these details will have large effects on tax revenues and also on the distribution of the tax burden.

The size of the tax cut and the distributional effects of the plan will likely be headline items in the press coverage of the plan. The focus here, however, is on the structure of the proposed tax system. There are two reasons for this focus. First, there has been little attention to structural issues, and these issues will have first order effects on the operation of the plan and its economic effects. Second, the revenue and distributional impacts, while contentious, are, to a great extent, relatively easy issues to resolve by choosing appropriate marginal rates. That is, there may be deep philosophical issues about the right degree of progressivity of the tax system and the right overall level of taxation, but any given resolution of those issues is relatively easy to implement through the choice of the rates. The structural issues may be much more difficult to resolve.

III. HOW DID WE GET HERE?

To understand the overall structure of the Brady plan, we need to understand the proposals for consumption taxation that have been made over the last 40 years. I offer a summary here. More detail can be found in numerous sources.\footnote{Much of the original work was done by David Bradford, including his works cited in note 7, David F. Bradford, Transition to and Tax-Rate Flexibility in a Cash-Flow-Type Tax, 12 TAX POLICY ECON. 151–172 (1998), DAVID BRADFORD, THE X TAX IN THE WORLD ECONOMY (2004), and U.S. DEPARTMENT OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977), which was primarily authored by Bradford. Other work on implementation of consumption taxes includes William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 HARV. L. REV. 1113 (1974); Michael J. Graetz, Implementing a Progressive Consumption Tax, 92 HARV. L. REV. 1575–1661 (1979); Weisbach, Ironing Out the Flat Tax, supra note 5; Weisbach, Does the X-Tax Mark the Spot?, supra note 5; ROBERT CARROLL AND ALAN D. VIARD, PROGRESSIVE CONSUMPTION TAXATION: THE X-TAX REVISITED (2012).}
Individuals can do two things with their income: they can use it for consumption or they can save it. Robert Haig and Henry Simons proposed defining income this way, according to its uses. In their formulation, an individual’s income in a given period is his consumption plus his change in net worth or savings.

Using this same identity, consumption is income minus changes in savings. This means that we can measure consumption by measuring income and allowing a deduction for savings (and an inclusion for withdrawals from savings).

An income tax with a deduction for savings (that is, a consumption tax) is simply a tax on cash flows.\footnote{This observation was first made by Nicholas Kaldor, Expenditure Tax (1955). Andrews, supra note 16, expanded on and developed the idea.} Taxpayers have income in a given year, say as salary or gains from investments. This income is an inflow. They subtract from this any amounts they save – their outflows. They pay tax on what is left, which is their consumption.

What makes this system so attractive from an administrative and compliance standpoint is that it does not need to use income tax accounting concepts such as realization, basis, depreciation, accrual, inventories, capitalization, and the like. To tax consumption, we just need to measure inflows less outflows. Switching to a cash-flow system, therefore, potentially allows substantial simplification of the tax rules.

A cash-flow system allows an immediate deduction for savings. Students of the tax law will remember that an immediate deduction of an expenditure is, with an exception discussed below, the equivalent of not taxing the return on the expenditure. To illustrate, suppose you purchase a share of stock or a machine for $100 and it produces a return of $110 in one year, for a 10% rate of return. An income tax would give you basis of $100, an amount realized of $110, and gain of $10. At a tax rate of 20%, you would owe $2.

A cash-flow system would allow an immediate deduction of the $100 purchase, saving you $20 in taxes.\footnote{The deduction either reduces taxes you would otherwise owe, or if you do not otherwise owe $20, would, in a pure cash-flow tax, be refundable. The Brady plan does not refund losses. Instead, it allows unlimited carry forwards with interest, which in economic terms is roughly the same thing. In the example, you would carryforward the $100 loss, increasing it by $10, to have a $110 loss which could be used against the $110 of income.} You do not have any basis in the asset (because you deducted its cost), so when you get the
$110 the next year, you have $110 of gain, and owe $22 in taxes. But note that the $22 you owe next year is just the future value of the $20 in taxes that you saved this year (at the 10% market rate of return). In present value terms, you owe no tax. In fact, if you wanted, you could invest the $20 tax savings at the 10% market rate of return and have $22 next year, so that you will have exactly enough to pay the tax.\(^\text{19}\) In this case, the tax has no effect on you at all: you get the refund, put it in the bank, and take it out of the bank at a future date to pay the tax. Your investment is unaffected. Therefore, in a cash-flow system, the investment bears no effective tax. As the Brady plan puts it, the effective marginal tax rate on new investment in a cash-flow system is zero.

Note that this is true regardless of the tax rate. If the rate were, say, 70%, the same analysis would hold. The deduction for the initial investment of $100 would be worth $70 and the tax on the return of $110 would be $77. The present value of these flows is $0. Because the effective marginal tax rate on new investment is zero, the nominal rate does not matter for new investment.

An exception to this conclusion is if the investment produces higher returns than are otherwise available in the market (adjusting for risk).\(^\text{20}\) These returns are variously called “inframarginal returns,” “rents,” or “economic profits.” To illustrate, suppose that the market rate of return is 10% but the investment has a yield of 20%, so that in one year you get back $120 instead of $110. In the year of the investment, you save $20 in tax. The next year, you have $120 in incoming cash flows, so you owe $24 in tax. The amount you owe, $24, is $2 more than in the $22 owed in the prior case when you only received the market rate of return. The additional $2 is the 20% tax on the $10 you earned that is above the normal market rate of return. If you put your tax refund of $20 in the bank, you would have only $22 next year. You would have to dig into your own pocket to find the additional $2 that you owe.

This analysis allows us to describe a consumption tax more precisely (which will end up being important in thinking about the structure of the Brady plan). There are two sources of income: income from labor and income from saving and investing. A consumption tax

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\(^{19}\) The investment of the $20 would also be deductible, producing $4 of tax savings, which you could also invest. Continuing this process, you would eventually be able to invest $25 in tax savings and owe $27.50, the future value of $25, in taxes.

\(^{20}\) The other key assumption is that tax rates stay the same. The effects of changing tax rates are discussed in Part IV.H.
is the same as an income tax except that (because of its cash-flow structure) it exempts the normal return from savings, but not economic profits. A consumption tax, therefore, can be thought of as a tax on labor income and economic profits.

There is also, potentially, a third component of a consumption tax, which relates to transition effects. Depending on how the transition is managed, a consumption tax might also fall on existing capital. If we think about sources of consumption in the future, one major source is liquidating existing investments, and using the cash to purchase consumption. For example, if you were retiring today, all or almost all of your future consumption would come from your existing investments, not from labor income or economic profits.

The Brady plan is silent on transition, so I will defer discussion of this issue (including a discussion of why the transition effect can occur). Because of the large existing base of capital, a tax on existing capital will substantially affect the overall operation of the tax, so it will be important to resolve the issue.

B. The Cash-Flow or Subtraction-Method VAT

An alternative way to tax consumption is to tax consumption purchases at the point of sale, a system known as a retail sales tax.\(^{21}\) If a retailer sells a widget to a consumer for $100, the consumer has $100 of consumption. We can simply have the retailer remit $20 of taxes to the government, thereby imposing a tax on the consumption of the widget. And although it would not be remotely obvious from thinking about a retail sales tax, since it is a tax on consumption just like a cash-flow tax is, it too is effectively a tax on labor income and economic profits, plus possibly existing capital depending on the transition rules.

The problem with retail sales taxes is that they are relatively easy to avoid: retailers simply sell goods under the counter for cash, sharing the tax savings with their customers. A VAT can be thought of as a retail sales tax designed to prevent fraud and to reduce the consequences of any fraud that remains. The way VATs do this is by collecting tax at each level of production.

To illustrate how a VAT works, we must know more about how the widget is produced. Suppose that our widget is produced in two stages. A manufacturer builds the widget using labor. Its labor costs are $50. The manufacturer then sells the widget to a retailer for $70.

\(^{21}\) Retail sales taxes, used in many states, tend to have narrow bases – for example they often exclude services – but retail sales taxes could, at least in theory, apply to the purchase of all consumption.
The retailer sells it to the customer for $100 and in doing so, incurs labor costs of $20. Table 1 summarizes these numbers.

<table>
<thead>
<tr>
<th>Assumptions</th>
<th>Manufacturer</th>
<th>Retailer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price</td>
<td>$0</td>
<td>$70</td>
</tr>
<tr>
<td>Labor cost</td>
<td>$50</td>
<td>$20</td>
</tr>
<tr>
<td>Sales price</td>
<td>$70</td>
<td>$100</td>
</tr>
<tr>
<td>Profit</td>
<td>$20</td>
<td>$10</td>
</tr>
</tbody>
</table>

A subtraction-method VAT is a tax on the cash flow at each stage in production, except there is no deduction for wages and financial flows are ignored. The retailer has a $100 inflow and a $70 outflow (not counting wages), so the retailer has a VAT base of $30. If the rate is 20%, the retailer owes $6 in tax.

The manufacturer has a $70 inflow and no non-wage, non-financial outflows, so it has a VAT base of $70 and owes taxes of $14. Together, the manufacturer and retailer owe $20, which is the same amount that would be owed under a retail sales tax. Therefore, a system that taxes the cash inflows of businesses and allows deductions for purchases of inputs from other businesses (in other words, a cash-flow system at the business level) is equivalent to a consumption tax. A VAT that measures cash flows, that is, a system that allows a deduction for purchases and an inclusion for sales, is called a “subtraction method” VAT. Table 2 summarizes the taxes imposed through such a system.

<table>
<thead>
<tr>
<th>Subtraction Method VAT</th>
<th>Manufacturer</th>
<th>Retailer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$70</td>
<td>$100</td>
</tr>
<tr>
<td>Less purchases</td>
<td>$0</td>
<td>$70</td>
</tr>
<tr>
<td>Net</td>
<td>$70</td>
<td>$30</td>
</tr>
<tr>
<td>Tax at 20%</td>
<td>$14</td>
<td>$6</td>
</tr>
<tr>
<td>Total tax collected</td>
<td>$20</td>
<td></td>
</tr>
</tbody>
</table>

The key difference between a retail sales tax and a VAT is that if a business does not participate in the system – it refuses to pay taxes
and does not claim deductions – the only tax that is lost is the tax at that level of production. For example, under a retail sales tax, if the retailer is a tax cheat and does not file tax returns, all $20 of taxes are foregone. In a VAT, the government still collects taxes paid at prior levels, in this case $14.

Note that the system ignores financial flows. We said nothing about how the retailer or manufacturer financed their businesses, how much stock or debt they had, and so forth. We simply ignored financial flows, which means, among other things that the businesses could not deduct their interest expense. With the exception of the consumption of financial services, discussed below, there is no need to consider financial flows when measuring consumption. Because the system only taxes real flows, not financial flows, it is known as an R-based tax. As we will see, consumption can also be measured by including financial flows through a system known as an R+F-based tax.

European VATs do not work exactly as described in the example. Rather than getting a deduction for the cost of their purchases, purchasers get a credit against tax for any tax paid by the seller, under a system known as a credit invoice VAT. As we know, however, credits and deductions are the same thing using different units. In a 20% tax, a $20 credit is the same as a $100 deduction. Both save you $20 in taxes. Going back to the example, in a credit invoice VAT, the retailer would have an inflow of $100 and owe a tax of $20 but would get a credit for the $14 of tax paid by the manufacturer, so it would owe $6, exactly as in the cash-flow system. The only difference is that instead of deducting $70, the retailer gets a credit of $14; different language to describe the same thing.

The reason European VATs use the credit invoice system is the invoices: the retailer gets an invoice from the manufacturer stating that the manufacturer paid $14 in VAT on the widget. The retailer can only claim a credit for the purchase of the widget if it gets the invoice. This generates an incentive for the retailer to demand that the manufacturer pay tax, and it creates a paper trail for audits. It also ensures that the system is what I have called “closed.”

Purchasers only get deductions or credits when sellers have paid a tax on the sale. Ensuring that the system is closed has important implications both for the scope

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22 Weisbach, Ironing Out the Flat Tax, supra note 5.
of the tax base and for enforcement.\textsuperscript{23} Subtraction method VATs could require invoices, but proposals for subtraction method VATs almost never do.

C. Destination v. Origin Basis: The Treatment of Cross-border Purchases and Sales

VATs around the world are, without exception, destination-based. In a destination-based system, exports are exempt from tax and imports are taxed.

In our example, under a destination-based system, if the retailer sells the widget in Canada, it would not have to include the $100 cash inflow. Because it does not count its $100 inflow, it has a net outflow for tax purposes of $70, so it would get a $14 rebate from the government. This rebate is known as a border adjustment and destination-based taxes are sometimes called “border adjustable” taxes. The border adjustment offsets prior taxes so that there is no net tax on the sale in Canada. This means that goods sold in foreign countries are exempt from U.S. tax.

In the other direction, goods produced in foreign countries and sold in the United States are subject to tax. For example, if the retailer bought the good from a Canadian manufacturer, it would not get a deduction for its $70 purchase price. When it sells the widget in the United States for $100, the retailer is taxed on the full amount, so it would owe $20 in tax. This means that the tax is the same on imported goods as goods produced in the United States. In both cases, the tax is $20 on a good that ultimately sells for $100.

A destination-based tax can be thought of as a tax on domestic consumption regardless of where goods are produced. If a good is produced domestically, there is a tax on the good only if it consumed domestically – border adjustments remove the tax if the good is exported. If a good is produced abroad, it is taxed if it is consumed domestically because border adjustments impose a tax when it is imported.

The alternative to a destination-based system is an origin-based system. In this system, domestic producers owe tax on the sale of their goods regardless of where the sale occurs. In the example, there would be $20 of tax on the manufacture and sale of the widget even if it is

\textsuperscript{23} For example, in a closed system, purchases from tax-exempts or other non-taxpayers are not deductible while in a system that is not closed – what I termed “open” – these purchases are deductible. The tax base is different in the two cases because in a closed system, value added by non-taxpayers is eventually taxed (unless provided directly to individuals for consumption) while in an open system it is not. The Brady plan is an open system.
sold in Canada. Goods produced abroad would not be taxed when sold here. This would mean that the retailer in our example would be able to deduct the $70 costs of the widget that it imports for sale here and pay tax only on the $30 value added in the United States.

An origin-based tax can be thought of as a tax on domestic production regardless of where the goods are sold. Goods produced domestically bear a tax even if sold abroad. Goods produced abroad do not bear a tax even if consumed domestically.

A common reaction to these systems (repeated in the Brady plan) is that the destination-based system is better for domestic producers. Under a destination-based system, both U.S. and foreign producers face the same tax when they sell goods in the United States. For sales abroad, the tax is removed allowing U.S. producers to compete with foreign producers.

With an origin-based tax, goods sold by U.S. producers in a foreign country still bear a U.S. tax. Foreign producers selling in their own country do not face a U.S. tax, seemingly giving them an advantage over U.S. producers. Similarly, foreign producers selling in the United States would not face a U.S. tax but competing U.S. producers would, again seeming to give foreign producers an advantage.

There is, however, a long line of literature showing that this initial reaction is incorrect. Rather than repeat the arguments in the literature, I refer readers to the many sources that explain it in detail.24 One intuition for the result is that in present value terms, domestic production (the base of an origin-based tax) and domestic consumption (the base of a destination-based tax) have to be equal. You can trade production today for consumption in the future (generating a trade surplus) or vice versa (generating a trade deficit) but in present value terms, trade has to balance. You can only consume what you have produced.

24 The literature on this issue is extensive, including, for example, Martin S. Feldstein & Paul R. Krugman, International trade effects of value-added taxation, in TAXATION IN THE GLOBAL ECONOMY 263–282 (1990). For a recent accessible discussion, see ALAN J. AUERBACH & DOUGLAS HOLTZ-EAKIN, THE ROLE OF BORDER ADJUSTMENTS IN INTERNATIONAL TAXATION, AMERICAN ACTION FORUM RESEARCH PAPER (2016). Note that the comparison in the text is between destination-based and origin-based consumption taxes. The U.S. currently has a source-based income tax. Eliminating the current source-based tax, as proposed in the Brady plan, would very likely affect location decisions.
Rather than through trade balance, the equivalence is usually explained in terms of price effects, which, with floating currencies, can be achieved by a change in the relative price of the currency. A destination-based tax increases demand abroad for U.S. goods, strengthening the dollar, which then offsets any apparent advantage for U.S. producers.\footnote{Michael Graetz gives the following illustration, taken from Al Warren: 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, the 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. product will retain $100 after payment of 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. will still sell for $110. Similarly, the U.S. product now looks less expensive than the Z product to country 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 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 products) 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 consumer’s 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 be exchanged for 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. Similarly, U.S. producers would be indifferent between selling in Z or domestically.} With a 20% tax rate, the dollar would increase by 25% so that an imported good that previously cost $100 now costs $80.
Currency effects, however, do not offset all of the differences between origin and destination-based taxes. In particular, to the extent that there are inframarginal returns, the two are not equal. Again, I will leave the details to others, but destination-based systems tax any economic profits U.S. consumers earn from investments abroad (even if made through a domestic multinational corporation) and exempt economic profits that foreign consumers earn in the United States. Origin-based taxes are the reverse: they tax U.S. economic profits of foreign producers and exempt foreign economic profits of U.S. producers.\textsuperscript{26}

The equivalence between destination and origin-based taxes (other than for economic profits) is an article of faith for economists, and, as far as I can tell, believed by nobody else. The Brady plan, for example, argues that border adjustments will help U.S. businesses compete with foreign businesses. Even if you believe that the destination and origin-based systems have the same economic effects, however, there may be good reasons to prefer one over the other because they have different administrative and compliance effects. In

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Taking into account the change in exchange rates brought about by the change in the 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. One of the U.S. products exchanges for one of the Z products in both the U.S. and country Z under both taxes, and the U.S. producer earns the same amount from a sale at home and a sale abroad under either tax.


\textsuperscript{26} One intuition for this result is to think of a destination-based system as a cash-flow system for outbound investment. The border adjustments acts like a deduction for flows out of the country and a tax for flows into the country. A cash flow tax will impose a present value tax for inframarginal returns received abroad because the present value of the tax on the inflow will exceed the tax rebate on the outflow. Origin-based taxes do not give the deduction on outflows and do not tax inflows so they do not tax inframarginal returns by U.S. consumers. The argument is reversed for inbound investment.

Although this paper focuses on implementation issues rather than revenue, distributional, or efficiency effects, it is worth noting that the two systems do not raise the same revenue if a nation imposes a consumption tax when it is either a net creditor or a net debtor. To the extent that a nation is a net debtor, it expects to export more in the future than it imports, which means that in present value terms, the origin base is larger than the destination base. In budgetary terms, which only look at a 10-year window and which do not use present values, however, a destination base may raise more money than an origin base, depending on the trade deficit or surplus during the budget window. For example, if the United States expects to run a trade deficit during the budget window, a destination-based tax will raise more revenue in that window.
particular, many prefer a destination-based system because it eliminates the problem of transfer pricing.

To illustrate why destination-based systems do not face transfer pricing problems, consider again our running example of a manufacturer and retailer but suppose, now, that the retailer is a foreign entity (so it does not bear U.S. tax). Under a destination-based tax, any foreign sales are excluded. Because the retailer is foreign, when the manufacturer sells to the retailer, the sale is not taxed. The price, therefore, has no effect on the manufacturer’s taxes. The manufacturer pays the same tax on the sale ($0) if the price is $0, the price is $70, or is any other value.

Under an origin-based tax, the manufacturer pays tax on its sale to the foreign retailer because sales abroad are taxed. The price, therefore, determines how much tax the manufacturer pays. It matters whether the price is $0 or the price is $70. If the manufacturer and retailer are not related, we can rely on the $70 price to be the true price. If the manufacturer and retailer are under common control, however, there may be an incentive to understate the price of the good when sold to the retailer to reduce U.S. taxation. If the price is $70, the manufacturer has a VAT base of $70 while if the price is $0, its base is $0. (The foreign retailer would have a correspondingly higher VAT base but it is not taxed by the United States because it is foreign.)

Therefore, origin-based systems require transfer pricing rules while destination-based systems do not. Eliminating transfer pricing disputes and the accompanying massive enforcement resources is a major advantage of a destination-based tax, and the core reason why many recent proposals have been destination-based.

D. The Flat Tax and the X-tax

Destination-based VATs are used throughout the developed world. We know how they work and how to implement them. If the United States were to adopt a destination-based VAT, there would be few new implementation problems. We could simply pick from the best practices used in other countries.

The problem with VATs, however, is that they are regressive. There are a number of different ways we can measure the progressivity of a tax system. The most common way is taxes paid relative to income: we look at the tax paid as a fraction of income at each level of income. VATs are regressive when measured this way because the rich consume a lower percentage of their income than the middle-class or the poor so that tax as a percentage of income goes down as income goes up. More generally, because VATs are imposed at the business level, they cannot easily be sensitive to the circumstances of individual
taxpayers, which means that there is no easy way to make a VAT progressive.

The so-called Flat Tax and the X-tax modify the VAT to reduce, and possibly eliminate, this problem. These systems allow business to deduct wages and salaries, and tax wages and salaries to individuals. Because individuals are taxed on their labor income, the tax rate can be based on each individual’s or family’s level of income (and other attributes such as mortgage and education payments, retirement savings, and charitable donations). They allow personalization of the tax and allow the tax to be progressive. (The Flat Tax, for reasons that are unclear other than to have a rhyming name, would limit the number of tax brackets to two. The X-tax allows the number of tax brackets to be whatever number is needed. Because it is the more general of the two, I will below refer to this system as the X-tax.)

Recall that a consumption tax is a tax on labor earnings and economic profits (and as discussed in Part IV.H., possibly existing capital on transition). If labor earnings under the X-tax are taxed at the individual level, the business tax is a tax only on economic profits and possibly existing capital on transition. That is, we can think of the X-tax as an individual-level wage tax and a business-level tax on economic profits and, possibly existing capital.

The usual structure of X-tax proposals is to set the business-level tax rate to be the same as the highest wage tax rate (which is not what the Brady plan does). For example, if the individual wage tax rates were 12%, 25%, and 33%, as in the Brady plan, the business tax rate would be set at 33%. The reason is that this eliminates the incentive for high wage earners to take their labor earnings out of the business as profits rather than salary.

To illustrate, consider the retailer in our running example and suppose that the owner is the only employee. The retailer has $30 of total proceeds and the owner/worker’s fair wages are $20. If both the retailer and the owner/worker are taxed at 20%, it does not matter whether the earnings are paid as salary or not. Either way, there is a 20% tax on $30. If, however, the tax rate on wages and salaries was 33%, any amounts paid as salary would face this higher rate while amounts treated as business profits would face only a 20% rate. There would be an incentive to avoid paying salaries, and directing the funds to workers in other ways, such as through dividends on shares that they own.
E. Destination-based X-tax

The original proposal for the X-tax was origin-based. The reason seems to be that the shift of the wage portion of the base from the business level to the individual level changes how the WTO classifies the tax and, therefore, the legality of using a border adjustment. As will be discussed below, under WTO law, it may be illegal to have border adjustments in an X-tax for reasons relating to how the tax is classified. WTO law only allows border adjustments for “indirect” taxes, which are taxes on businesses. Because the X-tax imposes the wage portion of the tax directly on individuals, it may be classified as “direct” tax, and, therefore, may not be border adjusted under the WTO. Given that destination and origin-based taxes have the same effect on new investment, WTO rules might seem to have no economic effect, requiring one approach and disallowing another, both of which end up in the same place. Therefore, given possible WTO problems, it seemed to make sense to make the X-tax origin-based.

As noted, however, origin-based taxes have transfer pricing problems not faced by destination-based taxes. Destination based systems will, as a result, be easier to administer. Moreover, as will be shown below, the distinction made by the WTO is non-economic. The X-tax base is the same as the VAT base, so it seems ridiculous to allow border adjustments only for a VAT. And many countries have VATs combined with wage subsidies, so the progressive portion of the wage tax that we find in an X-tax but not a VAT should not change the analysis. Why should the United States be forced by a treaty designed to promote trade into a tax system that is more difficult to administer and that has no trade advantages merely because it wants to make the tax progressive?

Based on these considerations, some believe that the WTO would not in fact hold that imposing border adjustments in an X-tax is illegal. While this may be wishful thinking – legal systems rarely feel a compulsion to follow economic logic – many believe that if the United States were to adopt a cash-flow system, it should be on a destination basis because of the substantial administrative advantages of using a destination base rather than an origin base.

Since the early 2000’s, a number of proposals have followed this logic. For example, the Bush tax reform commission studied a

27 For additional administrative problems raised by the Flat Tax, see Weisbach, Ironing Out the Flat Tax, supra note 5.
destination-based X-tax. Although they ultimately did not recommend this system – they favored a system much closer to the Brady plan – they included an extensive discussion of a destination-based X-tax, showing that it could be revenue and distributionally neutral. Moreover, they ultimately recommended a destination-based system very close to the Brady plan. Similarly a very large study of tax reform in the U.K., known as the Mirrlees Review carefully studied a destination-based X-tax, and the chapter on the design of corporate taxation recommended this system (although the Review as a whole recommended an origin-based system known as an ACE, which has effects but operates differently than the X-tax).

F. The Growth and Investment Tax Plan

The last step toward the Brady plan is the proposal put forth by the Bush Tax Reform Commission called the Growth and Investment Tax Plan. This plan is a destination-based X-tax with the addition of a flat 15% tax rate on interest, dividends, and capital gains at the individual level.

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28 THE PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, supra note 3. The first proposal for this system seems to be STEPHEN ROY BOND & MICHAEL DEVEREUX, CASH FLOW TAXES IN AN OPEN ECONOMY (2002), http://econpapers.repec.org/paper/cprceprdp/3401.htm (last visited Dec 22, 2016). Note that the terminology can get confusing because different taxes are often given the same label. In particular, many different systems are called a “destination-based cash-flow tax.” This description could include a cash-flow VAT (i.e., with no deduction for wages or salaries, ignoring cash flows on financial instruments), an X-tax (i.e., a cash-flow VAT with a deduction for wages and salaries) and what I will call an R+F cash flow tax.


30 THE PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, supra note 3.

31 As noted, the plan also includes a benefit for mortgage interest and the purchase of health care, retirement savings provisions, and a deduction for charitable donations. None of these are in the basic versions of the X-tax.
Although the reasons for this addition to the destination-based X-tax are not made explicit, it seems that the panel members were concerned about appearances. They showed in their study of the X-tax that, properly structured, the X-tax can be revenue and distributionally neutral. Nevertheless, even if it is distributionally neutral, it would still allow the very wealthy to pay few, if any, explicit taxes to the government. Someone who lived purely off an inheritance would receive no wage income and, therefore, would not have to remit any taxes. While such a person would bear taxes because taxes would be embedded in the price of goods that he purchased and because he may bear a large transition tax, many might view this result as unseemly, particularly in light of concerns about the growth of inequality.

As we will see when considering the implementation of the Brady plan, it will be difficult to make the combination of an X-tax and a flat rate tax on capital at the individual level work. A tax on capital income has to tax the current return to investments. Current law allows some deferral because it waits to impose tax until income has been realized, but it also has a large number of provisions designed to limit deferral.

One of the most important anti-deferral mechanisms in current law is the corporate income tax. If an individual buys stock, he is not taxed until dividends are paid or he sells the stock, creating the potential for deferral. The corporate income tax, however, taxes the current returns to the investment, thereby reducing or eliminating the deferral. If businesses are taxed on a cash-flow basis, they allow deferral by design: because businesses deduct the cost of investments, the returns to investment are not taxed. Keeping money in a business, therefore, gives indefinite deferral. The mere purchase of a share of stock becomes a tax shelter.

G. The Brady Plan

At this point, the connection to the Brady plan should be clear: the Brady plan is the Growth and Investment Tax Plan with minor modifications (plus, as was mentioned, there are some statements in the Brady plan which are inconsistent with this approach but it is not clear what to make of them). It is time, therefore, to consider the implementation of the Brady plan.

IV. ISSUES AND PROBLEMS WITH THE BRADY PLAN

The discussion above shows that the Brady plan is based on a long history of thought and research on consumption taxes. Even the purest of these systems has a number of problems, however. Moreover, parts of the Brady plan seem potentially inconsistent with
these systems, and most if not all of these inconsistencies generate yet additional problems. In the sections that follow, I discuss the eight most central implementation problems that I see in the Brady plan. There are likely many other issues that will also have to be resolved as the legislation moves forward.

A. Design of the Business Tax

As noted, there are a number of statements in the description of the business-level tax that seem inconsistent with the basic structure of an R-based cash-flow tax. If these statements are inadvertent, they should be fixed. If they are not inadvertent, for the most part they are bad choices and should be reconsidered.

**Inconsistent expensing**

There are a number of statements that indicate that the plan would not truly be a cash-flow tax. The two most prominent are (1) the explicit statement that purchases of land would not be expensed and (2) the statement that the LIFO inventory method would be retained.

In a cash-flow system, all non-financial outflows are deductible, including purchases of land and purchases of inventory. It makes no sense to deny deductions for purchase of land and of inventory while allowing a deduction for the purchase of other capital items. If some purchases are taxed on a cash-flow basis and others are taxed on a traditional income tax basis, the effective tax rate on different types of investments will be different. For example, if land is taxed on a traditional income tax basis but machines and buildings are taxed on a cash-flow basis, the effective tax rate on land will be higher than on machines or buildings. This will distort investment patterns and make the tax less efficient.

Moreover, even if there were a reason for introducing this distortion into the system, it would make the system more complex. One of the great virtues of a cash-flow system is its simplicity. Businesses do not need to use complex income tax accounting systems such as LIFO, FIFO, capitalization rules, or accrual concepts like economic performance. Instead, for tax purposes, businesses just deduct cash outlays and include cash inflows. Retaining income tax treatment for some investments means retaining most and possibly all of the income tax accounting rules, foregoing one of the major benefits of a cash-flow system. Moreover, it requires rules to distinguish investments in land from related investments: taxpayers making a joint

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32 Businesses, however, would likely have to continue to use income accounting for book purposes.
purchase of land and improvements have an incentive to allocate the purchase price to the improvements (while sellers would be indifferent).

Although the statements about inventory accounting and the treatment of land are explicit, in other parts of the plan, the corporate tax is described as a cash-flow tax. I cannot think of a reason for keeping land and inventory on a traditional income tax system while putting machines and other capital expenses on a cash-flow system. Therefore, I take these statements to be mistakes, and they should be fixed.

An alternative reading of the plan is that it is, like current law, a hybrid income-consumption tax system, only shifted more toward the consumption end of the spectrum. The plan might be read as allowing (very) accelerated depreciation and as making an attempt to equalize the treatment of debt and equity. The tax would, for the most part, be an income tax, and the implementation issues with a corporate income tax are well-known. Note, however, that if the plan is to keep the corporate tax as an income tax, it is extremely unlikely that the tax could be destination-based because it would almost surely be inconsistent with the WTO.

Given the various descriptions in the plan as a cash-flow tax and the centrality of border adjustments to the plan, in the remainder of the paper, I will assume that the plan would impose a cash-flow tax on corporations. If instead, the plan merely is an income tax with (very) accelerated depreciation for depreciable investments, most of current law would remain.

Inconsistent treatment of financial instruments

Separately, there are a number of statements in the plan that indicate that the business-tax portion of the system might not fully ignore financial flows. The draft plan states that net interest expense is not deductible and that any nondeductible interest expense may be carried forward to be used against interest income in a future year. That combined with nothing in the plan indicating that interest and other financial income, such as dividends, gains (and losses) on derivative financial instruments and gains from the sale of stock are exempt creates a strong inference that financial income is taxed. Moreover, it does not seem that financial income is taxed on a cash-

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My only guess as to the reason for the apparent treatment of land and inventory is that the drafters of the Brady plan viewed expensing as simply accelerated depreciation so that only purchases that were otherwise depreciable would get expensing. This is not the right way to view expensing in a cash-flow system. Instead, all non-financial cash flows should be deductible.
flow basis, so it seems that financial income is taxed under the usual income tax rules.

This approach generates a host of problems. Earnings on financial investments would be taxed on an income basis while earnings on physical or intangible investments are taxed on a consumption basis. For example, if you invest $100 in a machine that produces $110 in one year, the $10 return is effectively untaxed, as discussed above. If instead you lend the $100 to someone who invests it in the machine and who then pays you $10 of interest in one year, the $10 is taxed.\textsuperscript{34} The tax base is income when transactions are financed through lending, and the tax base is cash-flow when done directly. There seems to be no reason for disparity, and it may significantly distort how investments are structured.

Denying deductions for net interest expense while taxing net interest income may also generate problems, particularly for firms that have loans between subsidiaries. If internal capital structures are set up so that interest income exceeds interest expense, the firm would have a tax on purely internal flows. For example, suppose a parent firm is capitalized with $50 of equity and $50 of debt, with the debt instrument paying a 10% rate of return. The parent capitalizes its subsidiary with, say, $30 of equity and $70 of debt for good business reasons. If the subsidiary’s debt also pays an interest rate of 10%, the parent would have, $2 more interest income than interest expense, and would owe tax on this amount. Consolidated filing may reduce this problem somewhat, but not all capital structures allow consolidation of all subsidiaries, so the problem will inevitably remain. Under current law, corporations are allowed dividends received deduction to eliminate this cascading. There is no indication in the plan, however, that there would be a corresponding interest received deduction.

Moreover, denying deductions for interest expense but not expenses and losses on other financial instruments creates administrative complexity and incentives to use other financial instruments rather than debt. For example, lease payments will be deductible but equivalent interest payments will not be, creating incentives to lease rather than to own. Similar problems will arise with respect to swaps, futures and forward contracts which have embedded time-value of money aspects. To some extent current law faces this

\textsuperscript{34} Note that the borrower’s investment in the machine would be taxed on a cash-flow, so it is effectively untaxed. The borrower would also be denied a deduction for its interest expense. The borrower, in present value terms, therefore, bears no tax and has no deductible expenses. The only net tax on the transaction is the lender’s interest income.
problem, and the response is a host of complex rules designed to classify payments as interest or not. All of these rules and likely many more would be needed under the approach of the Brady plan because the disparity between interest expense and other expenses will be much more significant than under current law.

Finally, the taxation of financial flows on an income tax basis is incredibly complex. The current rules for taxing financial instruments are among the most complex and difficult to understand sets of rules in current law. These rules would have to be retained if financial instruments continue to be taxed on an income-tax basis.

The plan should take an approach to financial flows that is consistent with the consumption tax approach otherwise used in the plan. The standard approach in cash-flow systems is to ignore financial flows. This generates some problems with respect to the taxation of banks and other financial institutions but otherwise works reasonably well in a large number of tax systems used throughout the world. (I defer the discussion of the taxation of financial institutions to Part IV.D.)

Pass-throughs

The Brady plan would retain the pass-through regimes of current law but tax active income of pass-throughs at a maximum rate of 25%. It is a mistake to retain the pass-through regimes of current law and, with perhaps an exception for small, sole proprietorships, they should be repealed. Instead, all businesses should be taxed the same way. Doing so reduces economic distortions and, simultaneously, would simplify the law.

To see why, compare the taxation under the Brady plan of equivalent investments made, alternatively, through a corporation and through a partnership. Suppose that an individual has $100 and can purchase a machine or other asset that costs $100 and returns $110 in one year. If the individual makes the investment through a corporation, the corporation deducts the $100 and includes the $110 and pays no present value tax. When the $110 is distributed, the owner has a $10 dividend and a $100 return of capital, and pays a $1.65 tax on the dividend.

Suppose instead that the individual makes the same investment through a partnership. In this case, the cash flows are attributed to the individual via the normal partnership allocation rules. The individual

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35 See Part IV.E. for a discussion of the determination of which portion of a distribution is a dividend and which is a return of capital when corporations are taxed under a cash-flow system.
deducts and includes the $100 expense and $110 return at a 25% rate and bears no present value tax. There is no separate tax on distributions from the partnership.

The net result is that the Brady plan would retain the current law system in which investments in corporations are taxed at a higher rate than identical investments in partnerships and other pass-through entities. It creates an incentive to avoid using the corporate form.

That current law favors partnerships over corporations is a flaw not a feature to be retained. The distortions in investment patterns because of the preference for partnerships over corporations in current law is one of the reasons for the numerous proposals for corporate integration. Among other things, these proposals seek to reduce the distinction between the taxation of partnership investments and corporate investments under our current income tax. The benefits of reducing the differences in taxation between different business entities would similarly arise under the Brady plan.

Most corporate integration proposals, however, would retain the current system of having separate regimes for partnerships and corporations rather than unifying them in a single business tax regime. Although often not clear exactly why this approach is favored, it seems to be that the partnership regime is thought to be superior in theory but too complex to apply in the large, publicly traded corporation context. The partnership system is superior because it taxes partnership income at the owner’s rates while even the most sophisticated corporate integration systems can only approximate this.

With the exception of inframarginal returns, the pass-through system under the Brady plan does not achieve this goal (and even for inframarginal returns, it does not get it exactly right). Regardless of the investor’s marginal tax rate on capital income, partnership flows (other than inframarginal returns) are taxed at a zero rate while other capital income of the owner is taxed at a positive rate. A pass-through regime under the Brady plan fails the basic reason for having a pass through regime.


37 Inframarginal returns of a partnership will be taxed at the lesser of the partner’s rate and 25%. For partners whose tax rate is below 25% (such as tax-exempt investors), the partnership regime taxes them at that rate. For partners whose rate is above 25%, the partnership regime does not tax inframarginal returns at their tax rate.
At the same time that they fail to achieve their only plausible economic goal, pass-through regimes introduce significant complexity. Retaining the pass-through system means retaining the baroque rules of subchapter K, the rules for subchapter S, and adding additional rules to distinguish active earnings of a pass-through (eligible for the 25% rate) and passive earnings of a pass-through (not eligible for the 25% rate).

The solution is to repeal the pass-through regimes and to have a business tax regime which applies to all business operations. All business returns would be taxed the same way: normal returns would be taxed at a 0% rate at the business level and the shareholder’s rate when distributed; inframarginal returns would be taxed at a 20% rate and the shareholder’s rate when distributed. There would be no need for the complex partnership tax rules or for other types of separate systems.\footnote{The only argument I can think of for retaining the partnership and other pass-through regimes (other than for small, sole proprietorships) is to tax inframarginal returns of low-bracket investors like tax-exempt entities, at a low rate. This does not seem compelling because these returns are, by definition, above-market returns. Moreover, even if it were a desirable goal, it would have to be weighed against the considerations in the text.}

The only exception is that it may be desirable to have a simple pass-through system for small, informal businesses such as sole proprietorships. If I am otherwise a wage earner but cut some lawns on the side for extra money, at what point does my lawn mowing business have to be treated as a separate business? A simplified regime for small, closely-held businesses (i.e., one owner or maybe family ownership) would allow small business owners to report earnings on their personal return rather than having to file a separate return.

\textit{Losses}

The Brady plan allows net operating losses to be carried forward with interest. If the interest rate used for loss carryforwards is equal to the market rate, this system will have the same present value effect as refundability, but perhaps with a lower potential for fraud.

One problem with this approach is that businesses that consistently have tax losses (but have economic gains) will not be able to use their losses, possibly indefinitely. For example, corporations that produce in the United States but sell abroad will consistently have tax losses because foreign sales are not taxed but their production expenses are deductible. They can be wildly profitable but still have legitimate tax losses under a destination-based system.
To illustrate, consider the retailer in our running example. It purchases the widget for $70, incurs $20 of labor costs, and sells the widget for $100, making a $10 profit. Suppose that it sells the widget in Canada. Because the sale is foreign, the $100 sales proceeds would not be taxed. The retailer would have a $70 deductible expense for the widget, and a $20 wage deduction, but no income. It would have a $90 loss that it cannot use. If its business model is to sell widgets in Canada, it will never have taxable receipts to use against this loss.

VATs are typically refundable, which means that if a corporation has net losses, the government makes a cash payment to the corporation equal to the tax rate multiplied by the loss (20% of $90 or $18 in our example). VATs can do this in part because they use an invoice system to track tax payments. The invoice system makes it more difficult to claim a loss without actually incurring one because the taxpayers cannot claim credits (the equivalent of a deduction in a cash-flow system) unless they have an invoice showing taxes were paid by their suppliers. That invoice allows the government to audit the suppliers. Fraud is not impossible in this system – there is a business of creating fraudulent invoices – but it is more difficult.

X-tax type plans, including the Brady plan, tend not to use the invoice system used in VATs which means that refundability is more difficult to administer. The likelihood of fraud may be too high to allow refunds for losses.40

A recent Treasury study tried to estimate the extent to which firms in a cash flow tax would have losses that they cannot use for long periods of time.41 They looked at firms in the ten-year period from 2004-2013. Those firms under the income tax had unused losses equal to 18% of the corporate base. (The percentage is high because the period includes the Great Recession.) Had those firms been taxed during the same period under a destination-based cash-flow tax, unused losses would have been approximately 24% of tax base. Unused losses go up by about one-third.

To the extent that losses cannot be used, the tax system will distort corporate ownership patterns, creating incentives for non-economic conglomeration. That is, combining an exporting (or other loss producing business) with a business that has net receipts will allow

39 Assuming the treatment of inventory purchases is fixed.
40 For example, CARROLL AND VIARD, supra note 16, at 78–80, argue that without invoices, an X-tax should not allow refunds.
41 Patel & McClelland, supra note 4.
the losses to be used against those receipts. Profit-making businesses with large, unused tax losses will become takeover targets.

One possible, although limited change that might reduce the problem is to allow losses to be carried back as well as forward. Another is to expand the rules for consolidation, by, for example, allowing firms to consolidate with a greater than 50% ownership interest rather than an 80% interest. Broader consolidation will make it easier for companies generating gains to consolidate with companies generating losses so that the losses can be used. Yet another is to allow losses to be used against payroll tax liability. If these changes are insufficient and there are a substantial number of businesses that consistently generate losses, an invoice system like that used in credit-invoice VATs should be considered so that losses can be refunded.

B. Tax Rates

Tax rates are of central importance in any tax system. They effect the total revenue raised, the distributional and efficiency effects of the tax system, and tax administration. Estimating the total revenue raised and the distributional impacts requires a large model, and I leave that to others. I will focus here on the efficiency considerations for setting the corporate rate and how the corporate rate and individual tax rates relate to one other.

A headline of the Brady plan is that the corporate rate is reduced from 35% to 20%. Lowering the corporate tax rate is thought to be desirable because the U.S. corporate rate is among the highest in the world. U.S. businesses are thought to be at a disadvantage relative to competitors due to this rate, and the recent spate of inversions is possibly in response to the high U.S. corporate tax rate. There is broad support for lowering the corporate tax rate, and the Brady plan fulfills this need, in spades.

One of the reasons for adopting a destination-based cash-flow consumption tax, however, is that it eliminates the need to lower corporate tax rates in response to international competition. The reason is that the tax base is domestic consumption. The tax rate does not affect the location of production, where corporations make their home, or where profits are located, because regardless of these choices, the tax is the same. It depends only on where consumption takes place. The central reason for a lower corporate tax rate is solved in the Brady

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42 CARROLL AND VIARD, supra note 16, at 79.
43 Invoice systems have a number of other important features that are explored in Weisbach, Ironing Out the Flat Tax, supra note 5.
44 For additional detail, see AUERBACH AND DEVEREUX, supra note 29.
plan by structural changes. There is, therefore, no reason to lower the tax rate to prevent corporations from relocating or because U.S. corporations face international competition from lower-taxed companies.\footnote{Because the corporate tax applies to domestic consumption, it could affect the location of consumption. The effects, however, will likely be very small. In particular, there may be an incentive to purchase and consume mobile and expensive items such as yachts and planes abroad to avoid a high U.S. tax, but it is not clear we should want to lower tax rates for all purchases because of these items.}

Another, independent, reason for lowering corporate tax rates is to encourage investment. Leaving aside international competitiveness (i.e., suppose the United States were a closed economy so that only domestic investment mattered), high tax rates on corporate income may make many otherwise profitable investments unwise. Lowering the corporate income tax rate improves the efficiency of corporate investments.

While this argument might be important in an income tax, it does not apply to a consumption tax. The tax rate on marginal investment is zero in a cash-flow system. There is, therefore, no reason to lower the rate to promote new investment.

Rather than setting the corporate rate based on competitiveness or investment considerations, there are three much more modest efficiency considerations that need to be taken into account when setting the corporate rate. The first is that a lower rate will reduce the size of the required currency price adjustments and the costs to firms if the adjustments are not complete and quick. That is, a low corporate rate might alleviate the concerns many importing firms have about the required currency price adjustments.

Second, and offsetting this, we may want a higher rate on economic profits. Taxes on economic profits are to a great extent non-distortive and, in some models, desirable. Third, the tax rate affects the size of the transition tax, if any. Although the effects depend on the transition rules, in general, a higher tax rate means a higher tax on existing capital on transition.

Aside from these economic considerations, there are administrative reasons for setting the rate because of how it interacts with the tax on labor income and creates incentives to recharacterize income. In a pure X-tax, the corporate rate is normally proposed to be set equal to the highest tax rate on labor income. If the corporate rate is lower than the tax rate on labor earnings, there is an incentive to pay low salaries and to take the money out as corporate earnings. Setting
the corporate tax rate equal to the marginal rate on labor income eliminates the benefit of recharacterizing wages as corporate earnings.

Because the Brady plan has the additional tax on dividend income, however, equalizing the rates may no longer be desirable for preventing recharacterization of earnings. Instead, setting the corporate rate below the highest wage rate may be the right strategy. In particular, (1) conditional on deciding that we want a tax on dividends and other capital income at half of the rate applicable to wages and salaries, and (2) given that the corporate tax rate itself has few economic effects (as just argued), then (3) we might want to set the corporate rate to eliminate the incentive to recharacterize earnings as either salary or as dividends, which means (4) because of the tax on dividends, the corporate rate that achieves this goal will be below the tax rate on wages and salaries.

To illustrate, suppose that the Brady plan rate structure followed the standard X-tax approach and set the tax rate on corporate cash flow equal to the highest marginal tax rate on wages: the wage rate and corporate tax rate are both 33% and the tax rate on dividends is half of that or 16.5%. Suppose that a worker-owned corporation has a $100 receipt which it wants to distribute. Because the worker and the owner are the same, the money can equally be distributed as salary or as a dividend.

If the corporation pays the $100 as salary, the owner pays $33 in tax, leaving him with $67. If it pays the money as a dividend, the corporation would owe $33 in tax and the owner would pay an additional $11.06 in dividend taxes for a total of $44.06 in taxes, leaving the owner with $54.04, which is less than if the money were paid as salary. There would be an incentive to pay out earnings as salary.

A 20% corporate rate, as in the Brady plan, eliminates this incentive. If the corporation were to pay out the $100 as earnings, it would owe $20 in tax and the owner would pay an additional $13.20 in tax due to the 16.5% rate on dividends, leaving him with $66.80, which is effectively the same as if the earnings were paid out as salary. The relative rates in the Brady plan, therefore, are set consistently with the goal of eliminating the incentive to recharacterize earnings.

The major problem with the relative tax rates in the Brady plan is the special cap on tax rates for pass-through entities. As argued above, the best approach would be to eliminate the pass-through regime, but if it is to be retained, the tax rate cap should be eliminated. The reason is that the tax rate cap for pass-throughs creates obvious avoidance opportunities (and has no efficiency benefits).
In particular, the tax rate cap for pass-through income creates an incentive to recharacterize wage and salary income as pass-through income. Owners of pass-through entities could do so by paying a below-market salary (taxed at 33%) and increasing the entity’s earnings (taxed at 25%). Moreover, individuals who work for corporations could form pass-through entities which provide services to their employers in exchange for fees rather than having their employers pay them wages or salaries. To the extent the fees can be characterized as pass-through income rather than wages or salaries, they will be taxed at a 25% rate rather than 33% rate. To prevent this avoidance, the plan would require pass-through entities to pay reasonable compensation but this rule may be difficult to enforce.

Abolishing the special rate will have few if any effects on investment but will eliminate incentive to recharacterize cash flows. If both pass-through earnings and salary are taxed at a 33% rate, it will not matter whether a cash flow is characterized as earnings or salary. There would be no need for the reasonable compensation rule and no need to incur the expense of futilely attempting to enforce it.

C. International Issues

International taxation has the potential to be far simpler under a destination-based consumption tax than under an income tax. The tax base under a destination-based consumption is domestic consumption. Although not always straightforward, this concept is relatively well understood and has economic meaning. It can be identified by the physical location of the individual engaging in the consumption.

The tax base in an income tax is either worldwide income, income earned in a given territory, or a mix of the two. The U.S. system, for example, might loosely be characterized as based on worldwide passive income and repatriated worldwide active income. The location of income (and related expenses), however, is not well defined. There is no underlying economic reality. As a result, the rules can be manipulated both through actual transactions and through relabeling items. Capital is highly mobile and can be packaged in an almost infinite variety of investment vehicles to exploit the rules. The rules are then made more complex to combat the avoidance, leading to yet additional more sophisticated avoidance. Moreover, if different countries have different rules, taxpayers can take advantage of the differences.

Even if we could define the location of income and even if countries agreed on the definition, the tax base has to be coordinated with other countries who may also claim to tax those same returns. For
example, both the location where production takes place, the source country, and the location where the owner lives, the residence country, may want to tax the same income.

The end result of all this is a Byzantine tax system and very wealthy tax planners. Although it is surely the case that our current tax rules for international income can be improved, I do not think that any set of rules within an income tax would be simple and effective. The underlying concepts are ill-defined, and mobile capital makes it easy to exploit any problems.

One of the main benefits of the Brady plan is its potential to simplify the international tax rules. Nevertheless, the international tax aspects of the plan, particularly border adjustments, have more attention than almost any other aspect. Below I examine the problem of border adjustments and then turn to other international tax issues.

Border adjustments

Recall that the Brady plan includes border adjustments. Exports are not taxed, which means that an exporter will have domestic costs but no taxable cash flow on its sales, generating a net loss. In our running example, if the retailer purchases the good for $70 and sells it abroad for $100, it does not include the $100 but may deduct the $70, generating $14 of tax savings. This $14 of tax savings is the border adjustment.

Imports are not deductible. Importers will have taxable receipts when they sell their imports in the United States but will not have deductible costs, which means that the full value of goods when imported will be taxed. If the retailer imported the good for $70 and sold it in the United States for $100, it would not be able to deduct the $70 but would be taxed on the $100. For the moment, leaving aside the wage deduction and wage tax (which offset) the importer would owe $20, consisting of the $6 tax on the value it added in the United States and the $14 tax on the value of the good when imported. The $14 tax on import is the border adjustment on import. That is border adjustments are the $14 rebate on export for costs incurred in the United States and the $14 tax on import for value added abroad.

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46 Note, however, that as discussed in Part IV.A., the Brady plan seems to retain many elements of an income tax (possibly inadvertently). If these elements are part of the final legislation, many of the current law rules for taxation of international income would also have to be retained. The vast simplification of international tax rules that comes with a consumption base requires consistent use of a consumption base.
As noted, economists believe that in equilibrium, a destination-based system (i.e., a system with border adjustments) and an origin-based system (one without border adjustments) are equivalent except for how they tax inframarginal returns and on transition. As a result, notwithstanding much of the rhetoric surrounding border adjustments, a decision to have border adjustments should be made based on administrative considerations rather than a belief that one system or the other promotes U.S. businesses relative to foreign businesses.\footnote{If the United States is a net importer during the 10-year budget window, as is expected, border adjustments will be scored as raising revenue. Although I have not seen any official revenue estimates, I understand that this revenue is being used to pay for other aspects of the plan. Note, however, that to the extent that border adjustments are imposed at a time when the United States has a trade deficit, they lose rather than raise money in present value terms. Any claim that border adjustments raise money is due to an artifact in the scoring rules.}

To understand the administrative considerations, I list below the benefits and costs of having border adjustments. After going through the costs and benefits, I provide an overall evaluation.

The key benefit to border adjustments is that they reduce or even eliminate the transfer pricing problems of current law and that an origin-based consumption tax would face. If the manufacturer in our running example sells the widget to a foreign retailer in an origin-based system, the sales price determines how much tax the manufacturer owes. If the manufacturer sells the widget to the retailer for $50 (when its fair market value was $70), it eliminates $20 from its tax base. If the manufacturer and the retailer are commonly owned, there is no economic cost to lowering the price, generating the transfer pricing problem. With a destination-based system, the sale to the foreign retailer is not taxed regardless of the price, so there is no transfer pricing problem. A similar logic holds for imports: in an origin-based system, raising the price of an import reduces the U.S. tax base while in a destination-based system, it has no effect.

Eliminating transfer pricing problems is a substantial benefit. Recent estimates are that by 2012, the United States was losing between $77 and $110 billion annually due to transfer pricing manipulation.\footnote{Kimberly A. Clausing, The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond, 69 N.Y.U. L. REV. 905, 905-34 (2016).} This is a large sum by any measure. Moreover, it does not include the planning costs, such as paying lawyers, accountants, and bankers, and the economic distortions, such as the costs of relocating capital or individuals to increase the likelihood that transfer prices will be respected.
A second potential benefit of border adjustments is that they eliminate the incentives seen in origin-based systems for tax competition. In particular, in an origin-based system, countries have an incentive to lower tax rates to attract businesses that have mobile, source-based, inframarginal returns. This incentive goes away with a destination-based tax because the location of production has no effect on the level of the tax.

There are three key costs of a destination-based system. The first, which is unique to an X-tax structure like the Brady plan, is that border adjustments under such a structure may be contrary to WTO law. The problem can be thought of as one of substance versus form. If the income tax elements of the corporate tax discussed above, such as the non-deductibility of land and inventory are eliminated, the substance of the Brady plan with border adjustments is entirely consistent with WTO law. It is effectively the same as destination-based tax systems used throughout the world. The form, however, may be inconsistent with WTO law. The legal question is whether a WTO panel would follow the substance or the form of the law.

The “form” problem is that under the WTO Subsidies and Countervailing Measures Agreement, a tax can be border adjustable only if it is an “indirect” tax and not if it is a “direct” tax. A direct tax is a tax on “wages, profits, interests, rents, royalties, and all other forms of income.” An indirect tax includes a VAT and all taxes other than direct tax. Moreover, border adjustments for an indirect tax are allowed only if they do not exceed the amount of indirect tax levied on like products when sold for domestic consumption. I interpret this latter requirement as a requirement that border adjustments are accurate: rebates on exports cannot exceed previously imposed taxes and taxes on imports cannot exceed taxes that would be imposed domestically.

The Brady plan and similar plans like the X-tax, look like a VAT, which is an indirect tax, except that they have a deduction for wages at the business level and tax wages to individuals. The question is whether this treatment of wages makes the Brady plan a direct tax. There seems to be little or no jurisprudence giving further meaning to these terms, and there are no tax systems like the Brady plan or the X-tax to use as a comparison. Many commentators, however, believe that the best reading of these terms is that the Brady plan would be a direct tax, ineligible for border adjustments.

49 If these elements are retained, it is hard to see how border adjustments would be consistent with the WTO.
One reason why commentators believe that the Brady plan would be a direct tax is that because of the wage deduction, border adjustments would be inaccurate. They could exceed the indirect tax levied on like products when sold domestically. Although the accuracy requirement is distinct from the “indirect” requirement, the two are likely related: the inaccuracy of the border adjustments arises because the tax is not purely at the business level.

To illustrate why border adjustments would be inaccurate, consider our retailer who sells the widget for $100 to a foreign consumer. The retailer deducts $70 and gets a rebate of $14. The manufacturer that sold the good to the retailer, however, has a tax base of only $20: it has $70 of receipts and $50 of labor costs. It pays a tax of $4. The $50 of labor costs are taxed to the wage earners. The wage earners, however, do not necessarily pay $10 in tax. Depending on their rates, they may pay more than that or less. If they pay less, the retailer’s border adjustment of $14 exceeds the taxes paid at prior levels of production. Moreover, because only indirect taxes count when computing accuracy, and because the wage tax is not an indirect tax, there has only been a $4 indirect tax on the good even though the rebate is $14, clearly violating the accuracy requirement.

This argument, however, is purely formal rather than substantive because we can just change the labels without changing the tax that is levied and make the system unquestionably legal. Suppose that instead of giving businesses a deduction for wages and salaries and taxing workers on their wages and salaries, we instead imposed a normal VAT, with no deduction for wages. Wage income would then be taxed at the flat VAT rate rather than the desired progressive rates. This VAT could clearly be border adjustable because it is an indirect tax and the border adjustment would be accurate.

To make the taxation of wage income progressive, we can add a tax credit for low-income workers which offsets the VAT in the desired amounts, and, for high-income workers (if their marginal tax rate on wages exceeds the VAT rate), impose a tax on those wages to make up the difference. For example, if the VAT rate is 20% and we want high-wage earners to pay 33%, we could impose a tax rate of 16.25% on their wages. The corporation would pay them $80 after paying the 20% tax. A 16.25% tax on the $80 of wages would be $13, so the total tax would be $33, or 33% as desired. Similarly, we could offer low-wage workers a credit, such as an expanded earned income tax credit or an offset to payroll taxes, to give them the required combined tax rate. This labor income tax/credit system would be
entirely separate from the VAT. It would, therefore, not affect the border-adjustability of the VAT. It is simply a separate, progressive wage tax.

This is how European systems work. They have flat rate, border-adjustable VATs and separate progressive income taxes. Under the X-tax and the Brady plan, the two systems are combined because of the wage deduction at the business level and matching inclusion to workers. It is only because the two system are combined that there is an issue of WTO legality, but this is a mere formality rather than a substantive difference.

The question, therefore, is whether the substance of the Brady plan should prevail or its form. I am not sufficiently expert in WTO jurisprudence to have a view on the likelihood of success. Some authors conclude that the border adjustments would not be allowed under the WTO rules, but these authors rely on the formal structure of the plan. To get a sense of the risks, it would be nice to have a better understanding of whether, and when, the WTO is able to look at the substance of a law rather than its formal rules. There is nothing in the Brady plan that violates the substantive goals of the WTO.

Rather than confronting the WTO and having to make legal arguments about substance versus form, we could simply adopt the VAT/wage tax structure suggested above. For reasons that are unclear to me, however, actually adopting a VAT seems to be politically untenable even though, a just demonstrated, there is no economic difference between what is going proposed in the Brady plan and the modification just described.

An alternative is to modify the labels in the Brady plan to increase the likelihood of compliance while not formally adopting a VAT. For example, we could retain the current structure but require wage withholding at the corporate rate, rather than setting wage withholding based on each individual’s tax rate. In our example, if wage withholding were mandatory and always at a 20% rate, the manufacturer in the example would have remitted $14 in tax, so the retailer’s rebate will match tax remittance at prior levels of production. In effect, corporations would be required to remit as taxes the same amount that they would remit under a VAT, without exception. The

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50 Avi-Yonah & Clausing, supra note 4.
only difference is that a portion of the remittance is called a withholding tax rather than a corporate tax.\textsuperscript{51}

The second cost of border adjustments is the cost of uncertainty about currency adjustments. Recall that the switch from current law to a destination-based system requires the dollar to appreciate. Consider for example, an importer who currently buys goods from abroad for $95 and sells them domestically for $100, making a $5 profit. Under current law, it can offset the $95 of costs against its $100 receipts and pay tax on the net. If the tax rate is 20%, the importer is left with $4. With a destination-based system, it would not be able to deduct the $95 cost of import and it would owe $20 of tax on its $100 receipt. If nothing changed, the tax would greatly exceed its profits.

The expectation is that the dollar would appreciate. With a 20% tax rate, the dollar would appreciate by 25%, so that the importer could purchase the good for $76. If this happens, the importer would have $100 in receipts, pay a $20 tax and be left with a $4 after-tax profit. If this happens completely and quickly, nobody would be worse for the wear. The concern is that this will not happen quickly enough or completely. Importers are reluctant to rely on economic models when their entire business is at stake.

We have more than economic models, however, to give us confidence that the currency adjustments would, in fact, occur. Every VAT in the world relies on these currency adjustments. If they did not occur, importers in countries with VATs would face exactly the same problem that importers are worried about with the Brady plan. There are good reasons to be confident in the currency adjustments.

The real issue is transition. If the adjustments are slow or uneven, importers could be hurt. While the currency market is deep and liquid, so that one would expect the overall adjustments to be fast, some countries have their currencies pegged to the dollar or attempt to manage their currencies relative to the dollar. These countries would have to repeg or change their dollar targets. This might not happen

\textsuperscript{51} One cost of this approach is that withholding will be too high for low-income workers. To the extent these workers may be cash constrained, withholding at too high a rate may not be viable. Fixing this problem could be done by reducing withholding for payroll taxes or allowing an advance rebate implemented through debit cards. Michael Graetz considered both in his tax proposal. \textsc{Michael J. Graetz, 100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States} (2008).
Moreover, oil is traded in dollars, so currency adjustments will not affect the relative price of oil.

Because I view the problem of currency adjustments as one of transition, I discuss mechanisms to ease the transition in Part IV.H., where I discuss transition issues more generally. Note, however, that the risk of a rocky transition is a substantial cost of border adjustments. Incomplete or slow currency adjustments would be disruptive.

The third problem with border adjustments is enforcement. VATs have experienced two enforcement problems with their border adjustments. One is fake exports used to obtain tax rebates. The Brady plan is not refundable, unlike most VATs, which reduces this problem. A second problem is avoidance of the tax on import. This is a particular problem for intangibles such as purely electronic goods sold over the internet (e.g., software, videos, and computer games) and services provided from abroad (e.g., accounting or legal services provided remotely). To tax these items, we would need to impose a 20% excise tax on their purchase. Collecting such a tax may be difficult, and evasion levels may be high. One central problem with collecting an excise tax on import is that remote sellers do not have a permanent establishment in the United States, so imposing the tax on sellers may not be feasible. Imposing the tax on purchasers, which is what states try to do, ineffectively, with use taxes, would also not be simple.

One can weigh these costs and benefits differently. For example, the weight given to the WTO problems may depend on your reading of WTO law, views on the consequences of an adverse ruling, and the feasibility of modifying the plan to reduce the risk of an adverse ruling. Importers naturally heavily weigh the risk of slow or incomplete currency adjustments.

My overall view, which I hold weakly rather than strongly, is that I believe it is worth having border adjustments. The WTO problem and currency adjustments are one-time problems – serious ones to be sure – that with careful management can likely be overcome. Relabeling taxes can reduce the formal problem with compliance with the WTO without changing the substance of the tax law. Transition rules can reduce the risk of slow or incomplete currency adjustments. Transfer pricing is a permanent problem. I would rather try to get over

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52 Perhaps one should not underestimate the ability of people or countries to be irrational, but it is hard to see a reason for not repegging or retargeting. Moreover, failing to repeg or retarget would impose tremendous economic pressure on these countries.
the one-time problems to fix a serious and growing problem that will last indefinitely.

**Other international tax issues: treaties and creditability**

Countries that impose world-wide taxation on domestic companies typically allow the companies to claim a foreign tax credit for income taxes paid abroad. Credits are restricted to income taxes, which means that taxed paid under the Brady plan may not be creditable. Some have suggested that this may be a problem.

It is not clear, however, how big the problem would be because the net present value tax in a cash-flow system is zero. The initial reduction in credits when an investment is expensed exactly offsets the increase in credit from the U.S. tax on the return. There would be no need for a crediting system because there is no net tax.

Separately, the business portion of the Brady plan might not qualify as an income tax under our existing network of treaties because the base is consumption. VATs, for example, do not quality as income taxes for treaty purposes.

Treaties are important to U.S. businesses investing abroad because they provide relief from foreign withholding taxes, scale back the tax reach of foreign countries, and prevent discriminatory treatment of foreign investment. Foreign businesses, in return, receive similar benefits when investing in the United States.

The question is whether foreign nations will find it in their self-interest to continue their treaty relationships under the Brady plan. Because it eliminates U.S. source-based taxation, the Brady plan may, by statute, give foreign investors many of the benefits they currently receive by treaty. As a result, treaty partners may not see any need to give up any of their source tax revenues, and, therefore, not see any need to continue their treaties with the United States.

Foreign nations will have to make the determination of whether they wish to continue their treaty relationships with the United States. In the meantime, the United States should continue to treat the treaties as applying. Moreover, the plan should maintain the withholding tax on dividends, so that if a foreign nation terminates their treaty with the United States, the full withholding tax would apply, thereby creating an incentive for foreign nations to continue to treat the treaty as binding. Because of treaty nondiscrimination provisions, the United States may not be allowed to impose a withholding tax with treaty countries. If a country were to terminate its treaty with the United
States, the withholding tax would kick in, creating an incentive not to terminate the treaty.53

D. Financial Flows

The plan as written distinguishes between interest expense and payments on real assets. If it were fully R-based, it would distinguish financial flows from real flows. Regardless of which approach is taken, making these distinctions will generate a number of problems.54

Interest v. other payments

Suppose that the plan only disallowed net interest deductions but otherwise taxed financial flows, which is how the current draft reads.55 The plan would then need rules to determine when a flow is “interest” instead of something else. This problem exists under current law but would be worse under the Brady plan because the consequences of being labeled interest would be more severe.

To illustrate, suppose that a business wanted to borrow $100 at a 10% interest rate for one year. If it used a financial instrument formally labeled debt to borrow the $100, the $10 of interest that it pays would be non-deductible. Suppose instead that it borrowed the following way: it sells short $100 of Treasury securities and simultaneously enters into a forward contract to purchase Treasury securities in one year for $110. The cash flows on this second transaction are identical to the flows on formal borrowing. The second, however, uses the form of the sale and purchase of securities rather than of a debt instrument.

The combined sale and repurchase might be recharacterized as a borrowing because the flows precisely match those of a borrowing. If so, however, it would be straightforward to make the flows mismatch one another to avoid recharacterization but without changing the economics significantly.

There will be no easy way around this problem. Any set of flows where payments come in before they go out has implicit interest. Absent an attempt to impute interest to all flows, there will be ways to hide interest expense in real or other financial flows and generate deductions for what is economically interest expense.

Real v. financial flows

54 For additional detail, see, Chapter 6 in CARROLL AND VIARD, supra note 16, at 81-101.
55 As discussed above, I am assuming that to the extent the plan taxes financial flows, it does so on an income tax basis, not a cash-flow basis.
Suppose instead that the Brady plan were to take the more conventional approach used in VATs and in X-tax proposals and ignored all financial flows. Under this approach, the tax system would have to distinguish financial flows from real flows. Many transactions, however, have elements of both.

A typical case is the sale of a good on credit. For example, suppose a retailer sold a good with a fair market value of $100 to a customer and the customer agreed to pay $110 in one year’s time. If interest income is not taxed but sales proceeds are, the retailer will want to characterize the transaction as producing a $100 real inflow (which is taxable) and a $10 interest receipt (which is not taxable). If the value of the good cannot be readily determined, the retailer will have an incentive to overstate the interest, for example, by claiming the value of the good is only $95 and there is $15 of non-taxable interest income, reducing the tax base by $5.

Problems would also arise with transactions such as forward contracts that can be either cash settled or physically settled. For example, suppose that a corporation entered into a contract for the purchase of a unit of pork bellies in one year’s time for $100. If pork bellies went up in price over the course of the year, the corporation would have a gain on the transaction. In this case, it could cash settle the contract and report it as an excludible financial flow. If pork bellies went down in price, the corporation would have a loss, and it could physically settle the contract, reporting a deductible loss. If the other side of the contract is a taxable entity, its incentives would be the flip, so that any tax advantage to one party is a disadvantage to the other. If, however, the other side were not taxed or were taxed differently than the corporation (say because it is a financial institution using a special regime for financial institutions), their incentives might not offset.

The underlying problem is that there is no economic distinction between real and financial flows. The distinction is a tax distinction. Nevertheless, VATs around the world draw this line, so there is substantial experience with the problems that arise. Solutions used in VATs should be considered for the Brady plan.

Financial institutions

Regardless of which approach is taken, the system will have a problem taxing financial institutions. Suppose that all financial transactions are ignored. Financial institutions buy and sell (or issue) securities and other financial instruments, incurring labor and capital costs to do so. If financial flows are ignored, all they would have would be deductible costs for labor and physical capital (such as
buildings and computers). They would generate losses every year even if they are wildly profitable.

Financial institutions are a substantial portion of the U.S. economy. They include commercial and investment banks, property, casualty, and life insurance and reinsurance companies, securities brokers and dealers, mutual funds, market makers, and traders such as hedge funds. All of these entities would be effectively untaxed, or even generate net losses, in a pure R-based system.

An R-based tax system will need a special regime for the taxation of financial institutions. A likely candidate is to tax financial institutions on all flows (other than with respect to stock), both real and financial. This system is known as an R+F system and was original devised by a UK tax reform commission known as the Meade Commission. Like a cash-flow system on ordinary businesses, an R+F system taxes economic profits and, depending on the transition rules, existing capital.

Putting financial institutions on an R+F basis requires a definition of financial institutions. This will not be straightforward both because of the wide variety of financial institutions and because ordinary businesses may engage in a large number of financial transactions (such as lending to customers and hedging their risk) so that it may sometimes be difficult to tell when a business is a financial institution.

E. Corporate Transactions

The current income tax has a substantial body of law governing corporate transactions such as mergers, stock acquisitions, and corporate divisions. These rules were developed within an income tax and would need to be rethought if the corporate tax base is consumption.

Consider a corporation that has assets valued at $100 and has a basis in the assets of, say, $70. Under current law, if it were to sell all of its assets to another corporation, it would, without special provisions, owe a tax on its $30 of gain. If, however, the asset sale is done just the right way – meeting an endless list of seemingly arbitrary rules – the reorganization provisions of current law allow the corporation to avoid paying tax on its gain. Instead, the gain is transferred to the buyer by giving the buyer a $70 basis in the assets rather than a basis equal to its purchase price of $100. Similarly, if the

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57 INST. FOR FISCAL STUDIES, supra note 10, at 230-245.
corporation were to spin off the assets by incorporating them and
distributing the stock of the new corporation to its shareholders, special
rules, with yet more complex and arbitrary requirements, allow the
spin-off to defer taxation.

In a consumption tax system, there is, by operation of the
system and without special rules, no net tax on the sale of the assets
from one business to another. In the example, the selling business
would have a taxable inflow of $100 and the buyer would have a
deductible outflow of $100, netting to zero. There is no need for the
reorganization rules.

Moreover, even if desired, there would be no easy way to retain
the equivalent of the reorganization rules in a cash-flow system. The
current rules operate by not taxing the target corporation and not giving
the buyer basis for its costs. Instead, the buyer inherits the target’s
basis. There is, however, no concept of basis in a cash-flow system.
Not taxing the seller and not allowing the buyer a deduction does not
achieve the same thing as the current law reorganization rules unless
there is some way to shift the equivalent of basis – the deduction the
seller had when it purchased its assets – to the buyer. In particular, in
an income tax, we shift the capitalized cost of the seller’s assets to the
buyer by transferring the seller’s basis to the buyer. With a cash flow
system this would be very difficult because there is no basis. The seller
will have deducted the $70 when the assets were purchased, which
could have been many years ago. In fact, taxing the sale to the buyer
and giving the seller a deduction can be thought of as the consumption
tax equivalent of the reorganization rules because this treatment
effectively shifts the prior deduction to the new owner of the assets in
the same way that the income tax rules shift the basis.

There are two other effects of the reorganization rules under
current law. The first is that they allow shareholders to defer taxation
of gains when they exchange their shares of a target corporation for
the shares of a purchasing corporation. Because the Brady plan retains
the individual-level income tax, the rules would continue to matter for
shareholders. It is not clear, however, why it is desirable to allow
shareholders to exchange stock in one company for stock in another
without paying tax. Moreover, even if one could identify
circumstances when it is desirable to allow shareholders to defer
taxation, it is unlikely that those circumstances would be anything like
the cases allowed under current law. And finally, with a low tax rate
on capital income, there is little reason to have complex rules that
allow deferral.
The other effect of the reorganization rules is that they allow corporate tax attributes such as net operating losses and unused tax credits to be transferred from the buyer to the seller. If asset sales were fully taxable under the Brady plan, tax attributes would not transfer from target corporations to purchasers. If the target were to liquidate, moreover, the attributes might disappear. Structuring the same transaction as a stock purchase would mean that the attributes would remain with the target corporation and potentially be usable by the purchasing corporation via consolidation. The result would be a difference between stock transactions and asset transactions.

Given that asset purchases in a cash-flow system do not generate net tax, the key effects of reorganization rules would be to defer shareholder gain – something I view as undesirable – and to reduce the disparities between asset sales and stock sales with respect to the carryover of attributes. Given how much less is at stake, the best approach, in my view, is to make all corporate transactions taxable and all exchanges of shares taxable, with perhaps an exception for recapitalizations. Attributes would carry over in stock transactions but not asset transactions. Alternatively, greatly simplified rules could be adopted to allow attributes to be transferred. For example, attributes could be transferred in any transaction in which two companies merge or in which one purchases substantially all of the assets of another (regardless of the consideration). All the other ornate concepts of the current law reorganization rules could be eliminated.

The same arguments apply to the rules governing contributions to corporations. These rules rely on shifting the basis of assets to the corporation. Without a basis system, these rules may no longer make sense. Moreover, in this case, there is no attribute transfer under current law, so special attribute transfer rules would not be needed.

The rules defining dividends will also likely need to be revised. The current rules determine whether a distribution is a dividend by whether it comes out of corporate earnings and profits. The earnings and profits account is determined on an income basis. While an income-based earnings and profits account could be retained, doing so would mean that for tax purposes, corporations must compute both income and consumption tax bases and would require retention of many income tax rules.

An alternative would be to compute earnings and profits on a cash-flow basis. If this approach were taken, it would only make sense to use a cumulative account rather than the current approach of looking to a current account (and then a cumulative account). To illustrate, suppose that a corporation purchases an asset for $100 in year 1 and
receives $110 in year 2. On a cumulative basis, it has $10 of earnings which would support a $10 dividend. Looking only at year 2 (so looking at the current earnings and profits account, which is what current law does) would give the corporation $110 of earnings, which would then produce a $110 dividend, which is far excess of any measure of corporate earnings.

The current corporate tax system also has a number of rules designed to prevent losses from being transferred. For example, if a corporation changes control, it may be limited in its ability to use losses in the future. With a cash flow system, however, losses will be, for the most part, freely transferable simply because of the way a cash-flow system works. Consider a company with a $100 net operating loss. The company can transfer the loss simply by selling a $100 asset. The selling company will have $100 of taxable receipts, which it can use against the loss and the purchasing company will have a $100 deduction, effectively transferring the loss.

The Brady plan allows indefinite carryforward with interest, so the incentive to transfer losses will be reduced as compared to current law. On the other hand, under a destination-based cash-flow system, some businesses may be unlikely to be able to use losses for the indefinite future even if they are profitable. In these cases, incentives to transfer losses may remain. Given that loss transferability is built into the structure of the system, it may not be desirable to try to retain the current rules against loss transfers.

In short, one of the major simplification benefits of the Brady plan (if amended to consistently tax consumption) would be to revise and repeal most of the provisions governing major corporate transactions. (And if the pass-through regimes are repealed, the Brady plan could eliminate those rules as well.) These rules are not mentioned in the current draft plan. As the plan progresses, this simplification opportunity should be taken.

F. Deferral

The Brady plan taxes dividends, interest, and capital gains received by individuals at a rate equal to half of the tax rate applicable to other income. I assume, although the plan is silent, that the reduced rate also applies to flows from similar investments, such as from futures and forward contracts, swaps, options, and other financial instruments as well as non-business investments in property such as speculation in land, minerals, and collectibles.

Combining this tax on capital income with a cash-flow business-level tax may be challenging. The reason is that capital investments at the business level bear no tax (because of the cash flow
system). As a result, funds can be retained at the business level until needed for consumption, at which point they would be withdrawn and taxed. The effect is elective deferral of capital income, allowing capital income to grow tax free during the period of deferral.

The Bush tax commission’s Growth and Investment plan had the same problem. They suggested that one or more of current law’s anti-deferral regimes would be needed, but provided no details on how such a system would work. A serious problem with applying these regimes is that they will not be able to apply to funds that are genuinely invested in a business. They try to find “sham” investments, or incorporated pocketbooks, where individuals use shell corporations to hold funds and get deferral without really investing in active businesses. In the Brady plan, however, the tax rate on marginal investments is zero, so if funds are genuinely invested in a business, the marginal tax rate on the investment will be zero. Anti-abuse rules that disallow the zero marginal rate would be contrary to the basic structure and intent of the tax system.

I do not see an easy solution to this problem. There is a basic conflict in the plan between having a cash-flow tax at the business level and a tax on capital income at the individual level. The following approaches might reduce the problem it to some extent:

- Eliminate stepped-up basis at death. The plan repeals the estate tax but does not mention stepped-up basis at death. Proposals to repeal the estate tax are often accompanied by repeal of stepped-up basis at death. Getting rid of stepped up basis at death reduces the advantage of deferral.

- Lower the tax rate on capital income even further. The current plan imposes a top tax rate of 16.5% on capital income. If the rate is even lower, the incentive to plan to get deferral correspondingly goes down. (To retain progressivity, other rates would have to be adjusted.)

- Impose a mark-to-market regime for publicly-traded securities at a low tax rate.

- Instead of a mark-to-market regime, impose a regime that is economically equivalent to a mark-to-market regime, such as a system that imputes income based on an assumed return.

The only one of these solutions that really solves the problem is a mark-to-market regime or an equivalent. If such a system is not feasible, the best alternative might be to abandon the tax on capital income at the individual level and instead adopt a pure X-tax. The Bush commission studied (but did not propose) a pure X-tax. They
showed that a pure X-tax can be distributionally and revenue neutral, so there is little need for the additional tax on capital at the individual level. The tax on capital income creates terrible enforcement problems and will distort behavior as people seek to avoid it. Moreover, to the extent it can be enforced, it is inefficient relative to a pure consumption tax (for, apparently, no distributional benefit).

G. Other Individual Tax Provisions

The Brady plan indicates that it may revise many of the provisions that affect the tax liability of individuals, including the mortgage interest deduction, the charitable deduction, the retirement savings provisions, and the exclusion of employer provided health insurance. To a great extent, the choices made with respect to these provisions are independent of the consumption tax structure of the plan. Each raises complex issue that may have large effects on the relevant sectors of the economy. Because the choices for these provisions are largely orthogonal to the structural issues raised by the Brady plan and because the choices are so complex, I do not discuss these issues here, except for following three brief points.

First, if interest income is taxed at the individual level at half the individual tax rate and mortgage interest is deductible at the full rate, there will be an obvious arbitrage: increase the size of your mortgage and invest the funds in debt instruments. Interest received will be taxed at half the rate interest is deducted, generating net tax losses for no real activity.

The same concern applies to investment interest expense. If investment interest expense is fully deductible but interest income is taxed at only half that rate, there are obvious arbitrages. The plan makes clear that net interest expense is not deductible for businesses but says nothing about individuals and investment interest expense.

Second, the plan eliminates the state and local tax deduction (as well as other itemized deductions other than home mortgage interest and charitable donations). There is a substantial literature on the merits of the state and local tax deduction. A decision to repeal it will have important effects on the structure of local government and deserves careful consideration.

Third, the plan seems to retain payroll taxes. For many families, payroll taxes are the dominant tax. They are also currently about one-third of federal taxes. When we think about the tax rates

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applicable to wage income, we need to add in payroll taxes. For example, payroll taxes may alter the incentives to recharacterize capital income as wage income or vice versa.

H. Transition

The Brady plan says nothing about the transition to the new system other than it will provide clear rules “to serve as an appropriate bridge from the current tax system to the new system.” The transition to a consumption tax, however, is one of the most important and most difficult aspects of consumption taxation. The literature on transition is massive, and I can only touch on key points here. 69

Basic economics of transition

The transition to a consumption tax is often said to impose a tax on existing capital. There are two ways to see why. The first is definitional: existing capital is a source of consumption. If you have money in the bank, you can withdraw it and buy things. Therefore, if the tax is to be on all consumption, it must be on existing capital.

The second is transactional. Suppose that we have an income tax and that you own an asset worth $100 that you purchased for $100. Under the income tax, you would have a basis in the asset of $100 and if the income tax remained in place, you could sell the asset for $100 without tax. Suppose that at midnight tonight, we switch to a cash-flow consumption tax in which all purchases are deductible and all inflows are taxed. Under this system, there is no tax basis. The full amount of any inflow is taxed. The next day, you sell your $100 asset. You have a $100 inflow, which would be fully taxed. The cash-flow tax effectively taxes all existing capital when the capital is sold and used for consumption.

Whether this is desirable is not a matter of definitions or transactional rules. The question is whether it has desirable efficiency or distributional effects. The argument that it is efficient is that if the switch is unanticipated, the tax on existing capital is lump sum. Of course, transition would almost surely be anticipated, so people will take steps to avoid it, such as by accelerating their consumption to be before transition and deferring investments to be after transition. Moreover, if the new consumption tax has loopholes, there will be incentives to use those loopholes to avoid the tax on existing capital. Nevertheless, while the tax may not be lump sum, it may be reasonably efficient. A tax on transition on existing capital would also have

69 For a survey of the literature, see Louis Kaplow, Capital Levies and Transition to a Consumption Tax, in INSTITUTIONAL FOUNDATIONS OF PUBLIC FINANCE 112 (Alan J. Auerbach & Daniel Shaviro eds., 2008).
desirable distributional properties because most existing capital is held by wealthy individuals.

On the other hand, a tax on existing capital will likely raise vociferous objections. Going back to the example, you bought the $100 asset with after-tax cash – that is why you have basis in the asset. If you are asked to pay tax again on the $100, you will surely object, even if the tax is under a new system.

*Existing basis*

The reason cash-flow systems tax (or can tax) existing capital is because after the transition date, they ignore basis that was created under the now-repealed income tax. In the example given above, you had a $100 basis in your asset before the transition. After the transition, when you sold your asset for $100, you had a $100 cash inflow and could not use your income tax basis against the inflow because the new system does not use basis to compute tax liability. We can, therefore, think of the tax on existing capital as arising because basis under the income tax does not count under a consumption tax.

The central issue on transition, therefore, is whether businesses can use their existing basis. The extent to which businesses can use their existing basis determines the extent of transition relief or transition tax. Giving transition relief by letting taxpayer use existing basis, however, means that it could be years or decades before the system is fully on a cash-flow basis. Moreover, transition relief will be very expensive given the size of the existing capital base, which means that tax rates would have to be much higher than without transition relief.

The Brady plan says nothing about this, although I think the best reading of the text is that businesses will continue to be able to use existing basis. The text simply says that new investment will be expensed.

The Bush tax commission tried to take a middle course. They allowed businesses to continue to use their existing depreciation allowances but phased them out over five years. For example, in the second year of the new tax, businesses would be able to use 80% of the basis that they could have used under an income tax, 60% in the third year, and so forth. This approach reduces the extent of transition relief and also ensures that the income tax rules – basis and so forth – can be eliminated after five years rather than having to be retained indefinitely.
A way to generalize this system is to allow taxpayers to recover a fraction of their basis in all of their assets (not just depreciable assets) on a fixed schedule. Taxpayers would have to declare (and document) their basis and then could recover it (or a fraction) over a set period of time unrelated to the sale of their assets. This would allow any level of desired transition relief depending on the allowed fraction and would allow the system to move immediately to a cash flow basis, eliminating the need for income tax rules. Alternatively, basis could remain attached to assets so that it can be used when assets are sold, but would decline over a set period of time.

**Tax rate changes**

The transition effects of a tax rate change are exactly the same as the transition effects from the initial introduction of a cash-flow tax. Consider the example of the $100 investment, and suppose, now, that the investment was made under a cash flow system when the tax rate was 20%. The investment produced a $20 tax saving. A year from now, the investment is sold for $110. If the tax rate were still 20%, the tax due would be $22, which is the future value of the $20 of tax savings. Suppose, however, that in the interim, the tax rate was increased to 30%. The tax due would now be $33, $11 more than under the 20% tax. This $11 ($10 in present value terms) is a 10% tax on existing capital. It is a tax on existing capital equal to the tax increase of 10 percentage points. The opposite holds if tax rates go down. Taxpayers will receive a subsidy on existing capital equal to the amount by which taxes go down.

Transition relief is relatively easy for the switch from an income tax to a consumption tax because taxpayers can be allowed to continue to use their existing basis. The problem is much more difficult once taxpayers are in a cash-flow system and tax rates change because there is no basis to use. There is no straightforward way to provide transition relief.

Failing to provide transition relief for tax rate changes, however, may make the system less efficient because there would be an incentive to time transactions to take advantage of rate changes. In particular, if it is anticipated that rates will go up, there will be an incentive to accelerate consumption to avoid the transition tax. If it is anticipated that rates will go down, there will be a corresponding incentive to delay consumption. These timing effects are inefficient because the tax system is causing individuals to accelerate or defer their consumption.

Most cash-flow tax proposals ignore this problem, implicitly denying any transition relief for tax rate changes. To the extent we are
concerned about the transition effects, David Bradford proposed an economic equivalent to a cash flow system that uses basis, and, therefore, alleviates transition effects from tax rate changes. This system could be adopted if needed, although it is much more complex than a cash flow system.

**Interest deductions**

The plan would deny interest deductions. While debt issued after the enactment of the plan can take this into account, debt issued previously cannot. Denial of interest deductions on existing debt may make many loans non-economic, possible forcing creditors to restructure their debt, a process that may be expensive and difficult. In the worst case, some creditors could be forced into bankruptcy. Given the volume of outstanding loans, this is not a small problem.

One possibility is to grandfather debt issued prior to the effective date of the law. The problem with this approach is that debt can be outstanding for very long periods of time. Treating old debt and new debt differently for long periods of time would be complex. Moreover, if old debt gets better treatment than new debt, businesses will have a tax incentive to keep old debt rather than issue new debt even economically this is not desirable.

The Bush commission recommended a five-year phase-out of interest expense deductions, similar to their phase-out of depreciation deductions. Under this approach, interest deductions on all debt, regardless of when issued, are reduced gradually. The effect in each year would be the same as a 20% reduction in tax rates, and businesses have experienced tax rate changes of this size in the past without large disruptions. The tax plan introduced by Devin Nunes in H.R. 4377 (cited in the Brady plan) takes a similar approach. This approach is preferable to grandfathering old debt because it means we do not have to have dual tax systems running indefinitely, which we would need if old debt were grandfathered.

**Border adjustments**

As noted, it will be important to manage the transition to border adjustments so that importers are not adversely affected. Recall the

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61 My focus here is limited to issues of implementation. Note, however, that the currency price changes on transition to a destination basis may have substantial economic effects. In particular, U.S. holdings of foreign assets would decline in value and foreign holdings of U.S. assets would appreciate. Together, these changes would represent a net wealth loss to U.S. citizens. CARROLL AND VIARD, *supra* note 16 at 110-111, provide a discussion.
illustration used above: a firm that purchases goods from abroad for $95 and sells them domestically for $100. Under current law, the firm would be taxed on its $5 profit. The $95 purchase price would be effectively deductible against its $100 sale proceeds (through basis rather than a deduction but the effect is the same). Under a destination-based tax, the firm would no longer be able to deduct the $95 purchase price and would owe a tax on the full $100 sales proceeds. The tax could easily exceed its profit.

As noted, economists argue that currency prices will adjust so that the firm’s position remains unchanged. For example, if the dollar appreciates, the firm could buy the same good for $76, pay a $20 tax and still be left an after-tax profit of $4 (which can be thought of as a $5 pre-tax profit less a 20% tax). One immediate problem is that if the purchase contract is denominated in dollars, the price would not change when dollars appreciate. This means that dollar-denominated purchase contracts would have to be renegotiated. Like with debt instruments, renegotiation could take time so that a phase-in of border adjustments may be warranted.

The Bush commission also argued for a phase-in of border adjustments. The basic idea is that a small border adjustment induces only a small currency price effect. If the currency price effect is slow or incomplete, the harm to importers is modest. This idea is worth considering. A problem is that currency markets may anticipate the phase-in and force the dollar to appreciate faster than the phase-in. In this case, exporters would be hurt.

V. CONCLUSIONS

Implementing a tax system based on the Brady plan will present a substantial challenge. Many implementation problems arise because nothing like this has ever been tried by a developed country, not to speak of in a country the size of the United States. It is likely that over time, solutions to most issues will be found. Given the substantial number of issues, however, it is naïve to think that the plan can be passed into law quickly.

Some issues, such as correcting the treatment of land and inventory are straightforward. Others, such as the elimination of the regimes for pass-through taxation and rules for major corporate transactions, are conceptually straightforward but will be involve more substantial changes to current law. And others will be difficult. Among the most important and difficult issues are the following:

• Deferral and the collection of the capital income tax on individuals.
• The legality of border adjustments and possible design changes to improve the odds of compliance with the GATT.
• The treatment of financial institutions.
• The treatment of businesses that consistently generate tax losses while making economic profits.
• Distinguishing between real and financial flows, and making a consistent choice to have an R-based system (or an R+F system).
• Transition.

These issues do not have straightforward solutions and will need careful analysis as the legislative process moves forward.
PROBLEMS WITH DESTINATION-BASED CORPORATE TAXES AND THE RYAN BLUEPRINT

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Abstract
With the election of Donald Trump and the Republican Party’s domination of Congress, House Speaker Paul Ryan’s blueprint for fundamental tax reform requires more careful analysis. The Ryan blueprint combines reduced individual rates with a destination-based cash flow type business tax applicable to all businesses. The destination-based business tax at the center of the blueprint has several major problems: It is incompatible with our WTO obligations, it is incompatible with our tax treaties, and it will not eliminate the problems of income shifting and inversions it is designed to address. In addition, these proposals generate vexing technical problems that are not easily fixed as well as significant political problems. Finally, due to the tax rates that have been proposed, the plan is likely to generate large revenue losses and a less progressive tax system. We conclude by recommending better tax policy solutions to our current corporate tax problems.
I. INTRODUCTION .......................................................... 231
II. IS THE “BETTER WAY” PROPOSAL COMPATIBLE WITH
    THE WTO? ........................................................... 235
III. WHAT ABOUT TAX TREATIES? ...................................... 246
IV. TAX AVOIDANCE, INCOME SHIFTING AND
    INVERSIONS ......................................................... 247
V. VEXING TECHNICAL PROBLEMS ................................. 249
VI. PROGRESSIVITY AND REVENUE EFFECTS ................. 251
VII. CONCLUSION ......................................................... 253
I. INTRODUCTION

This part describes the Ryan proposal in more detail, describing in particular the plan’s destination-basis corporate tax. Part II discusses problems of WTO compatibility and trade distortions under this plan. Part III discusses issues surrounding tax treaty compatibility, and Part IV discusses the lingering potential for profit shifting under the plan. Part V describes technical problems associated with implementing the plan. Part VI addresses effects on the progressivity of the tax system and on government revenues, and Part VII concludes and offers other suggestions for reform.

House Speaker Paul Ryan’s (R-WI) blueprint to reform the tax code is gaining new prominence because of the Republican ascendancy in Washington following the 2016 election. Since President Trump is likely to sign any tax reform passed by a Republican Congress, it is worth serious consideration.

The introduction to the Ryan proposal (the “Blueprint”) states that:

This Blueprint represents a dramatic reform of the current income tax system. This Blueprint does not include a value-added tax (VAT), a sales tax, or any other tax as an addition to the fundamental reforms of the current income tax system. The reforms reflected in this Blueprint will deliver a 21st century tax code that is built for growth and that puts America first.

This statement is important, because as will be discussed below, the business part of the proposal can be seen as a modified subtraction method VAT. If it were a VAT, it would not have problems with tax treaties or with the WTO rules. But since it declares itself not to be a VAT, and has at least one crucial feature that differs from a VAT, it may have problems with both.

The individual tax section of the Blueprint is not a structural change, although it is quite regressive and would lead to massive budget deficits. It envisages a lower rate structure for ordinary

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2 Id. at 15 (emphasis added).
income (up to 33%), a capital gains and dividends and interest rate that is half the rate for ordinary income (up to 16.5%), and abolishing the individual AMT and estate tax. For pass-through businesses, the Blueprint envisages a rate of 25%, with special provisions to prevent shifting of wage income to pass-throughs.\footnote{The Tax Policy Center analysis mentions that there would likely be large enforcement problems with these rules, especially given the large rate differential under the plan. See Burman et al., supra note 3. Nonetheless, they assume that the rules would be enforceable in their revenue analysis. The plan would lose even more revenue absent that assumption.}

A particularly radical portion of the Blueprint is the corporate section. In addition to cutting the corporate tax from 35% to 20%, the Blueprint envisages three major reforms.\footnote{As explained below, if the Blueprint proposal reduced profit shifting opportunities as its proponents believe, it is not clear why a rate cut is indicated since the main rationale to cut corporate tax rate is reducing base erosion and profit shifting (BEPS).} First, businesses will be allowed to expense capital expenditures, resulting in a zero rate for the marginal return on investment:

This Blueprint will provide businesses with the benefit of fully and immediately writing off (or “expensing”) the cost of investments. This represents a 0 percent marginal effective tax rate on new investment.\footnote{A Better Way, supra note 1, at 25.}

Second, businesses will not be able to deduct net interest expense:

Under this Blueprint, job creators will be allowed to deduct interest expense against any interest income, but no current deduction will be allowed for net interest expense. Any net interest expense may be carried forward indefinitely and allowed as a deduction against net interest income in future years.\footnote{Id. at 26.}

Third, the Blueprint will be destination-based, i.e., be fully imposed on imports (without any deductions) and not imposed at all on exports:

This Blueprint eliminates the existing self-imposed export penalty and import subsidy by moving to a destination-basis tax system. Under a destination-basis approach, tax jurisdiction follows the location of consumption rather than the location of production. This Blueprint achieves this by providing for border adjustments exempting exports and taxing imports, not through the addition of a new tax but within the
context of the transformed business tax system. The Blueprint also ends the uncompetitive worldwide tax approach of the United States, replacing it with a territorial tax system that is consistent with the approach used by our major trading partners.\(^8\)

This means that imports will be taxed and exports exempted. In addition, the Blueprint will enable dividends from foreign subsidiaries of U.S.-based multinationals to be fully exempt, but will maintain the current Subpart F provisions for passive income, eliminating only the base company rule and section 956:\(^9\)

Today, all of our major trading partners raise a significant portion of their tax revenues through value-added taxes (VATs). These VATs include “border adjustability” as a key feature. This means that the tax is rebated when a product is exported to a foreign country and is imposed when a product is imported from a foreign country. These border adjustments reduce the costs borne by exported products and increase the costs borne by imported products. When the country is trading with another country that similarly imposes a border-adjustable VAT, the effects in both directions are offsetting and the tax costs borne by exports and imports are in relative balance. However, that balance does not exist when the trading partner is the United States. In the absence of border adjustments, exports from the United States implicitly bear the cost of the U.S. income tax while imports into the United States do not bear any U.S. income tax cost. This amounts to a self-imposed unilateral penalty on U.S. exports and a self-imposed unilateral subsidy for U.S. imports.

Because this Blueprint reflects a move toward a cash-flow tax approach for businesses, which reflects a consumption-based tax, the United States will be able to compete on a level playing field by

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\(^8\) Id. at 27 (emphasis added).

\(^9\) The base company rule, I.R.C. § 954 (2015), provides that selling goods or services through a “base company” in a low-tax jurisdiction triggers U.S. tax to the parent, and I.R.C. § 956 (2007) provides that using income otherwise eligible for deferral to invest in U.S. property (including a loan to the parent) triggers U.S. tax to the parent. The latter rule has been under pressure recently because of the $2.5 trillion in deferred income of foreign subsidiaries of U.S. parents located in low-tax jurisdictions.
applying border adjustments within the context of our transformed business and corporate tax system. For the first time ever, the United States will be able to counter the border adjustments that our trading partners apply in their VATs. The cash-flow based approach that will replace our current income-based approach for taxing both corporate and non-corporate businesses will be applied on a destination basis. This means that products, services and intangibles that are exported outside the United States will not be subject to U.S. tax regardless of where they are produced. It also means that products, services and intangibles that are imported into the United States will be subject to U.S. tax regardless of where they are produced. This will eliminate the incentives created by our current tax system to move or locate operations outside the United States. It also will allow U.S. products, services, and intangibles to compete on a more equal footing in both the U.S. market and the global market.10

The Blueprint then addresses the potential WTO issue as follows:

The rules of the World Trade Organization (WTO) include longstanding provisions regarding the use of border adjustments. Under these rules, border adjustments upon export are permitted with respect to consumption-based taxes, which are referred to as indirect taxes. However, under these rules, border adjustments upon export are not permitted with respect to income taxes, which are referred to as direct taxes. This disparate treatment of different tax systems is what has created the historic imbalance between the United States, which has relied on an income tax – or direct tax in WTO parlance – for taxing business transactions, and our trading partners, which rely to a significant extent on a VAT – or indirect tax in WTO parlance – for taxing business transactions. Under WTO rules, the United States has been precluded from applying the border adjustments to U.S. exports and imports necessary to balance the treatment applied by our trading partners to their exports and imports. With this Blueprint’s move toward a consumption-based tax approach, in the form of a cash-flow focused

10 A Better Way, supra note 1 at 28 (emphasis added).
approach for taxing business income, the United States now has the opportunity to incorporate border adjustments in the new tax system consistent with the WTO rules regarding indirect taxes.\textsuperscript{11}

This approach is similar to the one taken by the 2005 advisory panel on tax reform in the Growth and Investment Tax (GIT) proposal. Under the GIT, corporations were subject to a cash flow tax with expensing and no deduction for interest, but wages were deductible. The GIT was destination-based, but for revenue estimating purposes, the revenue associated with border adjustments was disregarded because of concerns about WTO compatibility. Since the U.S. has a large trade deficit, this represented a difference of \textbf{\$775 billion dollars} in revenues over the ten-year budget window.\textsuperscript{12} According to the Tax Policy Center analysis (2017), the revenue effects of the border adjustment are even larger now, at about \$1.2 billion dollars.\textsuperscript{13}

II. IS THE “BETTER WAY” PROPOSAL COMPATIBLE WITH THE WTO?

Under the WTO Subsidies and Countervailing Measures (SCM) Agreement,\textsuperscript{14} a tax may only be border adjustable if it is an “indirect” tax. A border adjustable “direct” tax is a prohibited export subsidy that can subject the U.S. to trade sanctions.

Annex I of the SCM includes as a prohibited export subsidy:\textsuperscript{15}

\begin{itemize}
  \item[(e)] The full or partial exemption remission, or deferral specifically related to exports, of direct taxes (58) or social welfare charges paid or payable by industrial or commercial enterprises (59).
\end{itemize}

Footnote 58 provides:

For the purpose of this Agreement:

\begin{itemize}
  \item[\textsuperscript{11}] Id. (emphasis added).
  \item[\textsuperscript{13}] Burman et al., supra note 3.
  \item[\textsuperscript{14}] Agreement on Subsidies and Countervailing Measures, 1869 U.N.T.S. 14 [hereinafter SCM].
  \item[\textsuperscript{15}] In addition, it is likely that the Blueprint would constitute prohibited discrimination against imports and in favour of domestic production under Article 3 of the GATT, because foreign businesses exporting to the U.S. would be pressed to move production to the U.S. in order to get a deduction for wages. This is particularly true for manufacturing units in developing countries, where you do not have sufficient local sales to compensate with. See General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194 [hereinafter GATT].
\end{itemize}
The term "direct taxes" shall mean taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property; …

The term "indirect taxes" shall mean sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges.\(^{16}\)

Footnote 59 provides:

The Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any Member may draw the attention of another Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultation created in the preceding sentence.

Paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.\(^{17}\)

The business tax regime of the Blueprint can be seen as a modified version of a consumption tax—specifically, a subtraction method VAT (although the Blueprint explicitly denies that it is a VAT). Specifically, the Blueprint imposes tax on cash flow, allows

\(^{16}\) SCM, supra note 16 (emphasis added).

\(^{17}\) Id.
expensing of capital expenditures, and disallows net interest expense. All of these are also features of a subtraction method VAT.\textsuperscript{18}

However, the Blueprint does allow a deduction for wages, while a subtraction method VAT would disallow them. This feature makes the Ryan tax not WTO compatible.\textsuperscript{19} Fundamentally, we need to consider the reason why a VAT, whether using a credit-invoice or subtraction method of calculating the tax, is border adjustable. Sales taxes, excises and VATs are border adjustable because there is no distortion introduced by the tax; goods receive like tax treatment in the domestic market irrespective of where they are produced. Both the tax component in exports and the price of imports are measurable, and the border adjustment does not exceed the tax that is levied because (in the case of import) the full tax is levied at the border, and (in the case of exports) the refunded amount in an invoice-credit VAT is only the amount that was levied at previous stages, as shown on the invoice. By so limiting border adjustments, the WTO reduces opportunities for countries to subsidize exports or overtax imports.

The Ryan Blueprint’s treatment of purchases (including capital and inventory) and labor highlights the difference between a tax on value added and Ryan’s tax on an income base.

If the factors of production employed at each stage of production and distribution of goods are totaled up, they should equal

\textsuperscript{18}A subtraction method VAT is a cash-flow tax that includes all sales but allows a deduction for all outlays, except for interest and wages. In principle, it has the same tax base as the normal invoice-credit VAT, as adopted by most countries. In an invoice-credit VAT, tax is paid at each stage of production on the sale price of outputs, with a credit given for tax on inputs. Both methods can be origin or destination-based, but all existing VATs are destination-based (imports are taxed and exports are exempt). The main difference is administrability: In an invoice-credit VAT, no credit is given unless tax was paid on the input, as shown on an invoice. In a subtraction method VAT, care must be taken not to allow a deduction unless there is a corresponding inclusion by the provider of goods, services or intangibles. This difference explains why no country has adopted a subtraction method VAT. The Blueprint proposal is based on a subtraction method VAT, but with a deduction for wages.

the retail sales price of the goods. A traditional VAT is imposed mainly on two factors of production, labor (about 2/3 of base) and income from capital or rents (extra profits above the normal return to capital). Under a sales-subtraction method VAT, taxes are collected and remitted to the government by business at each stage of production and distribution. The resulting tax should be equal to the tax imposed on the retail price of taxable goods under a single-stage retail sales tax. Purchases taxed at a prior stage of production or distribution are deductible, so that this value is not taxed again. Under that method of calculating VAT, the cost of labor is not deductible so that this factor of production can be included in the tax base. In contrast, under the Ryan Blueprint tax, a business can take an immediate deduction for its wage expense, leaving that factor of production out of the tax base. Workers bear tax at multiple rates on that labor income under the individual income tax. Even if the tax paid by the workers may be viewed as a surrogate for a business’s tax on labor, that surrogate tax cannot be accurately measured and that tax cost does not enter the tax-inclusive prices of the business’s outputs. Giving a full deduction for labor costs effectively subsidizes exports and overtaxes imports.

For example: Assume that a domestic grape grower has no business inputs. He has labor costs of 30 and profit of 10. He sells the grapes to a wine producer for $30 + $10 = $40. Since labor is deductible, the grape grower pays tax only on his profit. The tax is $10 \times 20\% = 2$, so the tax inclusive price is $40 + 2 = 42$. The wine producer buys the grapes for 42. She has labor costs of 45 and profit of 15. She sells the wine to a domestic consumer for $42 + 45 + 15 = 102$, and pays tax only on the profits of 15 since the other elements are deductible. Total tax paid by the wine producer is $15 \times 20\% = 3$, and the tax inclusive price to the consumer is $102 + 3 = 105$.

If the wine producer instead exports the wine by selling it to a foreign customer, she has 100 in exempt income, or zero income (assuming no other income). She also has $40 + 45 = 85$ in deductible costs, so in principle she should get a check from the Treasury of $85 \times 20\% = 17$. The foreign customer, assuming that his country also charges 20% VAT on imports, will pay 100 plus VAT of $100 \times 20\% = 20$, and the tax inclusive price will be 120. Note that this is a higher

\[\text{\footnotesize 20} \text{ In this example, we assume that the tax gets passed on to consumers in the form of higher prices.}\]

\[\text{\footnotesize 21 Under the Blueprint, Net Operating Losses (NOLs) are carried forward with an interest charge, rather resulting in an actual refund, but the end result should be the same. Still, many exporters may never show positive income under this tax system, so they may not be able to use NOLs.}\]
price than the price to the domestic wine consumer, because in the domestic sales the costs of goods sold and the labor are deductible whereas in the foreign sale they are not.

Now let us compare this to a normal invoice credit VAT of 20%. In the domestic case, the grape grower has 30 in labor costs and 10 of profit, and he will charge the wine producer a tax inclusive price of $40 + (40 x 20%) = 48. The wine producer will pay 48 to the grape grower and has 45 of labor costs and 15 of profits, so she will charge a tax inclusive price of $48 + 45 + 15 = 108 minus 8 refund of VAT paid on inputs, or $100 + (100 x 20%) = 120.

In the export case with an invoice-credit VAT, the grape grower still charges the wine producer 48. The wine producer adds labor costs of 45 and profits of 15 and since the wine is exported in a zero rated sale she receives a refund of 8 and the sale price to the foreign consumer is $48 + 45 + 15 – 8 = 100, plus 20% foreign VAT or 120.

If we compare the two cases, under the Ryan tax the domestic consumer pays 105 and the foreign consumer 120. The difference of 15 is the tax on the deductible U.S. labor costs (= (30 + 45) x 0.20). But if the wine producer wants to undercut wine produced in the foreign country, she can easily afford to sell for less than 100. Specifically, she could sell for as low as (100 – 17) + 20%, or $99.60 (tax inclusive). This demonstrates the export subsidy, which results from the ability to deduct labor costs in the U.S., whereas such costs are not deductible in the normal VAT in the foreign country. Under the normal VAT, the prices to the domestic and foreign customers are the same (120 domestic, 120 foreign) and there is no check from the Treasury other than the refund of VAT actually paid.

The reason for the export subsidy in the Ryan tax is that labor costs are deductible. In theory this should not make a difference if we could be sure that labor is subject to at least a 20% tax rate, since then the deduction and inclusion would offset each other. However, much labor income is taxed at lower rates due to the progressivity of the federal income tax as well as the earned income tax credit. Ryan also envisions a zero bracket of the first $24,000 of income and a 12% rate for those currently in the 10 or 15% brackets, so it is likely that many of the employees of the grape grower and the wine producer will be subject to individual tax at less than 20%.

Thus, the Ryan Blueprint should be classified as a modified consumption-style tax imposed on an income base. As such, it is not a border adjustable tax under the WTO rules, as currently interpreted. If the U.S. treated a Ryan-type tax as border adjustable,
we can expect our international competitors to challenge the tax at the WTO before it takes effect.

Economists, however, argue that exchange rate changes may offset this, because U.S. dollar appreciation would undo the export subsidy. But the exchange rate offset will not be perfect since the tax treatment will depend on individual firm circumstances, and the exchange rate only affects the overall prices of imports relative to exports. In particular, different goods will receive the export subsidy to different extents, because not all goods have the same share of labor in their production costs, and different tax rates apply to corporate and pass-through business. Yet any exchange rate changes will affect all goods equally.

Even more important, the literature on exchange rate determination makes any exchange rate offset hardly predictable or clear cut. Empirical studies in international finance makes it quite clear that exchange rates movements are divorced from most coherent theories of exchange rate determination. As noted by Rogoff:

The extent to which monetary models, or indeed, any existing structural models of exchange rates, fail to explain even medium term volatility is difficult to overstate. The out-of-sample forecasting performance of the models is so mediocre that at horizons of one month to two years they fail to outperform a naïve random walk model (which says that the best forecast of any future exchange rate is today’s rate). Almost incredibly, this result holds even when the model forecasts are based on actual realized values of the explanatory variables.

This may be due in part to the huge speculative component of exchange rate trading. The foreign exchange market has transactions that exceed $5 trillion each day; the U.S. dollar is involved in 88% of these currency trades. Compare the size of the world economy, with an annual GDP of about $75 trillion. All of world GDP could be

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24 Id. at 444.
purchased with about 15 days of foreign exchange! Thus, the bulk of exchange rate trading is not related to the purchase of goods or even assets, but rather to financial market trading. This may help explain why exchange rate movements are difficult to predict with standard theories or macroeconomic models. Indeed, macroeconomists have a dismal record of predicting exchange rate movements based on any fundamental theories of exchange rate determination. Thus, there should be grave doubts that exchange rate changes will smoothly offset the effects of the border adjustment.

The exchange rate offset argument is sometimes made by noting that trade must balance in the long run, or by simply assuming balanced trade. Yet while trade must balance in the long run, there is no reason why countries can’t run persistent trade deficits and surpluses. Indeed, the United States has experienced a trade deficit for every year of the last 40 years. Our persistent trade deficit is due to macroeconomic considerations, and in particular, the fact that U.S. savings are low relative to our private investment desires and government borrowing.26 If nothing changes those macroeconomic variables, then our trade deficit should remain constant, so the exchange rate offset must offset any trade distortions introduced by the tax changes. Still, it is far from clear that a tax change of the magnitude imagined here would not affect macroeconomic variables such as savings, investment, tax revenues, and government spending.

In addition, many countries do indeed fix their exchange rates, and this will also slow any adjustment to the introduction of the Ryan tax.27 Auerbach and Holtz-Eakin recognize that, but they note that most countries do this for reasons of “competitiveness” and therefore could be expected to adjust pegs accordingly.28 We disagree. Most countries peg to achieve other macroeconomic goals, and in particular

26 The borrowing that occurs from abroad is the “flip side” of the trade deficit. In particular, basic national income accounting indicates that EX-IM (the trade balance) must always equal the sum of the private savings/investment balance (S-I) and the government budget balance of tax revenues relative to government spending (T-G). In the case of the United States, our trade balance is often negative since our savings (S) fall short of demand for loanable funds due to private Investment (I) and government borrowing (G-T).


28 Auerbach & Holtz-Eakin, supra note 22.
to import creditability with respect to monetary policy, to target
inflation, to enhance exchange rate stability, etc. It is far from clear
that competitiveness is the determinative motive in most cases. (And
often pegs will have the opposite effect, when countries intervene to
support overvalued currencies.)

Further, trade contracts are often set in advance in dollar terms,
so even if exchange rates were to adjust immediately and fully, there
would still be a disruptive lag in terms of effects on those engaged in
international trade. This shock could be quite damaging to retailers in
the short run. Also, if lags in exchange rate adjustment convince
trading partners to undertake protectionist trade measures in response,
those measures are likely to prove more long-lasting.

In addition, one shouldn’t be sanguine about the effects of a
large dollar appreciation, as this redistributes wealth away from U.S.
owners of foreign assets (since their assets are now worth less in dollar
terms) and toward foreign owners of U.S. assets. These wealth effects
involve amounts in the trillions of dollars. \(^{29}\) Dollar appreciation can
also have dire fiscal consequences for emerging economies that are
borrowing in dollars; indeed U.S. dollar appreciation played a large
contributing role in several past developing country debt crises,
including the Latin American debt crises of the mid 1980s and the
Argentine debt crisis and default of 2001. \(^{30}\)

We are not aware of any empirical evidence on the exchange
rate mechanism, but that should be provided before adjustment is taken
on faith. Indeed, it seems dangerous to “bet” entire sectors of the
economy on such untested grounds, especially when no other major
country has adopted this type of corporate tax. The only empirical
study, by Desai and Hines, in fact suggests that trade effects may be
counter to expectations. According to Desai and Hines, “[e]conomic
theory implies that exchange rate adjustment prevents destination-
Based VATs from affecting exports and imports. Indeed, this
proposition is so well accepted among economists that it has not been
subjected to serious prior testing.” \(^{31}\) Still, Desai and Hines found that
countries that relied on VATs actually had worse export performance

\(^{29}\) See, e.g., Alan Viard, Border Tax Adjustments Won’t Stimulate Exports,
AM. ENTER. INST. (Mar. 2, 2009), http://www.aei.org/publication/border-tax-
adjustments-wont-stimulate-exports/ [perma.cc/65Vb-695H].

\(^{30}\) See Michael Graetz, The Known Unknowns of the Business Tax Reforms

\(^{31}\) Mihir Desai & James Hines, Value-Added Taxes and International
Trade: The Evidence (Nov. 2002) (unpublished manuscript), available at
http://pdfs.semanticscholar.org/0245/59563b9d470c5932a0b858bb9153ab750df.pdf [perma.cc/5SCZ-E7U5].
(and also lower imports), and this finding typically (but not always) persists when control variables and country fixed effects are included.32

Desai and Hines note that the real world features of VATs can explain their finding, since VATs tend to fall more heavily on traded goods than non-traded goods, and export rebates are often incomplete, thus discouraging trade. These two explanations also likely apply in the Ryan tax context. For reasons explained below, the unlikelihood of exporters getting full rebates for their export “losses” are even stronger in the Ryan tax context than in a traditional VAT,33 and there is reason to believe that the Ryan tax will be imposed differentially on tangible goods than on services and intangibles (discussed below).34

There are other WTO related problems with the Blueprint as well. First, the Blueprint explicitly declares up front that it is not a VAT but a corporate income tax (“This Blueprint does not include a value-added tax (VAT), a sales tax, or any other tax as an addition to the fundamental reforms of the current income tax system”). Second, the retention of an exemption for dividends from controlled foreign subsidiaries (on top of the destination basis) and subpart F and the imposition of tax on some interest and dividends make the Blueprint look more like a corporate income tax. In contrast, VATs are purely destination-based and do not apply to any foreign source income, so territoriality is not needed, and financial flows are disregarded.

Auerbach and Holtz Eakin argue that:

There is an open question whether a destination-based cash flow tax (DBCFT) would be determined to be compliant with the rules of the World Trade Organization. There are two primary issues here. First,

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32 Id.
33 Under the Blueprint, NOLs are carried forward with an interest charge. This may or may not result in an eventual payment. Many exporting firms may not ever show a taxable profit under this system.
WTO rules currently limit border adjustments to “indirect” taxes – taxes on transactions (e.g., sales, payroll, etc.) rather than “direct” taxes on individuals or businesses. It is not clear that a DBCFT would be successfully characterized as an indirect tax, even though it is economically equivalent to a policy based on indirect taxes (a VAT and a reduction in payroll taxes), and even though the distinction between direct and indirect taxes has little meaning and no bearing on any economic outcomes. In addition, there might be concerns under existing WTO rules regarding the combination of border adjustments with a deduction for domestic labor costs, since the border adjustment assessed on imported goods applies to the entire cost of the imports, with no deduction for the labor costs that went into the production of these imported goods. Some might see this treatment as favoring domestically produced goods over imported ones. But such an inference makes little sense from an economic perspective. Again, consider the equivalent policy of introducing a VAT and reducing payroll taxes, both elements of which are compatible with WTO rules. A reduction in payroll taxes would indeed encourage domestic production and employment to the extent that it lowered domestic production costs. But this is true of any reduction in taxes on US production, and it is difficult to comprehend why international trade rules should dictate the tax rate a country applies uniformly to its own domestic economic production activities.\textsuperscript{35}

Given these arguments, one might legitimately query why proponents have not simply suggested replacing the corporate tax with the combination of a VAT and a cut in payroll taxes.\textsuperscript{36} (Though to achieve a 20% wage subsidy, one would have to provide more tax relief than a complete elimination of the 15% payroll tax.) Still, regardless of the merits of such equivalence arguments, which neglect real world features of modern payroll taxes, it is unlikely that they will sway the WTO. WTO decisions tend not to respect this type of

\textsuperscript{35} Auerbach & Holtz-Eakin, supra note 22.

\textsuperscript{36} The real reason, one suspects, is the widely-held belief in the political implausibility of enacting a VAT in the United States. Given the WTO issue facing any border-adjusted tax that is not a VAT, this belief may be misguided. See Reuven Avi-Yonah, The Inexorable Rise of the VAT: Is the U.S. Next?, 150 TAX NOTES 127 (2016).
argument even if economists find this “difficult to comprehend.” The whole point of introducing the Ryan tax, as Auerbach and Holtz-Eakin concede, is to make the United States into a giant tax haven from the perspective of our trading partners, and induce their multinationals to move operations into the United States.\textsuperscript{37} Given the likely harm to their tax revenues from such a shift following the initial introduction of the Ryan tax, our trading partners, and especially the EU, are likely to sue. The result would be years of litigation with an uncertain outcome and potentially very large trade sanctions. Recent estimates suggest that dispute could result in retaliatory tariffs sufficient to eliminate over $200 billion in U.S. exports.\textsuperscript{38}

Such an outcome would be very worrisome for several reasons. First, we are already in an environment where the gains from trade are being threatened by a President that frequently urges the imposition of tariffs. Adding protectionist features to the tax code, even if some economists are convinced that there would be no net effect on prices, risks misunderstanding and increases the probability of retaliatory tariffs. Indeed, some countries have already pledged tariff retaliation if the United States moves forward with this plan. Protracted and contentious litigation could also reduce the U.S. political backing for the WTO, harming both the long-run prospects for an open trading system and our international relations.

Second, the ambiguities of whether these tax provisions would pass muster with the WTO creates a far more uncertain investment climate, making it more difficult for companies to resolve investment and location decisions. Further, if there is no assurance that the tax will be retained, that could also hamper the process of exchange rate adjustment.

Finally, if the WTO authorizes trade sanctions in response, such sanctions may lead to an endgame result where the U.S. government complies with the WTO by turning the Ryan tax into a “normal” VAT by denying the deduction for labor. This would make the tax far more regressive than the proposed cash-flow corporate tax it replaces.\textsuperscript{39} Of course, the border adjustment feature could not be dropped without huge revenue losses as well as enormous tax

\textsuperscript{37} Auerbach & Holtz-Eakin, \textit{supra} note 22 at 12-14.


\textsuperscript{39} See Sheppard, \textit{supra} note 19, at 914.
avoidance and profit shifting problems. Absent the border adjustment, the whole structure of the destination-based tax breaks down.

III. WHAT ABOUT TAX TREATIES?

There are three problems with tax treaties in the Blueprint, assuming that the proposed tax is an income tax subject to the treaties. The first problem is that if the business tax is an income tax covered by the treaties and we are serious about taxing on a destination basis goods and services imported into the U.S., we need to do away with the permanent establishment (PE) limitation in Article 7, because we need to be able to tax importers without a PE (or physical presence required under domestic law). While we believe that this is a long overdue reform, bringing the income tax treaty into the 21st century and the age of electronic commerce, it should be recognized that it involves a massive treaty override of a crucial aspect of the treaty bargain, which was considered and rejected by our treaty partners in the BEPS context.

The second problem is that if the business tax is an income tax, in order to levy it on a destination basis and include all imports, it must be imposed not just on goods and services (under Article 7) but also on intangibles that produce royalties (Article 12) and other types of deductible payments that can substitute for royalties (e.g., payments on derivatives, generally classified as Other Income under Article 21). While interest and dividends are not deductible, allowing royalties and derivatives to escape the tax on imports invites abuse (since there will always be lower tax jurisdictions). This requires another treaty override that can be avoided if the business tax is a VAT.

Finally, it could be argued that because the Ryan tax advantages domestic companies that export from the U.S. over similar foreign companies that import into the U.S., the Ryan tax is a violation of the non-discrimination provision of the treaties. An important related question is how our treaty partners will react to such sweeping changes and treaty overrides (which they regard as violations of international law). Given that the new U.S. tax (20% rate with expensing, territoriality, border adjustments) will create a strong attraction for foreign-based multinationals to shift profits into the U.S., it is likely that they will (a) refuse to give credit for the U.S. tax under tax treaties because (given expensing) it is not an income tax, and (b) apply their CFC rules to U.S. affiliate operations by their

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41 See Sheppard, *supra* note 19 at 909-10.
multinationals, which cannot invert in response because of exit taxes. The possible end result could be a collapse of the treaty-based international tax regime, to the disadvantage of U.S. taxpayer who will face increased withholding taxes overseas as well as increased transfer pricing enforcement.42

IV. TAX AVOIDANCE, INCOME SHIFTING AND INVERSIONS

The Better Way proposal argues that:

Taken together, a 20 percent corporate rate, a switch to a territorial system, and border adjustments will cause the recent wave of inversions to come to a halt. American businesses invert for two reasons: to avail themselves of a jurisdiction with a lower rate, and to access “trapped cash” overseas. Those problems are solved by the lower corporate rate and the territorial system, respectively. In addition, border adjustments mean that it does not matter where a company is incorporated; sales to U.S. customers are taxed and sales to foreign customers are exempt, regardless of whether the taxpayer is foreign or domestic.43

We do not believe the Blueprint proposal will completely stop the incentive for U.S. corporations to shift income overseas, because even with a 20% rate and expensing, rents (for example, from intangibles such as Apple’s “Irish” profits) can still be located in zero tax jurisdictions and then repatriated tax-free. While this problem can be minimized if it is limited to rents from exploiting foreign markets (which would be exempt even if carried out from the U.S.), we are doubtful that the line between U.S. and foreign markets can be drawn precisely where services and intangibles are concerned, where there can be no enforcement of the tax at the border. Even a normal (invoice credit) VAT has issues where imports of services and intangibles are concerned, since it is difficult to collect the tax from consumers who are not eligible for deductions or input credits.44

44 For the serious problems raised by application of VAT to cross-border trade in services and intangibles, see International VAT/GST Guidelines, OECD (Nov. 2015), http://www.oecd.org/tax/consumption/international-vat-gst-guidelines.pdf [perma.cc/8TQB-885Y] (recommended by the Council in September 2016). In an invoice credit VAT, exports are zero-rated in the country of origin, so
Moreover, experienced tax practitioners have already suggested ways of gaming the Blueprint. For example:

1. A U.S. pharmaceutical with foreign subsidiaries could develop its intellectual property in the United States (claiming deductions for wages, overhead and R&D), and then sell (i.e., export) the foreign rights to its Irish subsidiary (at the highest price possible). The proceeds would not be taxable. Ireland would allow that subsidiary to amortize its purchase price. This creates tax benefits in each jurisdiction by reason of the different regimes. If the Irish subsidiary manufactures drugs, the profits could be distributed up to the U.S. parent tax-free under a territorial system. If the Irish subsidiary is in danger of becoming profitable for Irish tax purposes, the U.S. parent would just sell it more IP.

2. If an Irish parent owns a U.S. subsidiary, the Irish parent can issue debt to fund the purchases of the IP. The U.S. subsidiary then invests the cash to generate more IP (expensing all equipment and deducting all salaries) and sells the IP to its parent.

3. If an Irish parent has purchased the U.S. IP rights, it would not want to license the rights to the U.S. a business importer does not get a tax credit on the purchase. If there is an output tax to the final consumer, it is simply charged and paid (like a typical retail sale under the U.S. RST). This means that, unlike the typical VAT situation, the entire collection even in a B2B context depends on the final sale to the consumer, and experience with retail sales taxes has illustrated that at high rates this becomes an avoidance problem (as anyone living in states that border states that do not tax sales can attest). The real problem in the B2C domain is simply that there is no jurisdiction to enforce the B2C tax, because there is no jurisdiction over the remote supplier. In the B2B context, the answer is the reverse charge, where the business purchaser self-assesses the tax and therefore gets an input tax credit on any further sale. In the B2C context, relying on the consumer to self-assess the tax amounts to a tax on honesty (like the U.S. state use tax where there is no collection by the remote seller). In general, determining exports and imports and tracking purchases of those engaged in cross-border business is not trivial. It is difficult to judge where services are consumed and to trace location of downloaded services.

subsidiary (income for Irish parent under Irish tax law and no deduction for U.S. subsidiary). So it just contributes the rights to another U.S. subsidiary. Could the U.S. subsidiary amortize the parent's basis under the Blueprint? When one U.S. subsidiary licenses to another, no net tax would be paid. Any royalties would be taxable to the licensor but deductible for the payor.46

4. How does the Blueprint work for services? If a U.S. hedge fund manager provides services to an offshore hedge fund, is that considered an export that is tax exempt? What if the U.S. manager develops a trading algorithm and sells it (or licenses) it to an offshore hedge fund? Are the proceeds and royalties exempt? If so, then the hedge fund becomes a giant tax shelter to the manager, because he would not pay 25% on this income – he would pay zero, with no further tax. This is much better than the current carried interest provision, which has attracted bipartisan condemnation because it enables individuals with income of many millions to pay a reduced rate. The Blueprint result is much worse.

V. VEXING TECHNICAL PROBLEMS

First, this tax system is very difficult to explain to the public or, even, experts. This creates a risk that loopholes will be easier to design due to the deliberate exploitation of the system’s complexity by savvy tax planners and lobbyists. Yet if the system is implemented in a more theoretically pure form, without opening the door to loopholes, it is not clear that the MNC business community would support the proposed changes. The net effect would be a tax increase for the intangible-intensive MNCs that had previously succeeded in achieving single-digit tax rates by gaming the old system (and shifting U.S. profits abroad). It is also a tax increase for highly-leveraged firms, since debt-financed investments would no longer be subsidized.

46 As Miller argues, this example suggests that inversions would in some cases still be valuable. Moreover, to the extent the Blueprint retains Subpart F, inversions can be helpful in avoiding it. For example, if an Irish subsidiary of a U.S. parent licenses intangibles to consumers in the U.S. and because it is difficult to enforce the tax on the consumers the IRS relies on Subpart F to tax the royalties, this rule (which is included in what remains of Subpart F in the Blueprint) can be avoided by an inversion.
Retailers that import into the U.S. and manufacturers that import parts are likely to object to a new tax system that means they cannot deduct their cost of goods sold.

Second, there is an increased likelihood that many profitable firms would show losses. This is especially the case for exporters, since they may have deductible expenses, but no taxable revenue. Exporting firms with persistent losses will find the credits do them no good, which would affect export incentives. While economists would support a refund system in order to keep tax neutral, there is a large potential for fraud, and politically it seems unlikely that the government could issue large checks to profitable corporations on a permanent basis. The alternative suggested by the Blueprint is unlimited carry-forwards, but this doesn’t solve the problem for businesses with losses that may not be offset. And this introduces new trade distortions since the border adjustment is not symmetric. Exporting companies could of course merge with non-exporters in order for the losses to be more useful, but inducing a slew of tax-motivated mergers would be inefficient.

Auerbach and Holtz-Eakin recognize that this would be a large problem for exporting firms. They suggest allowing firms to use credits to offset payroll taxes, or have a system of refundable border adjustments, but both of these solutions are problematic and difficult to implement.47

Third, there are myriad technical problems that remain to be worked out. For example, financial institutions require separate treatment. The pure form of this tax leaves out financial flows entirely. An augmented form of the tax can capture financial transactions in the base, but this would introduce complexity as all companies would need to keep track of financial transactions, as well as whether the transactions occurred with foreign companies. There is also substantial ambiguity between what transactions are real and what are financial, and such ambiguity raises both technical considerations as well as opportunities for tax avoidance.48

Fourth, there are likely to be important impacts on state government corporate tax systems, and these have also not been carefully considered. Fifth, there are large transition effects associated with moving to a destination-basis cash flow system that would need

47 Auerbach & Holtz-Eakin, supra note 22.
to be carefully considered.\textsuperscript{49}

VI. PROGRESSIVITY AND REVENUE EFFECTS

An essential problem with the Ryan Blueprint concerns the tax rates that were chosen. These very low tax rates make the system likely to lose a large amount of revenue in a regressive manner.

Indeed, the corporate rate chosen is intellectually incoherent. One of the purported advantages of a destination-basis corporate cash flow tax is that it is supposed to curb profit shifting by removing the incentive for shifting profits and activities abroad. But, if that is the case, why is the rate cut needed? If tax burdens truly depend only on the location of immobile customers, why not keep the corporate rate at the same level as the top personal rate? The usual argument for the lower rate relies on the international mobility of income and competitiveness concerns. If such concerns are moot, then there is no reason to tax at a low rate.

Further, the discrepancy between the top personal rate and the business rate will create new avoidance opportunities as wealthy individuals seek to earn their income in tax-preferred ways, reducing their labor compensation in favor of business income. Companies would be inclined to tilt executive compensation toward stock options and away from salary income, and high-income earners would be inclined to earn income through their businesses in pass-through form.

The Ryan proposal exempts the normal return from capital, giving these returns zero-tax treatment. Further, excess returns (profits above the normal level) are taxed through the business tax system, but at rates far lower than the top personal income tax rate. The theoretical rationale for justifying such a favorable tax treatment for rents (excess profits) is simply absent. From an efficiency or an equity perspective, taxing rents at a higher rate makes sense.

Recent evidence from Treasury suggests that now about 75\% of the corporate tax base is rents/extra-normal profits; this fraction has been steadily increasing.\textsuperscript{50} If destination-based taxes are meant to fall solely on rent, this implies a higher ideal optimal tax rate, since taxing

\textsuperscript{49} Absent relief, consumption taxes generate a tax on the initial capital stock; while this is an efficient tax (since it is an unexpected lump sum tax on the capital stock), it is arbitrary. However, attempts to provide relief would be expensive and would reduce the progressivity of the tax system, since the capital stock is concentrated in the upper part of the income distribution. See Weisbach, \textit{supra} note 48.

\textsuperscript{50} See Laura Power & Austin Frerick, \textit{Have Excess Returns to Corporations Been Increasing Over Time?}, 69 NAT’L TAX J. 831, 831-46 (2016).
rents is far more efficient than taxing labor or capital.  

Further, the regressive nature of these tax changes is unjustifiable given the increases in economic inequality over the previous decades and the large surge in the share of income earned by the top 1% of the income distribution. Capital income, and rents, are far more concentrated than labor income. Cutting taxes on capital and rents so dramatically risks further exacerbating recent increases in income inequality.

The Tax Policy Center calculates the distributional effect of the Ryan plan, which benefits the wealthy disproportionately. The average federal tax rate falls by about 0.4 percentage points for the bottom 80% of the population, but it falls by 3.4 percentage points for the top quintile, and by 9 percentage points for the top 1%. The top 1% receive a tax cut that averages $213,000. The tax cut of the bottom

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52 The U.S. Treasury reports that the top 5% of tax units report 24% of income in 1986 (the earliest year available), increasing to 37% in 2012. See INTERNAL REVENUE SERV., SOI Tax Stats – Individual Statistical Tables by Tax Rate and Income Percentile (Aug. 31, 2016), http://www.irs.gov/uac/soi-tax-stats-individual-statistical-tables-by-tax-rate-and-income-percentile [perma.cc/G99F-W2E4]. Indeed, capital income is much more concentrated than labor income. Data from the Tax Policy Center for 2012 indicate that the top 5% of tax units report 68% of dividend income and 87% of long-term capital gains income. T09-0492-Distribution of Long-Term Capital Gains and Qualified Dividends by Cash Income Percentile, 2012, TAX POLICY CTR. (Dec. 10, 2009), http://www.taxpolicycenter.org/model-estimates/distribution-capital-gains-and-qualified-dividends/distribution-long-term-capital-2 [perma.cc/Y4D8-FVSG]. The U.S. Treasury also reports data on the top 400 taxpayers. This particularly small group of taxpayers reports 1.48% of total income in 2012, but 0.16% of total wage and salary income, 8.3% of total dividend income, and 12.3% of total capital gain income. INTERNAL REVENUE SERV., The 400 Individual Income Tax Returns Reporting the Largest Adjusted Gross Incomes Each Year, 1992–2013 (Dec. 2015), http://www.irs.gov/pub/irs-soi/13intop400.pdf [perma.cc/ZA26-XM7X]. The overall share of this tiny group has more than doubled since 1992 (when the data series begins). The wage income share has been flat, while the capital gains share has more than doubled, and the dividends share has more than quadrupled. All of these trends occur within a context where the labor share of income is falling relative to the capital share of income. For more discussion of these trends, see Kimberly Clausing, Strengthening the Indispensable U.S. Corporate Tax,” WASH. CTR. FOR EQUITABLE GROWTH (Sept. 12, 2016), http://equitablegrowth.org/report/strengthening-the-indispensable-u-s-corporate-tax/ [perma.cc/DQE8-WUMJ].
Finally, the Ryan proposal loses large amounts of tax revenue. The business tax features of the proposal are a large share of the ten-year, $3 trillion revenue loss, according to the Tax Policy Center. Prior research by Auerbach suggests that this type of corporate tax reform would not change revenue very much at the same corporate tax rate, and work by Devereux has suggested that the tax base would be smaller under a DBCT, but that this could be compensated for by higher rates. Under the Ryan plan, however, the rate is much lower, leading to large deficits.\footnote{Some recent work by Treasury economists has a somewhat more optimistic view of the tax base under this type of tax system, but the additional size of the base comes entirely from the border adjustment. See Elena Patel & John McClelland, What Would a Cash Flow Tax Look Like for U.S. Companies? Lessons from a Historical Panel (Office of Tax Analysis, Working Paper No. 116, 2017). It is important to note that the revenue from the border adjustment is contingent on the U.S. being in a trade deficit position. Since trade deficits (and the associated financial borrowing) eventually have to be paid back in the form of trade surpluses, these revenue gains are really being borrowed from future U.S. taxpayers. See Alan Viard, The Border Tax Adjustment Can’t Make Mexico Pay for the Wall, AEI, (Jan. 27, 2017, 10:45am), http://www.aei.org/publication/the-border-tax-adjustment-cant-make-mexico-pay-for-the-wall/ [perma.cc/T8Q2-TEKD].}

VII. CONCLUSION

The Ryan Blueprint destination-based cash-flow tax is not ready for prime-time. No other country had adopted a similar tax, and as the above analysis makes clear, there are myriad issues that would need to be worked through before any such tax were adopted. These issues are not small: the plan is incompatible with trade rules in a manner which harms our trading partners, it is incompatible with our treaty obligations, it is unlikely to end income shifting, it generates political problems due to large numbers of companies that would experience adverse tax treatment changes, it makes the tax system less progressive at the proposed tax rates, and it is likely to generate large revenue losses. In addition, there are important issues surrounding how exporters with losses would be handled (which could lead to inefficient mergers), how financial firms and financial transactions would be handled, how U.S. state corporate tax systems would be affected, and how the transition to the new tax system would be handled.

One pressing problem is that the Ryan blueprint is incompatible with WTO rules. And this incompatibility is no mere

80% averages $210.\footnote{Burman et al., supra note 3, at 271 (Table 4).}
technicality. U.S. trading partners are likely to be hurt in several ways. The effects of the wage deduction render the corporate cash-flow tax different from a VAT, and these differences have the net effect of increasing the incentive to operate in the United States, as both proponents and economists recognize. In addition, such a tax system would exacerbate the profit-shifting problems of our trading partners, since the United States will appear like a tax haven from their perspective. If multinational firms shift profits to the United States on paper, this will reduce foreign revenues without affecting U.S. revenues.

While economists have argued that exchange rate changes may reduce trade-distorting effects of such tax law changes, there are several reasons to suspect that such exchange rate changes will not be sufficient to neutralize the effects of such a tax law change. First, exchange rate changes are uniform, yet the export subsidy component of the DBCT plan would treat different firms differently. Second, exchange rate markets are very large, exchange rate movements are not well predicted by economic fundamentals, and many countries fix their exchange rates, all factors that would reduce hopes of smooth countervailing exchange rate adjustment. Third, exporting firms may receive incomplete loss offsets, and that would cause trade distortions.\textsuperscript{55}

However, even if these economic effects were disregarded, it is clear that the DBCT is on shaky legal ground with respect to both WTO rules and our tax treaties. The WTO is likely to recognize that this DBCT is non-equivalent to a VAT, and thus a direct tax, where border adjustments are not allowed. This will likely lead to years of litigation and perhaps an endgame whereby the DBCT is simply jettisoned in favor of a VAT. This would convert one of the most progressive tax instruments in our tax system into a regressive consumption tax. In the meantime, we are likely to face the prospect of large tariff retaliations by our trading partners, in an environment where the incoming U.S. administration has already provided ample reason to fear trade wars.

\textsuperscript{55} Even if the dollar appreciates fully, there are still serious concerns. Exchange rate appreciation generates its own risks to the world economy, generating serious financial vulnerability in a large number of countries that have substantial dollar liabilities. Dollar appreciation will also result in a multi trillion-dollar deterioration in the U.S. net international investment position, a large wealth redistribution away from U.S. holders of foreign assets and toward foreign holders of U.S. assets.
Given these concerns, we would recommend that Congress reject the Ryan Blueprint. Instead, it should focus on a revenue-neutral tax reform that reduces the corporate tax rate and eliminates the major corporate tax expenditures including deferral, taxing accumulated offshore earnings in full. Eliminating deferral would eliminate the incentive to earn income in low-tax countries, by treating foreign and domestic income alike for tax purposes. Pairing that reform with a lower corporate tax rate need not raise tax burdens on average, although it would create winners and losers among corporate taxpayers. A more fundamental reform would require worldwide corporate tax consolidation; this would better align the tax system with the reality of globally-integrated corporations.

Taxing foreign income currently also eliminates the incentive to build up large stocks of unrepatriated foreign income, now estimated at $2.6 trillion. This income is often invested in U.S. capital markets, and it increases the creditworthiness of U.S. multinational corporations, who can easily finance worthy investments. But corporations are inhibited from repatriation by the prospect of more favorable tax treatment if they delay, so this makes it difficult for them to return profits to shareholders. Indeed these concerns about repatriation are likely to give the multinational business community a large interest in corporate tax reform. Settling the future tax treatment of foreign income should be a key goal of these efforts.56

In terms of more incremental reforms, even a per-country minimum tax would be a big step toward reducing profit shifting toward tax havens and protecting the corporate tax base. A minimum tax would currently tax income earned in the lowest tax countries, and work by Clausing suggests that 98% of the profit shifting out of the United States is destined for countries with foreign tax rates below 15%.57 Other helpful incremental steps include stronger “earnings-stripping” rules and anti-corporate inversion measures such as an exit tax.

56 Toward this end, the U.S. Congress did a great disservice when they enacted a one-time holiday on dividend repatriation as part of the American Jobs Creation Act of 2004. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004). Ever since, companies have been more likely to delay repatriation in the hope of future holidays (or permanently more favorable treatment).

57 See Kimberly Clausing, The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond, 69 NAT’L TAX J. 905, 905-34 (2016).
AN ANALYSIS OF THE HOUSE GOP TAX PLAN

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Abstract

This paper analyzes the House GOP tax reform blueprint, which would significantly reduce marginal tax rates, increase standard deduction amounts, repeal personal exemptions and most itemized deductions, and convert business taxation into a destination-based cash flow consumption tax. Taxes would drop at all income levels in 2017, but the highest-income households would gain the most. Federal revenues would fall by $3.1 trillion over the first decade (static) and $3.0 trillion after accounting for macroeconomic feedback effects. Including added interest costs, the federal debt would rise by at least $3.6 trillion over the first decade and by as much as $9.2 trillion by the end of the second ten years.

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I. INTRODUCTION

II. MAJOR ELEMENTS OF THE PROPOSAL
   A. Individual Income Tax
   B. Estate and Gift Taxes
   C. Business Taxes
   D. ACA Taxes

III. IMPACT ON REVENUE AND DISTRIBUTION
   A. Impact on Revenue
   B. Impact on Distribution

IV. DYNAMIC EFFECTS ON THE ECONOMY
   A. Impact on Aggregate Demand
   B. Impact on Potential Output
   C. Impact on Saving and Investment
   D. Impact on Labor Supply
   E. Long-Run Impact on Output and Revenues
   F. Sensitivity of Macro Estimates to Assumptions

V. APPENDIX A. UNCLEAR DETAILS AND TPC’S ASSUMPTIONS ABOUT THE HOUSE GOP TAX PLAN
   A. Clarifying Questions and TPC’s Working Assumptions about
      Broad Provisions of the Plan (Sent to the Speaker’s Staff on June
      30, 2016)
      2. Transition Rules
      3. Border Adjustments
      4. Estate and Gift Taxes
   B. TPC Assumptions (Absent Clarifications) about Other
      Provisions
      1. Individual Income Tax
      3. Effective Date
   C. Provisions that TPC Will Assume are Unchanged
   D. Health-Related Tax Provisions
   E. “Special-Interest” Tax Provisions
      1. Corporate Income Tax
      2. Individual Income Tax (including pass-through businesses)
      3. Payroll Tax
   F. Additional Clarifying Questions and TPC Assumptions about the
      Plan (Sent to the Speaker’s Staff July 7, 2016)
      1. “Special Interest” Tax Provisions
      2. Rate Cap on Active Business Income
      3. Child Tax Credit and New Credit for Other Dependents
      4. Standard Deduction for Dependents
      5. Base Year for Indexing

VI. APPENDIX B. MEASURING DISTRIBUTIONAL EFFECTS OF TAX CHANGES
I. INTRODUCTION

House Speaker Paul Ryan announced on June 24, 2016 the House GOP blueprint for broad income tax reform. The proposal would reduce tax rates, simplify many provisions, and convert the taxation of business income into a destination-based cash-flow consumption tax. Many important details are not specified in the blueprint. We needed to make assumptions about these unspecified details for our analysis (see Appendix A). In addition, Speaker Ryan’s staff says the plan will be adjusted if necessary to offset any net revenue loss attributable to the tax provisions including macroeconomic feedback effects and excluding the effect of repealing the taxes enacted as part of the Affordable Care Act.

The Tax Policy Center (TPC) has estimated the revenue cost and the distributional effects of a plan consistent with the House GOP blueprint. We estimate that a plan such as this would reduce federal revenue by $3.1 trillion over the first decade of implementation and by an additional $2.2 trillion in the second decade, before accounting for added interest costs or considering macroeconomic feedback effects. Most of the revenue loss arises from business tax cuts.

TPC, in collaboration with the Penn-Wharton Budget Model (PWBM), also prepared two sets of estimates of the House GOP plan

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2 That is, the net revenue loss estimated by dynamic scoring could be as great as $0.8 trillion over the first decade and $1.4 trillion over the second. Ryan argues that the revenue loss from the ACA taxes should be offset “by repealing the massive new entitlement program created by Obamacare.” supra note 1 at 16. It is unclear what the replacement for ACA would be and we did not consider changes in health care outlays—including the refundable premium tax credit—in our analysis.

3 These estimates account for many microeconomic behavioral responses, such as reduced use of tax preferences and increased capital gains realizations when marginal tax rates on income and capital gains decline. The methodology we follow in preparing these estimates follows the conventional approach used by the Joint Committee on Taxation and the U.S. Department of the Treasury to estimate revenue effects before considering the macroeconomic effects. As noted in the text, we do not model certain potentially large tax avoidance responses because of uncertainty about exactly how the proposal would be implemented.
that take into account macroeconomic feedback effects. Both sets of estimates indicate that the plan would boost GDP in the short run, reducing the revenue cost of the plan. However, longer-run estimates indicate that over time the effect on output would become negative, increasing the revenue cost of the plan. Including macroeconomic feedbacks, the revenue loss falls to $3.0 trillion over the first decade, but rises to $3.4 trillion over the second decade. Including interest costs, the federal debt would increase by $3.6 trillion by 2026 and by $9.2 trillion by 2036. Eventually, rising debt pushes up interest rates, which crowds out private investment and slows growth. By 2036, the PWBM estimates that GDP would be 2.6 percent lower than if the tax cuts had not been enacted. These estimates are sensitive to parameter assumptions and the effects on GDP could be larger or smaller in both the short- and the long-run.

The plan would cut taxes at every income level in 2017, but high-income taxpayers would receive the biggest cuts, both in dollar terms and as a percentage of income. Overall, the plan would cut the average tax bill in 2017 by $1,810, increasing after-tax income by 2.5 percent. Three-quarters of the tax cuts would benefit the top 1 percent of households. The average tax cut for the highest-income 0.1 percent (incomes over $3.7 million in 2015 dollars) would be about $1.3 million, 16.9 percent of after-tax income. Households in the middle fifth of the income distribution would receive an average tax cut of almost $260, or 0.5 percent of after-tax income, while the poorest fifth of households would see their taxes go down an average of about $50, or 0.4 percent of their after-tax income. By 2025, households in some upper-middle income groups would have tax increases (although staff report that the plan will be adjusted so that no income group would experience an overall tax increase). The average tax cut at other income levels would be smaller in 2025, relative to after-tax income, than in 2017.

The plan would reduce the top individual income tax rate to 33 percent from the current 39.6 percent, reduce the corporate rate from 35 to 20 percent, and cap at 25 percent the tax rate on profits of pass-through businesses (such as sole proprietorships and partnerships), which are taxed under the individual income tax. Individuals could

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deduct half of their capital gains, dividends, and interest, reducing the top effective rate on such income to 16.5 percent.

The plan would increase the standard deduction and child tax credit. It would repeal personal exemptions and all itemized deductions except those for charitable contributions and home mortgage interest. The plan would also eliminate the alternative minimum tax (AMT), estate and gift taxes, and all taxes associated with the Affordable Care Act (ACA).

The corporate income tax would be replaced by a cash-flow consumption tax that would apply to all businesses: investments would be immediately deducted (i.e., expensed) and interest would no longer be deductible. The cash flow tax would be border adjustable, meaning receipts from exports would be excluded and purchases of imports would not be deductible. The plan would move the U.S. tax system to a destination-based system in which all sales to U.S. consumers would be taxable, regardless of their source, and all sales to foreign consumers would be exempt from U.S. tax.

The marginal tax rate cuts would boost incentives to work, save, and invest if interest rates do not change. The plan would reduce the marginal effective tax rate on most new investments, which would increase the incentive for investment in the U.S. and reduce tax distortions in the allocation of capital. In the short run, increased investment would raise labor productivity and U.S. wages by increasing capital per worker. However, increased government borrowing would push up interest rates and crowd out private investment, eventually offsetting the plan’s positive effects on private investment unless federal spending was sharply reduced to offset the effect of the tax cuts on the deficit. If the plan is modified to reduce the overall revenue loss, the adverse effects of rising interest rates could moderate or be eliminated. Those unspecified modifications could also, of course, modify economic incentives.

II. MAJOR ELEMENTS OF THE PROPOSAL

A. Individual Income Tax

The House GOP tax plan would consolidate the regular standard deduction, additional standard deductions for age or blindness, and the personal exemption for tax filers into new standard deduction amounts of $12,000 for single filers, $18,000 for head of household filers, and $24,000 for joint filers.

The plan would reduce the number of individual income tax brackets from the current seven brackets to three—12, 25, and 33
percent—cutting the top 39.6 percent rate by 6.6 percentage points (Table 1).

The plan would replace the special rates on capital gains and dividends with a 50 percent deduction, which would also apply to interest income. The top rate on capital gains and dividends would be reduced from 23.8 percent (including the 3.8 percent surtax on net investment income) to 16.5 percent, a decrease of over 30 percent. The top rate on interest income would be reduced from 43.4 percent to 16.5 percent, a decrease of over 60 percent.

The plan would repeal the deduction for personal exemptions for children and other dependents, which in 2016 is $4,050 and indexed for inflation. In its place, the plan would increase the child tax credit from $1,000 to $1,500 and create a new nonrefundable credit of $500 for other dependents. The child tax credit would phase out beginning at $75,000 of adjusted gross income for single filers (as
under current law) and $150,000 for joint filers (an increase from $110,000 under current law). The plan would eliminate all itemized deductions except the deductions for mortgage interest and charitable contributions. The plan would, nonetheless, reduce or eliminate tax savings from the remaining deductions for many taxpayers for three reasons. First, eliminating most itemized deductions and increasing the standard deduction would significantly reduce the number of taxpayers who itemize. We estimate that 38 million (84 percent) of the 45 million filers who would otherwise itemize in 2017 would opt for the standard deduction. Nonitemizers obviously do not benefit from itemized deductions. Second, for many who continue itemizing, the fraction of their mortgage interest or charitable contributions that exceeded the standard deduction (that is, reduces taxable income) would decline. Third, many would face lower marginal tax rates, which would reduce the value of any deduction.

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5 The plan does not specify whether these credits would be indexed for inflation (the current child tax credit is not), whether the phase-out ranges for the child tax credit would be indexed for inflation (they are not indexed under current law), or whether the new $500 credit for other dependents would be subject to an income phase out (personal exemptions are phased out at higher income levels under current law). Speaker Ryan’s staff did not respond to our request for clarification on these issues. For our analysis we have assumed that neither credit is indexed for inflation, that the new credit for other dependents phases out in the same manner as the child tax credit, and that the phase-out ranges are not indexed for inflation.

6 For our analysis we have assumed that the plan repeals the limitation on itemized deductions for high-income taxpayers, although Speaker Ryan’s staff did not provide clarification on this issue.

7 The effective subsidy rate for an itemized deduction is the marginal tax rate multiplied by the fraction of the deduction in excess of the standard deduction. Thus, for example, if a taxpayer in the 25 percent tax bracket has $10,000 of mortgage interest, but total itemized deductions exceed the standard deduction by $5,000, the effective subsidy rate is 12.5 percent (5,000/10,000*25 percent). Since the plan eliminates some large itemized deductions, such as the deduction for state and local taxes, and raises the standard deduction, the fraction of itemized deductions in excess of the standard deduction will decline.
The plan would repeal the individual AMT and a number of “special interest” tax provisions, only some of which were explicitly identified and included in our estimates.\(^8\)

B. Estate and Gift Taxes

The House GOP tax plan would eliminate the federal estate, gift and generation-skipping transfer taxes.\(^9\)

Eliminating the estate tax would remove several economic distortions (such as the incentive it creates to spend down asset balances to below the threshold for taxation). However, eliminating the estate tax would also remove the incentive it provides the wealthy to make charitable contributions.\(^10\)

C. Business Taxes

The House GOP tax plan would cut the top corporate tax rate from 35 percent to 20 percent. A top rate of 25 percent would apply to pass-through entities such as sole proprietorships, partnerships and S corporations, which are taxed at individual rates of up to 39.6 percent under current law.\(^11\)

The 8 percentage point differential between the top rate on pass-through business income and wages could create a strong incentive for many wage earners to form a pass-through entity that provides labor services to their current employer instead of taking

\(^8\)Because Speaker Ryan’s staff did not respond to our request for clarification on the specific provisions that would be repealed under the plan, our revenue and distributional estimates only include repeal of the “special interest” provisions explicitly identified in the plan description. However, we do show as an addendum to our revenue estimates (Table 2) the revenue effect of repealing the other “special interest” provisions listed in Appendix A.

\(^9\)The plan does not specify whether the basis of inter vivos gifts would continue to carry over from the transferor (carryover basis), or whether the basis of assets transferred at death would continue to be stepped up (stepped-up basis), as under current law, or whether limits would apply to the amount of stepped-up basis with carryover basis applying to the remainder, as under the law in effect in 2010 (when the estate tax was temporarily repealed). For our analysis, we have assumed that carryover basis would continue to apply to inter vives gifts, and that the 2010 limitation on stepped-up basis would apply.

\(^10\)Repealing the estate tax would also reduce an individual’s incentive to make donations during his or her lifetime. Under current law, such donations produce an income tax deduction and reduce the size of the taxable estate, thereby saving both income and estate taxes. Overall, for wealthy individuals the plan would substantially increase the tax price of donating, which would tend to reduce charitable giving. However, the large tax cuts for high-income households discussed later would produce a partially offsetting income or wealth effect because giving tends to rise with income, all else being equal.

\(^11\)Certain income of pass-through entities is also subject to the 3.8 percent rate on net investment income, making the top rate 43.4 percent.
compensation in the form of wages. To stem such tax avoidance, the plan would require pass-through businesses to pay “reasonable compensation” for tax purposes, so that the preferential 25 percent rate would not apply to all income of pass-through owner-operators. The plan does not specify how reasonable compensation would be defined or the rule enforced. Current-law rules are very difficult to enforce, leading to significant tax avoidance; with the much larger rate differential under the House GOP plan avoidance would be much more prevalent. Nevertheless, for purposes of our analysis we have assumed that reasonable compensation would be defined in an enforceable manner and would not permit a shift from reported wages to business income. With imperfect enforcement, the plan would lose substantially more revenue than we estimate.

Both corporations and pass-through businesses would be permitted to expense (i.e., immediately deduct) all investments in equipment, structures, and inventories, rather than having to capitalize and depreciate these purchases over time as current law generally requires. In addition, businesses’ net interest expense would no longer be deductible, but any unused net interest expense could be carried forward indefinitely. These rules would transform the corporate income tax and the individual income taxation of the profits of pass-through businesses into a cash-flow tax, treating business income as it would be treated under a consumption tax that allows deductibility of wages.

If all business income were taxed at the same rate, the tax would be equivalent to a subtraction method value-added tax with an offsetting credit—at the same rate—for wages. If the tax rate were set at the top individual income tax rate (33 percent in the proposal) and individual taxes on capital income were eliminated, the proposal would be equivalent to Bradford’s X-tax, a progressive variant of a consumption tax. The fact that there are two business tax rates, both

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12 Under current law, for high earners any income earned through a pass-through entity that is not subject to payroll tax can reduce the rate on that income by as much as 3.8 percent. Under the House GOP tax plan, any portion of current wages that could avoid payroll tax would save 2.9 percent, and if not part of “reasonable compensation” another 8 percent (the difference between the 33 percent top ordinary income tax rate and the 25 percent pass-through tax rate), for a total of 10.9 percent. Shifted earnings below the Social Security maximum ($127,200 in 2017) would also avoid the 12.4 percent OASDI tax.

below the top individual income tax rate, create numerous complications, including the incentive for income shifting already discussed.

The proposal includes a “border adjustment,” which is intended to make the business income tax apply only to domestically consumed goods and services, regardless of where they are produced. Businesses would be permitted to exclude receipts from exports, and imports would not be deductible. To make the border adjustment completely neutral, taxpayers with negative taxable cash flow—which would include many or most exporters—would receive any negative tax liability as a refund. The refunds could be large. The dual business rate system also would mean that exporters would have a strong incentive to be structured as pass-throughs rather than corporations (since the refunds would be larger at a 25 percent rate than at 20 percent). Importers would be more likely to incorporate than under current law, although the proposal could still penalize corporations relative to pass-throughs because dividends and capital gains would continue to be taxed at the individual level.

If there is no change in the balance of trade, the border adjustment would increase revenues because U.S. imports (which would become taxable) exceed U.S. exports (which would become tax-exempt). Although it appears unlikely that such a border adjustment would be permissible under current international trade law, we have nevertheless included the revenue and distributional effects of them in

14 Provisions would need to be made to limit the value of deductions for purchases from corporations (which are taxed at 20 percent) by pass-through entities that export their products. This could be extremely complicated. Other countries with border-adjustable tax systems use a credit-invoice VAT, which makes rebating taxes paid much simpler. Exporters simply receive a credit for taxes remitted by their suppliers, which are tracked via tax invoices.

15 Imports direct to consumers would presumably be taxable, although it is unclear whether they would be taxed at the 20 percent corporate tax rate or the 25 percent pass-through rate.
Many analysts have noted that this short-run revenue source—$1.2 trillion over 10 years by our estimate—is effectively a form of borrowing since current trade deficits must eventually be offset by trade surpluses. Moreover, Setser argues that the trade surplus may be artificially inflated due to businesses shifting profits overseas to avoid U.S. tax and that border adjustments might raise substantially less revenue than estimated.

Under the plan, the U.S. would no longer tax repatriated profits from foreign-source income generated from overseas sales. The plan would make up part of this loss of future revenue by imposing a transition tax on the existing unrepatriated earnings of U.S. firms’ foreign subsidiaries. Earnings held in cash would be taxed at 8.75 percent and other earnings at 3.5 percent, with the liability for this one-time tax payable over eight years.

Adopting a destination-based tax system and eliminating deductibility of net interest expense would eliminate U.S. corporations’ incentives to move their tax residences overseas (i.e., “corporate inversions”) and to recharacterize domestic corporate income as foreign-source income. Border adjustability would remove these incentives, because the amount of U.S. income tax a corporation paid would not depend on where it was incorporated, where its product or service was produced, or where its shareholders resided. However,

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17 For example, under current law, U.S. multinationals have an incentive to shift profits to low-taxed foreign subsidiaries by transferring ownership of intangible assets to them at low price, so the subsidiaries earn artificially high profits. Those transfers (which are counted as U.S. exports) would become nontaxable in the U.S. with the border adjustment, so U.S. multinationals could reduce their worldwide tax payments by increasing the value they place on the transfers. U.S. exports would increase, with a corresponding diminution of our balance of trade deficit. Brad Setser, Dark Matter. Soon to be Revealed?, COUNCIL ON FOREIGN RELATIONS (Feb. 2, 2017), http://blogs.cfr.org/setser/2017/02/02/dark-matter-soon-to-be-revealed [perma.cc/VXS3-2WCQ].
as noted above, border adjustments are unlikely to be legal under existing trade law. If the plan were adopted without border adjustability and with exemption of sales from foreign production, it would be a territorial tax and would retain incentives for U.S. corporations to shift their profits to low-tax foreign subsidiaries.

The plan would repeal the corporate AMT and a number of “special interest” business tax provisions, only some of which were explicitly identified and included in our estimates.\footnote{See supra note 8 for a discussion of special interest provisions.}

D. ACA Taxes

The House GOP health plan repeals all ACA taxes, including the 3.8 percent surtax on net investment income, the 0.9 percent additional Medicare rate on high-income workers, excise taxes (for example, the excises on medical devices and high-premium health insurance), premium credits, and related fees. We include the repeal of ACA taxes in our analysis of the House GOP tax plan. Note that the House GOP health plan also proposes a new limit on the tax exclusion for employer-provided health insurance and a new credit for non-group health insurance. We assume that the limit on the tax exclusion has the same revenue and distributional effects as the current excise tax on high-premium health insurance.\footnote{While an exclusion cap is a more direct and potentially more progressive way to reduce the incentive for provision of overly generous health insurance, the Cadillac plan tax is so onerous that most employers would reduce their spending to below the cap and (eventually) pass on the savings to employees. As a result, Blumberg, Holahan, and Mermin (2015) conclude that “the incidence of the ACA’s excise tax is identical in most circumstances to a cap on the employer exclusion that would raise the same revenue.” Linda J. Blumberg, John Holahan & Gordon Mermin, The ACA’s ‘Cadillac’ Tax Versus a Cap on the Tax Exclusion of Employer-Based Health Benefits: Is This a Battle Worth Fighting? URBAN INST. (Oct. 22, 2015), http://www.urban.org/sites/default/files/publication/72391/2000482-the-acas-cadillac-tax-versus-a-cap-on-the-tax-exclusion-of-employer-based-health-benefits.pdf [perma.cc/X3NS-YB8K].}

In addition, we exclude replacement of the ACA premium credit with the proposed non-group health insurance credit because we do not include the ACA premium credit in our current-law tax baseline.\footnote{The ACA premium credit is advanceable and refundable, making it more like a spending program than a tax provision. It is unclear what the replacement credit would look like.}

III. IMPACT ON REVENUE AND DISTRIBUTION

A. Impact on Revenue

\footnote{See supra note 8 for a discussion of special interest provisions.}
We estimate that the House GOP tax plan would reduce federal receipts by $3.1 trillion between 2016 and 2026 before accounting for macroeconomic feedback effects (Table 2).\textsuperscript{21} Nearly two-thirds of the revenue loss would come from business tax provisions. Corporations would pay less due because their top rate would be reduced to 20 percent and the corporate AMT would be repealed. Pass-through businesses taxed under the individual income tax would pay less because they would face a 25 percent top rate. All businesses would benefit from expensing of investment, which would be partially offset by the disallowance of interest deductibility, repeal of some tax expenditures, and, for corporations, the border adjustments and transition tax on unrepatriated foreign income.\textsuperscript{22}

The remainder of the revenue loss would result primarily from net cuts in nonbusiness individual income taxes. Reductions in income tax rates, the 50 percent exclusion for capital income, and repeal of the ACA taxes and the individual AMT would all reduce revenue. The increased standard deduction amounts, the higher child tax credit, and the new credit for other dependents would also reduce revenue, but these losses would be more than offset by the repeal of personal exemptions and itemized deductions other than those for mortgage interest and charitable contributions.

Repealing the estate and gift taxes and requiring the basis of inherited assets to be carried over (as was done in 2010, when the estate tax was temporarily repealed), would reduce revenues by $187 billion over the budget period.

We also estimate the effect of the tax changes in the second decade (2027–2036) and find the revenue loss ($2.2 trillion) is smaller in nominal terms than that in the first 10 years, and also represents a smaller share of cumulative gross domestic product (GDP)—0.6 percent versus 1.3 percent in 2017–2026.

The House GOP blueprint indicates the plan would repeal “special interest” tax provisions, but explicitly identifies only employee fringe benefits (other than for health and retirement), the domestic production activity deduction, and credits (with several

\textsuperscript{21} Although we assume an effective date of January 1, 2017, we estimate a slight revenue loss in 2016 because taxpayers would postpone realizing capital gains in anticipation of the 2017 reduction in capital gains rates.

\textsuperscript{22} We report all revenues from the border adjustments as corporate, although some portion would be from pass-through entities.
exceptions).\textsuperscript{23} We included only those explicitly identified provisions. However, the Addendum to Table 2 shows our estimates of other tax provisions the plan might repeal.

Aside from the unspecified and uncertain provisions, there are a number of uncertainties associated with the revenue projection. As noted, House GOP staff argue that repealing the ACA taxes should not be considered a revenue loss attributable to tax reform since those will be dealt with in health reform legislation. Subtracting those provisions would reduce the revenue loss by $0.8 trillion in the first decade and $1.4 trillion in the second. On the other side, the border adjustments will eventually lose revenue, and our estimate of the revenue raised by the border adjustments could be too high if the current reported trade deficit is artificially inflated by tax-motivated transfer pricing strategies. Finally, conversion of wages and salaries into pass-through business income to take advantage of the lower tax rates could result in substantial revenue losses. We have not estimated the revenue loss from such shifting in the House GOP plan, but our analysis of the Trump plan, which would have taxed pass-through income at 15 percent (10 percentage points lower than the House plan), estimated that income shifting could ultimately cost more revenue than the direct effect of cutting pass-through tax rates. The direct revenue losses understate the effect on the national debt because they exclude the additional interest that would accrue if debt were to increase. Including interest, the proposal would add $3.7 trillion to the national debt by 2026 and $8.0 trillion by 2036 (Table 3). If the tax cuts were not offset by spending cuts, we estimate the national debt would rise by 13.5 percent of GDP by 2026 and 19.3 percent of GDP by 2036. Taking macroeconomic feedback effects into account, the ratio of additional debt to GDP would be lower after ten years and larger after 20 years, rising to at least 13.2 percent by 2026 and to 22.7 percent by 2036. The PWBM model estimates that after 2036, revenues and GDP fall below the levels estimated without macro feedback by increasing amounts, so the ratio of debt to GDP would climb more rapidly in later years.

\textsuperscript{23} The credits identified (directly or by implication) in the House GOP blueprint document as retained are the child tax credit, the EITC, education credits, the savers’ credit, the research and experimentation credit, and the foreign tax credit; all other credits would presumably be repealed.
**TABLE 2**

Estimated Effect of House GOP Tax Plan on Tax Receipts
$ billions, FY 2016–36

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<tbody>
<tr>
<td>Repeal ACA taxes</td>
<td>-5.6</td>
<td>-23.1</td>
<td>-57.0</td>
<td>-72.2</td>
<td>-78.5</td>
<td>-82.4</td>
<td>-802.1</td>
<td>-1,430.0</td>
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<tr>
<td>Repeal alternative minimum tax</td>
<td>0.0</td>
<td>-25.0</td>
<td>-34.7</td>
<td>-37.2</td>
<td>-40.1</td>
<td>-42.9</td>
<td>-427.3</td>
<td>-723.7</td>
</tr>
<tr>
<td>Individual income tax rates of 12, 25, and 33 percent</td>
<td>0.0</td>
<td>-92.6</td>
<td>-129.2</td>
<td>-135.9</td>
<td>-143.1</td>
<td>-149.6</td>
<td>-1,542.9</td>
<td>-2,620.4</td>
</tr>
<tr>
<td>Repeal itemized deductions (other than charitable and mortgage interest) and Pease</td>
<td>0.0</td>
<td>108.6</td>
<td>150.3</td>
<td>161.8</td>
<td>174.8</td>
<td>187.3</td>
<td>1,907.6</td>
<td>3,342.0</td>
</tr>
<tr>
<td>Increase standard deduction to $24,000/$48,000/$12,000</td>
<td>0.0</td>
<td>-93.5</td>
<td>-126.7</td>
<td>-128.9</td>
<td>-131.6</td>
<td>-135.9</td>
<td>-1,361.0</td>
<td>-1,911.1</td>
</tr>
<tr>
<td>50 percent inclusion rate for capital income</td>
<td>-5.2</td>
<td>-22.8</td>
<td>-34.4</td>
<td>-44.2</td>
<td>-48.3</td>
<td>-50.6</td>
<td>-497.8</td>
<td>-846.6</td>
</tr>
<tr>
<td>Top rate of 25 percent on active business income</td>
<td>0.0</td>
<td>-22.7</td>
<td>-32.3</td>
<td>-34.8</td>
<td>-37.5</td>
<td>-39.2</td>
<td>-412.8</td>
<td>-709.5</td>
</tr>
<tr>
<td>Repeal personal exemptions for taxpayer and dependents</td>
<td>0.0</td>
<td>108.8</td>
<td>148.3</td>
<td>153.2</td>
<td>158.6</td>
<td>165.3</td>
<td>1,653.6</td>
<td>2,427.9</td>
</tr>
<tr>
<td>Additional nonrefundable credit of $500 per dependent; increase CTC phaseout for MFJ</td>
<td>0.0</td>
<td>-25.3</td>
<td>-33.9</td>
<td>-33.8</td>
<td>-33.7</td>
<td>-33.6</td>
<td>-325.5</td>
<td>-312.6</td>
</tr>
<tr>
<td>Repeal child and dependent care and elder credits</td>
<td>0.0</td>
<td>2.7</td>
<td>3.6</td>
<td>3.7</td>
<td>3.8</td>
<td>3.9</td>
<td>38.9</td>
<td>48.8</td>
</tr>
<tr>
<td>Expense all investment; disallow deduction for net interest expense on new loans</td>
<td>0.0</td>
<td>-93.6</td>
<td>-113.7</td>
<td>-99.0</td>
<td>-86.8</td>
<td>-71.9</td>
<td>-637.5</td>
<td>487.6</td>
</tr>
<tr>
<td>Repeal individual tax expenditures explicitly identified in House GOP plan</td>
<td>0.0</td>
<td>25.2</td>
<td>35.5</td>
<td>37.2</td>
<td>38.1</td>
<td>39.0</td>
<td>385.2</td>
<td>515.7</td>
</tr>
<tr>
<td><strong>Total for individual income and payroll tax revenue</strong></td>
<td>-19.8</td>
<td>-153.3</td>
<td>-224.1</td>
<td>-230.2</td>
<td>-224.4</td>
<td>-210.7</td>
<td>-2,022.8</td>
<td>-1,733.9</td>
</tr>
</tbody>
</table>

**Corporate income tax**

<table>
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<tr>
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</thead>
<tbody>
<tr>
<td>Reduce corporate rate to 20% and repeal the corporate AMT</td>
<td>0.0</td>
<td>-80.7</td>
<td>-163.6</td>
<td>-183.4</td>
<td>-194.0</td>
<td>-192.7</td>
<td>-1,844.9</td>
<td>-2,751.5</td>
</tr>
<tr>
<td>Expense all investment; disallow deduction for net interest expense on new loans</td>
<td>0.0</td>
<td>-70.0</td>
<td>-120.3</td>
<td>-103.4</td>
<td>-86.1</td>
<td>-66.5</td>
<td>-447.5</td>
<td>636.4</td>
</tr>
<tr>
<td>Territorial system of taxing foreign-source income earned after 12-31-16</td>
<td>0.0</td>
<td>-3.6</td>
<td>-7.3</td>
<td>-8.4</td>
<td>-8.7</td>
<td>-9.0</td>
<td>-67.9</td>
<td>-139.2</td>
</tr>
<tr>
<td>Deemed repatriation of pre-2017 profits of CFCS; taxed at reduced rates; paid over 8 years</td>
<td>0.0</td>
<td>7.8</td>
<td>15.6</td>
<td>17.3</td>
<td>17.3</td>
<td>17.3</td>
<td>138.3</td>
<td>0.0</td>
</tr>
<tr>
<td>Border adjustments (export receipts excluded; purchases of imports not deductible)</td>
<td>0.0</td>
<td>49.9</td>
<td>101.4</td>
<td>115.5</td>
<td>118.9</td>
<td>122.4</td>
<td>1,179.6</td>
<td>1,689.3</td>
</tr>
<tr>
<td>Repeal corporate tax expenditures explicitly identified in House GOP plan</td>
<td>0.0</td>
<td>5.0</td>
<td>10.6</td>
<td>13.2</td>
<td>14.8</td>
<td>16.6</td>
<td>171.7</td>
<td>372.5</td>
</tr>
<tr>
<td><strong>Total for corporate income tax revenues</strong></td>
<td>0.0</td>
<td>-91.7</td>
<td>-163.6</td>
<td>-149.1</td>
<td>-137.8</td>
<td>-112.0</td>
<td>-890.7</td>
<td>-192.5</td>
</tr>
</tbody>
</table>

**Estate and gift taxes**

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</thead>
<tbody>
<tr>
<td>Repeal the estate, gift and GST taxes; carryover basis for gains</td>
<td>0.0</td>
<td>0.4</td>
<td>-13.2</td>
<td>-20.1</td>
<td>-21.3</td>
<td>-21.4</td>
<td>-187.4</td>
<td>-299.2</td>
</tr>
<tr>
<td>Total for estate and gift tax revenues</td>
<td>0.0</td>
<td>0.4</td>
<td>-13.2</td>
<td>-20.1</td>
<td>-21.3</td>
<td>-21.4</td>
<td>-187.4</td>
<td>-299.2</td>
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</tbody>
</table>

**Total revenue effect of all provisions**

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<tbody>
<tr>
<td>Total revenue change before macro feedback (sum of amounts above)</td>
<td>-19.8</td>
<td>-246.6</td>
<td>-401.0</td>
<td>-399.5</td>
<td>-383.6</td>
<td>-344.1</td>
<td>-3,100.9</td>
<td>-2,225.6</td>
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<tr>
<td>Total revenue change after macro feedback (dynamic score)</td>
<td>-10.8</td>
<td>-203.6</td>
<td>-372.5</td>
<td>-387.4</td>
<td>-376.6</td>
<td>-342.6</td>
<td>-3,008.8</td>
<td>-2,226.6</td>
</tr>
<tr>
<td>TPC Keynesian model estimates</td>
<td>-10.8</td>
<td>-203.6</td>
<td>-372.5</td>
<td>-387.4</td>
<td>-376.6</td>
<td>-342.6</td>
<td>-3,008.8</td>
<td>-2,226.6</td>
</tr>
<tr>
<td>PWBM overlapping generations model estimates</td>
<td>-10.8</td>
<td>-203.6</td>
<td>-372.5</td>
<td>-387.4</td>
<td>-376.6</td>
<td>-342.6</td>
<td>-3,008.8</td>
<td>-2,226.6</td>
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</table>

**Exhibit: difference in total revenue change due to macro feedback**

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</thead>
<tbody>
<tr>
<td>TPC Keynesian model estimates</td>
<td>0.0</td>
<td>43.0</td>
<td>28.5</td>
<td>12.1</td>
<td>7.0</td>
<td>1.5</td>
<td>92.1</td>
<td>0.0</td>
</tr>
<tr>
<td>PWBM overlapping generations model estimates</td>
<td>0.0</td>
<td>49.6</td>
<td>33.6</td>
<td>18.1</td>
<td>13.5</td>
<td>7.4</td>
<td>64.0</td>
<td>-1,146.1</td>
</tr>
</tbody>
</table>

**ADDENDUM** Tax expenditures possibly included but not explicitly identified in the House GOP tax plan

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</thead>
<tbody>
<tr>
<td>Individual income tax and payroll tax expenditures</td>
<td>0.0</td>
<td>30.1</td>
<td>51.9</td>
<td>54.5</td>
<td>56.9</td>
<td>59.7</td>
<td>822.8</td>
<td>1,083.0</td>
</tr>
<tr>
<td>Corporate income tax expenditures</td>
<td>0.0</td>
<td>8.4</td>
<td>17.1</td>
<td>19.6</td>
<td>20.1</td>
<td>20.7</td>
<td>198.9</td>
<td>286.1</td>
</tr>
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</table>

**Sources:** Urban-Brookings Tax Policy Center (TPC) Microsimulation Model (version 0516-1); TPC off-model estimates; TPC Keynesian model; Penn-Wharton Budget Model (PWBM) overlapping generations model.

**Note:** AMT = alternative minimum tax; CFCS = controlled foreign corporation; CTC = child tax credit; GDP = gross domestic product; GST = generation skipping transfer; MFJ = married filing jointly.
B. Impact on Distribution\textsuperscript{24}

The House GOP tax plan would reduce taxes throughout the income distribution in 2017.\textsuperscript{25}

\textsuperscript{24} This distributional analysis is based on the Urban-Brookings Tax Policy Center Microsimulation Model. For a brief description of the model, see \textit{Brief Description of the Tax Model}, TAX POLICY CTR. (Dec. 21, 2015), http://www.taxpolicycenter.org/taxtopics/Brief-Description-of-the-Model-2015.cfm. [perma.cc/4ABR-E74Q].

\textsuperscript{25} Appendix B discusses alternative distribution measures and illustrates several alternatives for the House GOP tax plan.
Taxes would decrease by an average of $1,810, or 2.5 percent of after-tax income (Table 4). On average, households at all income levels would receive tax cuts, but the highest-income households would receive the largest cuts, both in dollars and as a percentage of income. The top quintile—or top fifth of the distribution—would receive an average tax cut of about $11,800 (4.6 percent of after-tax income). Three-quarters of total tax cuts would go to the top 1 percent, who would receive an average cut of nearly $213,000, or 13.4 percent of after-tax income. The top 0.1 percent would receive an average tax cut of about $1.3 million (16.9 percent of after-tax income). In contrast, the average tax cut for the lowest-income households would be just $50, 0.4 percent of after-tax income. Middle-income households would receive an average tax cut of $260, about the same relative to after-tax income—0.5 percent—as for the lowest-income households.

### Table 4

**Distribution of Federal Tax Change By expanded cash income percentile, 2017**

<table>
<thead>
<tr>
<th>Expanded cash income percentile</th>
<th>Percent change in after-tax income (%)</th>
<th>Share of total federal tax change (%)</th>
<th>Average federal tax change ($)</th>
<th>Average Federal Tax Rate*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Change (%) points</td>
<td>Under the proposal (%)</td>
</tr>
<tr>
<td>Lowest quintile</td>
<td>0.4</td>
<td>0.8</td>
<td>-50</td>
<td>-0.4 3.4</td>
</tr>
<tr>
<td>Second quintile</td>
<td>0.4</td>
<td>1.4</td>
<td>-120</td>
<td>-0.3 8.1</td>
</tr>
<tr>
<td>Middle quintile</td>
<td>0.5</td>
<td>2.8</td>
<td>-260</td>
<td>-0.4 13.2</td>
</tr>
<tr>
<td>Fourth quintile</td>
<td>0.5</td>
<td>3.7</td>
<td>-410</td>
<td>-0.4 17.0</td>
</tr>
<tr>
<td>Top quintile</td>
<td>4.6</td>
<td>89.0</td>
<td>-11,760</td>
<td>-3.4 22.7</td>
</tr>
<tr>
<td>All</td>
<td>2.5</td>
<td>100.0</td>
<td>-1,810</td>
<td>-2.0 18.0</td>
</tr>
</tbody>
</table>

#### Addendum

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</thead>
<tbody>
<tr>
<td>80–90</td>
<td>0.2</td>
<td>1.2</td>
<td>-310</td>
<td>-0.2</td>
<td>20.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>90–95</td>
<td>0.2</td>
<td>0.7</td>
<td>-370</td>
<td>-0.2</td>
<td>22.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>95–99</td>
<td>2.5</td>
<td>11.0</td>
<td>-7,890</td>
<td>-1.9</td>
<td>23.6</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top 1 percent</td>
<td>13.4</td>
<td>76.1</td>
<td>-212,860</td>
<td>-8.9</td>
<td>24.5</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top 0.1 percent</td>
<td>16.9</td>
<td>46.5</td>
<td>-1,282,530</td>
<td>-11.1</td>
<td>23.4</td>
<td></td>
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</tr>
</tbody>
</table>

**Source:** Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

**Notes:** Number of Alternative Minimum Tax (AMT) taxpayers (millions): Baseline: 4.8; Proposal: 0.


(b) The percentile includes both filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative adjusted gross income are excluded from their respective income class but are included in the totals. For a description of expanded cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm

(c) The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are $15,000: 20% $24,800; 40% $48,400; 60% $83,300; 80% $143,100; 90% $262,100; 95% $699,000; 99.9% $3,749,600.

(d) After-tax income is expanded cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); estate tax; and excise taxes.

(e) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, the estate tax, and excise taxes) as a percentage of average expanded cash income.
As with the revenue estimates, there are several sources of uncertainty associated with the distributional estimates. In the short-run, the burden of the net revenue raised by the border adjustments depends on how prices adjust. If exchange rates fully adjust to offset the border adjustments, then domestic prices would remain unchanged and the net revenue should be distributed similar to a cash flow tax that does not burden wage income. However, if exchange rates do not fully adjust, then domestic prices would rise, resulting in a burden more similar to that of a broad-based consumption tax.\(^{26}\) An alternative approach would attribute zero burden to the border adjustments under the view that current trade deficits are temporary and will eventually be offset (with interest) by trade surpluses in the future. Additionally, the plan is unclear on many details of the business tax changes, and our methodologies differ for distributing changes in existing income taxes and consumption-based taxes. Our analysis distributes the changes in business taxes as incremental changes to the income tax according to our established methodology,\(^{27}\) but this approach does not yield the same result as if the cash flow tax was distributed as a replacement for the current income tax on business income.\(^{28}\)

In order to illustrate the uncertainty concerning the short-run effects of the plan across the income distribution, we report the percent change in after-tax income in 2017 under alternative assumptions about the size of the changes in tax burdens due to the business tax provisions and the border adjustments, and how those burdens are distributed (Table 5). Overall, under the alternative assumptions the


\(^{28}\) Further, by convention, TPC’s distributional analyses do not include short-run wealth effects. In particular, if exchange rates adjust to offset the effect of the border adjustments on international trade, the appreciation of the dollar would reduce the value of Americans’ foreign asset holdings. This reduction in the value of existing (foreign) assets, which would primarily affect high-income households, is not included in the distribution tables. In addition, replacing the corporate income tax with a cash flow consumption tax could reduce the value of old capital—another transitory effect; however, we assume that transition rules (allowing existing asset holders to continue to deduct unused depreciation and interest on outstanding loans) would largely offset this wealth effect. We are reexamining our distributional assumptions and may revise our analysis in a future report.
plan would increase after-tax income in 2017 by between 1.7 and 3.4 percent. Households in the bottom four quintiles would see their after-tax income rise by as much as 1.4 percent. Households in the 80th to 95th percentiles would fare the worst. Higher-income households would receive the largest tax cuts. The top 1 percent would see after-tax incomes rise by between 8.0 and 14.1 percent, while the richest top 0.1 percent would receive tax cuts equal to between 10.0 and 17.4 percent of after-tax income.

In the longer-run, the burden of the border adjustments would not depend on which prices adjust and the distribution of tax changes would be similar to the full exchange rate adjustment scenario. Although, by 2025, the average tax cut would be smaller and households in the 80th to 95th percentiles on average would have tax increases rather than cuts. (Speaker Ryan’s staff have told us that the

<table>
<thead>
<tr>
<th>Expanded cash income percentile</th>
<th>Percent change in after-tax income (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No exchange rate adjustment</td>
</tr>
<tr>
<td>Lowest quintile</td>
<td>0.4</td>
</tr>
<tr>
<td>Second quintile</td>
<td>0.4</td>
</tr>
<tr>
<td>Middle quintile</td>
<td>0.5</td>
</tr>
<tr>
<td>Fourth quintile</td>
<td>0.5</td>
</tr>
<tr>
<td>Top quintile</td>
<td>4.6</td>
</tr>
<tr>
<td>All</td>
<td>2.5</td>
</tr>
</tbody>
</table>

Addendum

<table>
<thead>
<tr>
<th></th>
<th>No exchange rate adjustment</th>
<th>Full exchange rate adjustment</th>
<th>No burden from border adjustments</th>
</tr>
</thead>
<tbody>
<tr>
<td>80–90</td>
<td>0.2</td>
<td>0.7</td>
<td>1.2</td>
</tr>
<tr>
<td>90–95</td>
<td>0.2</td>
<td>0.5</td>
<td>1.1</td>
</tr>
<tr>
<td>95–99</td>
<td>2.5</td>
<td>2.4</td>
<td>3.4</td>
</tr>
<tr>
<td>Top 1 percent</td>
<td>13.4</td>
<td>10.8</td>
<td>14.1</td>
</tr>
<tr>
<td>Top 0.1 percent</td>
<td>16.9</td>
<td>13.1</td>
<td>17.4</td>
</tr>
</tbody>
</table>

Notes:
(b) The percentile includes both filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative adjusted gross income are excluded from their respective income class but are included in the totals. For a description of expanded cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm
(c) The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2016 dollars): 20% $24,800; 40% $48,400; 60% $83,300; 80% $143,100; 90% $208,800; 95% $326,100; 99% $699,000; 99.9% $3,749,600.
(d) After-tax income is expanded cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); estate tax; and excise taxes.
ultimate proposal will not raise taxes on any income group so presumably the plan will be revised to meet this objective.)

IV. DYNAMIC EFFECTS ON THE ECONOMY

In addition to conventional estimates, which are based on fixed macroeconomic assumptions, TPC also prepared, in collaboration with the Penn Wharton Budget Model (PWBM), a set of estimates of the House GOP plan that take into account macroeconomic feedback effects. Estimates of the impacts of tax changes on the economy are subject to considerable uncertainty and can vary widely depending on the models and assumptions chosen. We present “dynamic” estimates from two models to illustrate different ways that tax policy can influence the economy. Estimates using the TPC Keynesian model illustrate how the plan’s impact on aggregate demand would influence the economy in the short run—that is, over the next few years. Estimates using the PWBM illustrate the longer-run impact of the plan on potential output through its effects on incentives to work, save, and invest, and on the budget deficit. TPC also plans to build a neoclassical model of potential output whose results could be integrated with those of the Keynesian model, but that work is still in process.

### TABLE 6
Dynamic Effects of House GOP Tax Plan on GDP
FY 2016–36

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Before macro feedback</strong></td>
<td>18,490.8</td>
<td>19,296.5</td>
<td>20,127.1</td>
<td>20,906.0</td>
<td>21,709.7</td>
<td>22,592.2</td>
<td>23,327.5</td>
<td>24,672.4</td>
<td>25,506.6</td>
<td>26,569.2</td>
<td>27,660.0</td>
<td>27,660.0</td>
<td>41,511.7</td>
<td></td>
</tr>
<tr>
<td><strong>After macro feedback</strong></td>
<td>18,490.8</td>
<td>19,297.2</td>
<td>20,126.3</td>
<td>20,906.2</td>
<td>21,709.2</td>
<td>22,592.2</td>
<td>23,327.5</td>
<td>24,672.4</td>
<td>25,506.6</td>
<td>26,569.2</td>
<td>27,660.0</td>
<td>27,660.0</td>
<td>41,511.7</td>
<td></td>
</tr>
<tr>
<td>TPC Keynesian model</td>
<td>18,490.8</td>
<td>19,497.2</td>
<td>20,260.3</td>
<td>20,962.7</td>
<td>21,742.2</td>
<td>22,600.2</td>
<td>23,527.5</td>
<td>24,972.4</td>
<td>25,506.6</td>
<td>26,559.2</td>
<td>27,660.0</td>
<td>27,660.0</td>
<td>41,511.7</td>
<td></td>
</tr>
<tr>
<td>PWBM overlapping generations model</td>
<td>18,490.8</td>
<td>19,497.2</td>
<td>20,260.3</td>
<td>20,962.7</td>
<td>21,742.2</td>
<td>22,600.2</td>
<td>23,527.5</td>
<td>24,972.4</td>
<td>25,506.6</td>
<td>26,559.2</td>
<td>27,660.0</td>
<td>27,660.0</td>
<td>41,511.7</td>
<td></td>
</tr>
</tbody>
</table>

| Exhibit: Percentage change in GDP due to macro feedback (%) |
|-------------|------|------|------|------|------|------|------|------|------|------|-----------|-----------|-----------|-----------|
| TPC Keynesian model | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| PWBM overlapping generations model | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

Source: Congressional Budget Office, TPC Keynesian model, Penn-Wharton Budget Model (PWBM) overlapping generations model.

(a) End of period.

A. Impact on Aggregate Demand

The House GOP tax plan would increase aggregate demand, and therefore output, in two main ways. First, by reducing average tax rates for most households, the plan would increase after-tax incomes. Households would spend some of that additional income, increasing demand. This effect would be attenuated to some degree because most tax reductions would accrue to high-income households, which are likely to increase spending proportionately less than would lower-income households in response to increased after-tax income. Second, the provision allowing businesses to expense investment would create
an incentive for businesses to raise investment spending, further increasing demand. These effects on aggregate demand would raise output relative to its potential level for the next few years, until actions by the Federal Reserve and equilibrating forces in the economy returned output to its long-run potential level.

Using the TPC Keynesian model, we estimate that these factors would boost output by about 1.0 percent in 2017, by 0.7 percent in 2018, and by smaller amounts in later years (Table 6). Using a range of assumptions about the response of household spending to changes in income, the response of investment to the expensing provision, and the impact of increased demand on output, TPC estimates that the impact on output could be between 0.2 and 2.3 percent in 2017, 0.1 and 1.5 percent in 2018, and smaller amounts in later years.

Those increases in output would boost incomes, which in turn would raise tax revenue, offsetting some of the revenue losses from the tax plan. TPC estimates that the plan’s effects on demand would, in themselves, boost revenues by $43 billion in 2017 (or between $12 billion and $129 billion in calendar year 2017 using TPCs full range of estimates), by $29 billion (or between $4 and $42 billion) in 2018, and by smaller amounts in later years. The revenue effect of the House GOP plan, taking into account the dynamic revenue gains based on the TPC Keynesian model using standard parameters, is shown in Table 2.

B. Impact on Potential Output

In addition to short-run effects on aggregate demand, the House GOP tax plan would have a lasting effect on potential output—altering incentives to work, save, and invest—as well as on the budget deficit. Those lasting effects, described below, were estimated using the PWBM.

C. Impact on Saving and Investment

The House GOP tax plan would alter incentives to save and invest in the United States. Large reductions in the tax rates on corporate and pass-through business income, lower effective marginal tax rates on long-term capital gains and qualified dividends for most taxpayers with such income, and much lower rates on interest income throughout the income distribution would all increase the after-tax return to savers (Table 7). Assuming that interest rates do not change and that the tax cuts are not eventually financed in ways that reduce
incentives to save and invest, these effects, in themselves, would tend to increase saving and investment in the U.S. economy.

The overall effect of taxes on incentives to save and invest can be summarized in the proposal’s effect on marginal effective tax rates (METRs) on new investments.\(^\text{29}\) METR is a forward-looking measure of the tax system’s effect on the rate of return of a hypothetical marginal investment project (i.e., one that just breaks even). We compare the METR on different investments under the House GOP tax plan with the METR under current law. Because the plan would allow expensing (i.e., immediate deduction) of all investment and would reduce average individual-level taxes on interest, capital gains, and dividends, METRs for most new business investment would decrease significantly (Table 8). Investments in intellectual property would face higher METRs than under current law because business interest deductions would be disallowed, but intellectual property would still face the lowest METRs of any form of investment because the plan

would retain the research and experimentation credit. Business investments financed by debt would face higher effective tax rates than under current law, because the loss of interest deductibility would exceed the benefit of expensing. Overall, the plan would lower METRs, making investment more attractive, and would eliminate the tax advantage for debt-over equity-financed investments, which could reduce corporate leverage.

Although the House GOP tax plan would improve incentives to save and invest, it would also substantially increase budget deficits unless offset by spending cuts, resulting in higher interest rates that would crowd out investment. While the plan would initially increase investment, rising interest rates would eventually decrease investment below baseline levels in later years.

<table>
<thead>
<tr>
<th>Category</th>
<th>Current Law</th>
<th>House GOP Tax Plan</th>
<th>Change (percentage points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business investment</td>
<td>22.0</td>
<td>6.3</td>
<td>-15.7</td>
</tr>
<tr>
<td>Corporate</td>
<td>24.0</td>
<td>8.8</td>
<td>-15.2</td>
</tr>
<tr>
<td>Equipment</td>
<td>18.9</td>
<td>9.3</td>
<td>-10.6</td>
</tr>
<tr>
<td>Structures</td>
<td>27.9</td>
<td>9.3</td>
<td>-18.6</td>
</tr>
<tr>
<td>Intellectual property products</td>
<td>-0.1</td>
<td>4.1</td>
<td>4.2</td>
</tr>
<tr>
<td>Inventories</td>
<td>38.4</td>
<td>9.3</td>
<td>-29.1</td>
</tr>
<tr>
<td>Pass-through</td>
<td>18.9</td>
<td>2.5</td>
<td>-16.4</td>
</tr>
<tr>
<td>Equipment</td>
<td>15.5</td>
<td>3.1</td>
<td>-12.4</td>
</tr>
<tr>
<td>Structures</td>
<td>22.3</td>
<td>3.1</td>
<td>-19.2</td>
</tr>
<tr>
<td>Intellectual property products</td>
<td>-3.4</td>
<td>-3.0</td>
<td>0.4</td>
</tr>
<tr>
<td>Inventories</td>
<td>31.6</td>
<td>3.1</td>
<td>-28.5</td>
</tr>
</tbody>
</table>

Addendum

<table>
<thead>
<tr>
<th>Category</th>
<th>Current Law</th>
<th>House GOP Tax Plan</th>
<th>Change (percentage points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate (equity financed)</td>
<td>30.8</td>
<td>8.3</td>
<td>-22.5</td>
</tr>
<tr>
<td>Corporate (debt financed)</td>
<td>-7.4</td>
<td>9.8</td>
<td>17.2</td>
</tr>
<tr>
<td>Variation (s.d.) across assets</td>
<td>12.2</td>
<td>1.4</td>
<td></td>
</tr>
<tr>
<td>Variation (s.d.) across industries</td>
<td>6.1</td>
<td>0.7</td>
<td></td>
</tr>
</tbody>
</table>


Notes: s.d. = standard deviation. Estimates for are calendar year 2017. The baseline is current law.
D. Impact on Labor Supply

The House GOP tax plan would reduce effective tax rates on labor income (i.e., wages and salaries for employees and self-employment income for others). Effective marginal tax rates on labor income would be reduced by an average of about 2 percentage points and by over 7 percentage points for the top 0.1 percent (Table 9). In combination with increased investment, which raises worker productivity and wages, these effects would initially raise labor supply. Over time, however, because the plan would eventually reduce investment and the capital stock, it would also ultimately depress pretax wages and reduce labor supply.

<table>
<thead>
<tr>
<th>Expanded cash income percentile</th>
<th>Tax units (thousands)</th>
<th>Individual income tax</th>
<th>Individual income tax plus payroll tax</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Current law</td>
<td>House GOP Tax Plan</td>
</tr>
<tr>
<td>Lowest quintile</td>
<td>48,340</td>
<td>2.3</td>
<td>2.2</td>
</tr>
<tr>
<td>Second quintile</td>
<td>38,630</td>
<td>15.6</td>
<td>14.1</td>
</tr>
<tr>
<td>Middle quintile</td>
<td>33,880</td>
<td>19.2</td>
<td>17.8</td>
</tr>
<tr>
<td>Fourth quintile</td>
<td>28,660</td>
<td>20.1</td>
<td>19.3</td>
</tr>
<tr>
<td>Top quintile</td>
<td>23,960</td>
<td>31.1</td>
<td>28.4</td>
</tr>
<tr>
<td>All</td>
<td>174,680</td>
<td>24.7</td>
<td>22.9</td>
</tr>
<tr>
<td><strong>Addendum</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>80–90</td>
<td>12,390</td>
<td>25.5</td>
<td>25.0</td>
</tr>
<tr>
<td>90–95</td>
<td>5,910</td>
<td>27.8</td>
<td>26.6</td>
</tr>
<tr>
<td>95–99</td>
<td>4,530</td>
<td>33.0</td>
<td>30.4</td>
</tr>
<tr>
<td>Top 1 percent</td>
<td>1,130</td>
<td>38.8</td>
<td>32.3</td>
</tr>
<tr>
<td>Top 0.1 percent</td>
<td>120</td>
<td>39.5</td>
<td>32.4</td>
</tr>
</tbody>
</table>

**Source:** Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

(a) Projections are for calendar year 2017. Effective marginal tax rates are weighted by the wages and salaries.
(b) Includes both filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative adjusted gross income are excluded from their respective income class but are included in the totals. For a description of expanded cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm
(c) The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2016 dollars): 20% $24,000; 40% $46,400; 60% $83,300; 80% $143,100; 90% $200,000; 95% $292,100; 99% $698,000; 99.9% $3,749,000.
E. Long-Run Impact on Output and Revenues

The PWBM estimates that the House GOP tax plan’s effects on investment and labor supply would boost GDP by 0.9 percent in 2017, but would reduce GDP by 0.5 percent in 2026 and by 2.6 percent in 2036 (Table 6). Those economic effects would in turn alter revenues, increasing them by $49.6 billion in 2017 and by $64.0 billion between 2017 and 2026, but reducing them by $1.1 trillion between 2027 and 2036 (Table 2). Taking into account the dynamic effects on GDP and revenues from the PWBM, the plan would increase debt by 13.2 percent of GDP by 2026 and by 22.7 percent of GDP by 2036 (Table 3). The impact on the ratio of debt to GDP is lower in 2026, but higher in 2036, than projected in TPC’s conventional estimates.

F. Sensitivity of Macro Estimates to Assumptions

Macroeconomic models are sensitive to assumptions about how individuals respond to incentives, the operation of world capital markets, and other government policies. Different types of models also can produce very different estimates. The PWBM allows users to see how different assumptions change the model’s estimates. For example, compared with the baseline before incorporating

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30 A user interface to the PWBM is available here: http://www.budgetmodel.wharton.upenn.edu/tax-policy-2/ [perma.cc/CCN4-5M4J]. Users may alter assumptions and see effects on GDP, employment, capital stock, etc.
macroeconomic response (labeled “pre-policy baseline” in figure 1), the PWBM’s baseline estimates (labeled “dynamic”) show GDP rising in the short run before eventually returning to the pre-policy level and then falling below the pre-policy baseline.

The best case scenario for a large and sustained supply-side response is one in which capital markets are open and U.S. deficits do not affect the interest rates facing investors, which are solely determined on world markets.\(^{31}\) For the “optimistic” scenario in figure 1, we assume 100 percent openness and that labor supply and savings are very responsive to wages and interest rates (represented by elasticities of 1, compared with 0.5 in the baseline). GDP under this set of assumptions rises very quickly to about 1 percent above the pre-policy level. The effect is roughly stable over time in percentage terms.

The pessimistic scenario makes the opposite assumptions. It assumes capital markets are closed—i.e., no borrowing abroad—and that workers and savers are relatively unresponsive to wages and interest rates. In this scenario, GDP falls below the static level starting in 2019. By 2040, it falls by about 9 percent compared with the level in the pre-policy baseline because the government’s borrowing creates a shortage of capital and pushes up interest rates.

V. APPENDIX A. UNCLEAR DETAILS AND TPC’S ASSUMPTIONS ABOUT THE HOUSE GOP TAX PLAN

Although Speaker Ryan released a “blueprint” that describes many details about the House GOP tax plan, that document lacks some important details necessary to score the plan accurately. TPC sent the Speaker’s staff two sets of clarifying questions along with TPC’s working assumptions, one set on June 30, 2016, and a second on July 7, 2016. These are listed below. We based our assumptions on the Tax document released by the Speaker. The Speaker’s staff was not able to provide the clarifications we requested, indicating these represented issues that Members had not yet resolved. However, they did point out that the blueprint intends that the ultimate plan be revenue neutral (after including macroeconomic feedback effects) and not raise average taxes on any income group. Some key parameters, therefore, will have to change (assuming the Joint Committee on Taxation’s analysis is similar to ours), but we cannot anticipate exactly how

\(^{31}\) This is typically referred to as a “small open economy” model, where a nation’s capital market activity is inconsequential to world markets. It is probably not appropriate for the U.S. given how large we are relative to the world economy, but is shown as a point of comparison.
without further guidance. If we receive clarifications in the future, we will update our analysis.

A. Clarifying Questions and TPC’s Working Assumptions about Broad Provisions of the Plan (Sent to the Speaker’s Staff on June 30, 2016)


<table>
<thead>
<tr>
<th>Q1.</th>
<th>The Tax document indicates that the plan would repeal a number of “special-interest” exemptions, deductions and credits for individuals and deductions and credits for businesses, but only identifies one of those provisions (the section 199 domestic production deduction). What, specifically, are these provisions?</th>
</tr>
</thead>
<tbody>
<tr>
<td>A1.</td>
<td>TPC will assume the repealed provisions would include all of the tax expenditures listed at the end of this document.</td>
</tr>
</tbody>
</table>

NOTE: We included in our revenue and distributional estimates only the repeal of those tax expenditures that were clearly identified in the blueprint released by the Speaker: the section 199 domestic production deduction, employee fringe benefits (except those related to health and retirement), and all individual and business tax credits (except the child tax credit, the EITC, education credits, the saver’s credit, the research and experimentation tax credit, and the foreign tax credit, all of which the blueprint identifies as retained). Revenue estimates for the other provisions listed below are included as an addendum item in Table 2.
2. **Transition Rules**

The document indicates that the Committee on Ways and Means will develop transition rules for the plan. Because these rules could have a significant impact on scoring of the plan, key transition rules must be specified.

<table>
<thead>
<tr>
<th>Q2.</th>
<th>Could unused depreciation and amortization on existing assets be used after the plan goes into effect, and if so what rules would apply?</th>
</tr>
</thead>
<tbody>
<tr>
<td>A2.</td>
<td>TPC will assume that unused depreciation and amortization could be used under current law rules.</td>
</tr>
<tr>
<td>Q3.</td>
<td>Would the plan’s rules for disallowance of businesses’ net interest expense, with an indefinite carryforward (with interest), apply to debt outstanding when the rules go into effect?</td>
</tr>
<tr>
<td>A3.</td>
<td>TPC will assume that the plan’s rules would not apply, so that interest on existing debt would remain deductible without limit.</td>
</tr>
<tr>
<td>Q4.</td>
<td>Could unused credits repealed by the plan, including unused AMT credits, be used once the plan goes into effect, and if so what rules would apply?</td>
</tr>
<tr>
<td>A4.</td>
<td>TPC will assume that unused credits could be used, generally under current law rules.</td>
</tr>
<tr>
<td>Q5.</td>
<td>Would existing NOLs [net operating losses] be subject to the new rules under the plan?</td>
</tr>
<tr>
<td>A5.</td>
<td>TPC will assume that existing NOLs would be subject to the new rules.</td>
</tr>
</tbody>
</table>

3. **Border Adjustments**

The document indicates that the plan would move to a destination-basis tax system “by providing border adjustments exempting imports and taxing imports... within the context of the transformed business tax system.”

| Q6. | How would these border adjustments be made, and would any adjustment apply to direct imports by final consumers (households and governments)? |

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32 *supra* note 1 at 27.
A6. TPC will assume that businesses would simply exclude receipts from exports and not deduct imported purchases, and that an excise tax of 20 percent (the corporate rate) would apply to direct imports by final consumers.

4. Estate and Gift Taxes

The plan would repeal the estate and generation-skipping transfer taxes. The plan does not indicate whether the gift tax would also be repealed, or how the basis of gifts and inheritances received would be determined.

| Q7. Would the plan also repeal the gift tax? | A7. TPC will assume that the gift tax is repealed. |
| Q8. Would the basis of gifts and inheritances received a) be carried over from the donor, b) stepped up to their current market value, or c) treated differently? If basis is stepped up, would there be any limits on the amount stepped up? | A8. TPC will assume that inter vivos gifts will continue to have carryover basis and that inheritances will receive stepped-up basis, but with the limits in effect in 2010 ($1.3 million plus an additional $3 million for surviving spouses, with any additional unrealized gains carried over) but indexed for inflation from 2010. |

B. TPC Assumptions (Absent Clarifications) about Other Provisions

1. Individual Income Tax

1. All current law filing statuses would be retained.
2. Individual income tax brackets would match current law (e.g., the plan’s 12 percent bracket ends at the same level as the current law 15 percent bracket for each filing status).
3. The 50 percent deduction for dividends would apply only to “qualified dividends” as defined under current law.
4. Interest received from a pass-through would be reduced by interest paid by the pass-through (but not below zero) before applying the 50 percent deduction.
5. The limit on current deductibility of capital losses would be retained, but reduced from $3,000 to $1,500.
6. The limitation on itemized deductions (Pease) would be repealed.
7. The new credit for non-child dependents would phase out under the same (revised) rules used to phase out the child tax credit.


8. Adequate definitions and safeguards would be included in the plan to guide (and enforce) the “reasonable compensation” requirement for sole proprietors and pass-through businesses.

9. The 25 percent rate cap on the active business income of sole proprietors and pass-through businesses would be computed much like the current rate cap on capital gains and dividends (i.e., with active business income treated as otherwise taxable at the highest rate(s) applicable to the taxpayer).

10. The interest rate that applies to carryforwards of unused NOLs would be the 10-year Treasury rate.

11. The foreign tax credit allowed against the deemed repatriation of accumulated untaxed earnings and profits of foreign subsidiaries (as of the effective date of the plan) would be scaled down by the same ratio as the applicable rate (8.75 percent or 3.5 percent) to 35 percent.

3. Effective Date

12. All provisions would become effective January 1, 2017.

C. Provisions that TPC Will Assume are Unchanged

The Tax document identifies a number of current law provisions that the plan leaves to the Committee on Ways and Means to examine with the goal of reforming them. Because the document proposes no specific reforms of the following provisions, TPC must assume for its analysis that the current law specification of the following provisions would remain unchanged. However, we’d be happy to model the specific reforms if you can provide details.

- Earned Income Tax Credit (EITC)
- Education incentives
- Employer-provided health insurance benefits, including FSAs and HSAs [flexible spending accounts and health savings accounts]
- Employer-provided retirement benefits
- Other saving incentives (including both retirement-related and other saving incentives)
- Mortgage interest deduction
- Charitable contribution deduction
• Foreign earned income exclusion and other special rules for individuals living abroad
• Deductibility of interest paid by financial services businesses
• Research and experimentation (R&E) credit

D. Health-Related Tax Provisions

The document only partially addresses reform of health-related tax provisions. The plan would repeal all itemized deductions other than those for mortgage interest and charitable contributions, but does not specifically list the deduction for medical and dental expenses. The plan also assumes that all of the taxes enacted as part of the ACA would be repealed and not replaced with other taxes. However, repeal of these taxes is not considered part of the plan, but rather part of a separate proposal of the Health Care Task Force. The plan description includes no other health-related tax provisions. The report of the Health Care Task Force\(^ {33}\) indicates other health-related tax changes that would be made (e.g., a cap on the exclusion for employer-provided health benefits), but does not provide specifications that would allow scoring them.

In order to make its analysis consistent with the health-related tax changes that are specified in the plan and related plans, TPC will assume that the itemized deduction for medical and dental expenses would be repealed, along with all of the ACA taxes including the 3.8 percent net investment income tax, the 0.9 percent additional Medicare rate, excise taxes (e.g., on medical devices and high premium health insurance), and related fees. Note that the premium credit is treated as an outlay, rather than a tax, by CBO, so we do not include it among the repealed ACA taxes.

E. “Special-Interest” Tax Provisions

The following is the list of tax expenditures (including related payroll tax expenditures) that TPC assumes are repealed by the plan. Please let us know if any of these items would be retained under the proposal.

1. Corporate Income Tax
   Energy credit (section 48): Solar
   Energy credit (section 48): Geothermal
   Coal production credit: Refined coal
   Coal production credit: Indian coal
   Excess of percentage over cost depletion, fuels: Oil and gas

\(^{33}\) supra note 1.
Excess of percentage over cost depletion, fuels: Other fuels
Excess of percentage over cost depletion, nonfuel minerals
Special rules for mining reclamation reserves
Special tax rate for nuclear decommissioning reserve funds
Exclusion of contributions in aid of construction for water and sewer utilities
Exclusion of earnings of certain environmental settlement funds
Exclusion of cost-sharing payments
Credit for low-income housing
Credit for rehabilitation of historic structures
Credit for rehabilitation of structures, other than historic structures
Deferral of gain on non-dealer installment sales
Deferral of gain on like-kind exchanges
Exemptions from imputed interest rules
Completed contract rules
Credit for employer-paid FICA taxes on tips
Deduction for income attributable to domestic production activities
Credit for the cost of carrying tax-paid distilled spirits in wholesale inventories
Exclusion of gain or loss on sale or exchange of brownfield property
Income recognition rule for gain or loss from section 1256 contracts
Exemption of credit union income
Small life insurance company taxable income adjustment
Special treatment of life insurance company reserves
Special deduction for Blue Cross and Blue Shield companies
Tax-exempt status and election to be taxed only on investment income for certain small property and casualty insurance companies
Interest rate and discounting period assumptions for reserves of property and casualty insurance companies
Proration for property and casualty insurance companies
Deferral of tax on capital construction funds of shipping companies
Special tax provisions for employee stock ownership plans (ESOPs)
Deferral of taxation on spread on acquisition of stock under incentive stock option plans
Deferral of taxation on spread on employee stock purchase plans
Disallowance of deduction for excess parachute payments
Limits on deductible compensation
Credit for employer-provided dependent care
Credit for disabled access expenditures
Credit for orphan drug research
Tax credit for small businesses purchasing employer insurance
Exclusion of disaster mitigation payments

**Tax Expenditures permanently extended by HR 2029:**
Modification of tax treatment of certain payments under existing arrangements to controlling exempt organizations made permanent
Permanently extend and modify employer wage credit for activated military reservists
Minimum LIHTC rate for non-Federally subsidized new buildings (9%) made permanent

2. *Individual Income Tax (including pass-through businesses)*
Exclusion of benefits and allowances to armed forces personnel
Exclusion of military disability benefits
Deduction for overnight-travel expenses of national guard and reserve members
Exclusion of energy conservation subsidies provided by public utilities
Energy credit (section 48): Solar
Energy credit (section 48): Geothermal
Excess of percentage over cost depletion, fuels: Oil and gas
Excess of percentage over cost depletion, fuels: Other fuels
Exceptions for publicly traded partnership with qualified income derived from certain energy-related activities
Excess of percentage over cost depletion, nonfuel minerals
Special rules for mining reclamation reserves
Special tax rate for qualified timber gain (including coal and iron ore)
Treatment of income from exploration and mining of natural resources as qualifying income under the publicly-traded partnership rules
Exclusion of cost-sharing payments
Exclusion of cancellation of indebtedness income of farmers
Income averaging for farmers and fishermen
Exclusion of capital gains on sales of principal residences
Credit for low-income housing
Credit for rehabilitation of historic structures
Credit for rehabilitation of structures, other than historic structures
Deferral of gain on non-dealer installment sales
Deferral of gain on like-kind exchanges
Exemptions from imputed interest rules
Completed contract rules
Credit for employer-paid FICA taxes on tips
Deduction for income attributable to domestic production activities
Exclusion for gain from certain small business stock
Income recognition rule for gain or loss from section 1256 contracts
Exclusion of employer-paid transportation benefits (parking, van pools, and transit passes)
Exclusion of employee meals and lodging (other than military)
Exclusion of housing allowances for ministers
Exclusion of miscellaneous fringe benefits
Exclusion of employee awards
Exclusion of income earned by voluntary employees' beneficiary associations
Special tax provisions for employee stock ownership plans (ESOPs)
Deferral of taxation on spread on acquisition of stock under incentive stock option plans
Deferral of taxation on spread on employee stock purchase plans
Credit for employer-provided dependent care
Exclusion of certain foster care payments
Adoption credit and employee adoption benefits exclusion
Credit for disabled access expenditures
Credit for orphan drug research
Tax credit for small businesses purchasing employer insurance
Exclusion of workers' compensation benefits (disability and survivors payments)
Exclusion of damages on account of personal physical injuries or physical sickness
Exclusion of special benefits for disabled coal miners
Premiums on group term life insurance
Premiums on accident and disability insurance
Exclusion of survivor annuities paid to families of public safety officers killed in the line of duty
Exclusion of disaster mitigation payments
Exclusion of veterans' readjustment benefits
Deferral of interest on savings bonds

**Tax Expenditures permanently extended by HR 2029:**
Parity for exclusion from income for employer-provided mass transit and parking benefits made permanent
Permanently extend and modify employer wage credit for activated military reservists
Treatment of certain dividends of RICs made permanent
Exclusion of 100 percent of gain on certain small business stock made permanent
Reduction in S corporation recognition period for built-in gains tax made permanent
Minimum LIHTC rate for non-Federally subsidized new buildings (9%) made permanent
Military housing allowance exclusion for determining LIHTC eligibility made permanent
Treatment of RICs as "qualified investment entities" under section 897 (FIRPTA) made permanent
Deductibility of excise tax on high cost employer-sponsored health coverage

3. **Payroll Tax**
Exclusion of employer-paid transportation benefits (parking, van pools, and transit passes)
Exclusion of employee meals and lodging (other than military)
Exclusion of housing allowances for ministers
Exclusion of other employee benefits: Premiums on group term life insurance (excludes payroll taxes)
Exclusion of other employee benefits: Premiums on accident and disability insurance

**Tax Expenditure permanently extended by HR 2029:**
Parity for exclusion from income for employer-provided mass transit and parking benefits made permanent
F. Additional Clarifying Questions and TPC Assumptions about the Plan (Sent to the Speaker’s Staff July 7, 2016)

1. “Special Interest” Tax Provisions

In addition to the list of tax expenditures listed in our prior document, we will also assume repeal of all private purpose tax exempt bonds; repeal of above-the-line deductions for expenses of educators and reservists, etc., moving expenses and alimony paid; and repeal of all personal credits (except the child tax credit, education credits, saver’s credit, and the foreign tax credit; so, for example, we will assume the child and dependent care tax credit is repealed).

NOTE: We included in our revenue and distributional estimates only the repeal of those tax expenditures that were clearly identified in the blueprint released by the Speaker: the section 199 domestic production deduction, employee fringe benefits (except those related to health and retirement), and all individual and business tax credits (except the child tax credit, the EITC, education credits, the saver’s credit, the research and experimentation tax credit, and the foreign tax credit, all of which the blueprint identifies as retained). Revenue estimates for the other provisions listed above are included as an addendum item in Table 2.

2. Rate Cap on Active Business Income

We will assume that income currently subject to SECA, or taxed as wages of worker/owners of subchapter S corporations, is “reasonable compensation”. For the remaining income of sole proprietors and pass-through businesses, we will assume that only income that is currently not considered “passive” will qualify for the rate cap. Current active business losses will be allowed, rather than being carried forward with interest (which will shift the timing of income tax receipts somewhat, but generally not the present value of these receipts).

3. Child Tax Credit and New Credit for Other Dependents

We will assume these are not indexed for inflation.

4. Standard Deduction for Dependents

We will assume that the standard deduction for dependents (in 2016 dollars) is the smaller of: (i) the greater of (a) earned income plus $350 and (b) $1,050, and (ii) the regular standard deduction for the dependent’s filing status (as modified by the proposal). We will assume all amounts are indexed for inflation.
5. **Base Year for Indexing**

We will assume that all indexed parameters are stated at 2016 levels, so are indexed beginning in 2017 (our assumed effective date for the plan).

VI. **APPENDIX B. MEASURING DISTRIBUTIONAL EFFECTS OF TAX CHANGES**

Analysts use a variety of measures to assess the distributional effects of tax changes. There is no perfect measure—often a combination of measures is more informative than any single measure.

The Tax Policy Center generally focuses on the percentage change in after-tax income because it measures the gain or loss of income available to households to buy goods and services, relative to the amount available before the tax change. A tax change that raises or lowers after-tax income by the same percentage for all households leaves the progressivity of the tax unchanged.

Other measures used to assess a tax change’s effects include shares of the tax cut going to different parts of the income distribution, the size of each group’s cut measured in dollars, and the percentage change in tax liability. The first two measures poorly indicate the effects of a tax change because they ignore the initial distribution of taxes and thus do not assess changes in a tax’s progressivity. The percentage change in tax liability can be particularly misleading because it relies too much on the initial distribution of taxes. Cutting the tax on a person making $1,000 from $50 to $10 is an 80 percent cut, whereas reducing taxes on a person making $1 million from $250,000 to $150,000 is just a 40 percent cut. But the tax savings boosts after-tax income by only about 4 percent for the poorer person, compared with a more than 13 percent increase for the higher-income person.
Table B1 shows several different measures of the effects of the House GOP tax plan on households at different income levels in 2017. The tax cut is most significant as a share of after-tax income (column 1) for those with high incomes, as discussed above. It’s also true that for this plan, high-income people get the bulk of the tax cuts (column 2), that the average tax change is highest at high income levels (column 3), and that the tax cut is a larger share of tax liability for high-income households (column 4). Finally, the share of federal tax burdens increases at most income levels, falling only for the top 1 percent (column 5).

<table>
<thead>
<tr>
<th>Expanded cash income percentile</th>
<th>Percent change in after-tax income</th>
<th>Share of total federal tax change</th>
<th>Average federal tax change</th>
<th>Share of federal taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(a)</td>
<td>(%)</td>
<td>Dollars</td>
<td>Percent</td>
</tr>
<tr>
<td>Lowest quintile</td>
<td>0.4</td>
<td>0.8</td>
<td>-50</td>
<td>-9.3</td>
</tr>
<tr>
<td>Second quintile</td>
<td>0.2</td>
<td>1.4</td>
<td>-120</td>
<td>-3.9</td>
</tr>
<tr>
<td>Middle quintile</td>
<td>0.2</td>
<td>2.8</td>
<td>-260</td>
<td>-2.9</td>
</tr>
<tr>
<td>Fourth quintile</td>
<td>0.5</td>
<td>3.7</td>
<td>-410</td>
<td>-2.1</td>
</tr>
<tr>
<td>Top quintile</td>
<td>4.6</td>
<td>89.0</td>
<td>-11,760</td>
<td>-13.1</td>
</tr>
<tr>
<td>All</td>
<td>2.5</td>
<td>100.0</td>
<td>-1,810</td>
<td>-10.8</td>
</tr>
<tr>
<td>Addendum</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>80–90</td>
<td>0.2</td>
<td>1.2</td>
<td>-310</td>
<td>-0.9</td>
</tr>
<tr>
<td>90–95</td>
<td>0.2</td>
<td>0.7</td>
<td>-370</td>
<td>-0.7</td>
</tr>
<tr>
<td>95–99</td>
<td>2.5</td>
<td>11.0</td>
<td>-7,690</td>
<td>-7.3</td>
</tr>
<tr>
<td>Top 1 percent</td>
<td>13.4</td>
<td>76.1</td>
<td>-212,660</td>
<td>-26.7</td>
</tr>
<tr>
<td>Top 0.1 percent</td>
<td>16.9</td>
<td>46.5</td>
<td>-1,282,530</td>
<td>-32.0</td>
</tr>
</tbody>
</table>

**Source:** Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

**Notes:**
(b) The percentiles include both filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative adjusted gross income are excluded from their respective income class but are included in the totals. For a description of expanded cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm
(c) The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2016 dollars): 20% $24,900; 40% $48,400; 60% $83,300; 80% $143,100; 90% $258,800; 95% $292,100; 99% $659,000; 99.9% $3,749,600.
(d) After-tax income is expanded cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); estate tax; and excise taxes.
(e) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, the estate tax, and excise taxes) as a percentage of average expanded cash income.
I. INTRODUCTION .......................................................................................... 297
II. TAX PLANNING UNDER THE DBCFT .................................................... 297
   A. Generating Deductions........................................................................... 297
   B. Excluding Income from Exports.......................................................... 298
   C. Transforming an Onshore Brick and Mortar Importing
      Business into an Online Direct-Order Business Conducted by
      a Foreign Subsidiary ............................................................................. 298
   D. Earnings and Profits Under the DBCFT .............................................. 299
   E. Using Corporate Inversions ................................................................. 300
   F. Using Transfer Pricing to Import at a Low Cost................................. 301
   G. Generating and Using Export Losses................................................... 301
   H. Converting Carry from Foreign Investors into Tax-Exempt
      Export Income....................................................................................... 302
   J. Using Affiliate Sales to Achieve a Tax-Free Step-Up................. 303
   K. Using Partnerships to Sell Export Losses to Importers ...... 303
   L. Tax-Exempt Entities ............................................................................ 304
   M. Using U.S. Corporations as Tax Shelters........................................... 305
   N. Preserving Interest Deductions............................................................ 306
   O. Foreign Companies Could Move to the United States to
      Receive a Subsidy.................................................................................. 307
   P. Low-Cost Insurance in the Event of Repeal....................................... 307
III. CONCLUSION ......................................................................................... 308
I. INTRODUCTION

This essay describes some basic tax-planning strategies under the destination based cash flow tax (DBCFT) proposed as part of the “Blueprint” published by the Committee on Ways & Means of the House of Representatives.¹ This article is designed first for policymakers so that they can either correct or confirm the strategies I describe, and second for the practitioners and taxpayers that will navigate the DBCFT if it is enacted.

A central theme of the discussion that follows is that the DBCFT contained in the Blueprint is not the “pure” DBCFT proposed by economists.² Instead, it is a hybrid that incorporates aspects of the pure DBCFT, but also elements of our current income tax. Many of the planning opportunities under the DBCFT arise because of its hybrid nature.

II. TAX PLANNING UNDER THE DBCFT

A. Generating Deductions

Tax planning under an income tax system is based upon maximizing deductions and avoiding or deferring income. To illustrate, assume a U.S. pharmaceutical company (currently subject to a nominal U.S. corporate tax rate of 35%) has an Irish subsidiary (currently subject to a nominal rate of 12.5%). Under current income tax law, the U.S. parent would seek to transfer intellectual property to its Irish subsidiary at a low transfer price, develop the intellectual property substantially using personnel located in Ireland, and have the Irish subsidiary receive royalty payments from unrelated parties that would not be Subpart F income.³ The U.S. parent would report any gain on the initial sale, but could defer the subsequent profits of the Irish subsidiary indefinitely.


² See Auerbach, et al., Destination Based Cash-Flow Taxation 17 (Oxford U. Ctr. for Bus. Tax’n, Working Paper No. 17/01, 2017). When I refer to the DBCFT, I mean the one in the Blueprint. I refer to the one proposed by economists as the “pure” DBCFT.

³ See Temp. Treas. Reg. § 1.954-2T(c)(3)(i) (exempting royalty income earned with respect to property to which the foreign subsidiary has “added substantial value” if “regularly engaged in the development, creation, or production of … property of such kind”).

All references to section numbers are to the Internal Revenue Code or its regulations.
Under a DBCFT, generating deductions onshore would remain an important tax planning strategy, but the tools to accomplish this strategy would change. For example, interest could no longer be used to strip earnings, but deductions could be generated by making capital investments that may be immediately expensed. For example, a taxpaying company operating under a DBCFT could generate deductions by buying business assets and leasing them (especially to companies (like exporters) that could not use the deductions that would be generated from purchasing the equipment). Likewise, a taxpaying company could buy a building, and lease it back to the seller. The purchase of the building would generate a deduction, which could shelter other income.

Returning to the example above, if the DBCFT is enacted, the U.S. pharmaceutical company’s strategy would be reversed. The U.S. parent would fully develop the intellectual property in the United States with its own employees. Their salaries would be deductible.

B. Excluding Income from Exports

Under a DBCFT, exporting products, services, and intangibles abroad is even more important than deferring income because the proceeds would be exempt under the tax’s border adjustment feature. Exporting may be accomplished by providing products, services, and intangibles to a foreign customer, but also to a foreign affiliate. The Blueprint appears to respect the residence of entities, and because the corporate residence of a client or affiliate is effectively elective, there are plenty of tax planning opportunities to create exports.4

C. Transforming an Onshore Brick and Mortar Importing Business into an Online Direct-Order Business Conducted by a Foreign Subsidiary

Next, consider a U.S. corporation that is in the domestic retail sales business. It buys all of its products domestically at wholesale prices and sells them at retail prices to U.S. customers. Now assume that this U.S. corporation organizes a wholly-owned Irish subsidiary that qualifies for the benefits of the U.S.-Irish tax treaty. The Irish subsidiary could buy the products from its U.S. parent, and then sell the products directly to the customers of its parent, with the assistance of an independent agent located in the United States. Under the

4 The OECD’s International VAT/GST [goods and services tax] guidelines would also respect the sales of services and intangibles to the immediate buyer without looking through to subsequent users. See Chapter 3 of the International VAT/GST Guidelines, OECD (Nov. 2015), http://www.oecd.org/tax/consumption/international-vat-gst-guidelines.pdf [perma.cc/K53K-YZK3].
Blueprint, the U.S. corporation could exclude the gross proceeds from the export to its Irish subsidiary. The Irish subsidiary would avoid U.S. federal income tax because it would not have a permanent establishment in the United States by reason of all activities being conducted through an independent agent. In fact, because the Blueprint would repeal the foreign base company sales rules, the Irish subsidiary's profits would not be Subpart F income and could be repatriated tax-free to its U.S. parent. Thus, under the Blueprint, the U.S. parent could avoid all U.S. federal income tax.

To prevent this outcome, the United States would first have to dramatically expand its extra-territorial taxing powers to impose a 20% excise tax on the price of goods, services and intangibles sold by any foreign entity directly to a U.S. consumer, regardless of whether that entity has a physical presence in the United States. Additionally, the United States would have to modify tax treaties to permit the United States to impose tax on a resident of a treaty jurisdiction that sells into the United States, even if the resident does not have a permanent establishment in the United States. Enforcing these powers would be very difficult. Convincing our treaty partners to agree to these changes will be equally difficult.

D. Earnings and Profits Under the DBCFT

Assume that a U.S. corporation, in its first year of operation, receives $100 from exports, and has total costs of $85 (but no imports). It earns economic income of $15, but has a tax loss of $85 (because it is able to exclude the $100 of export revenue). Now assume the corporation distributes all of its revenue. Under our current income

5 See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, U.S.-Ir., art. 5, July 28, 1997, S. TREATY DOC. NO. 105-31 (1997); Id. at art 6 (an enterprise does not have a permanent establishment merely by carrying on business through a broker or agent of independent status); Id. at art. 7 (profits of an enterprise are taxable by the other contracting state only if carrying on business through a permanent establishment situated in that state). Best Buy argues that China’s Alibaba would be able to avoid the tax by making sales online and shipping to U.S. consumers directly. Ginger Gibson & David Shepardson, How Toyota, Target, Best Buy are Fighting Back Against Republican Border Tax Push, REUTERS (Jan. 31, 2017), http://www.reuters.com/article/us-usa-trump-companies-tax-insight-idUSKBN15F0FK [perma.cc/7QDX-AC4G].

6 Supra note 1 at 29.


tax system, if a corporation has a tax loss in its first year of operation and makes a distribution, the distribution is treated as a return of capital (because generally a tax loss also means a deficit in earnings and profits). What result under the DBCFT?

The Blueprint is silent but my guess is that distributions, to the extent of earnings and profits (determined under current rules), would be treated as dividends. If the dollar appreciates to neutralize the effect of a DBCFT, and exporters can fully use their losses, then importers, exporters, and wholly domestic businesses should have the same amount of after-tax income after a border adjustment as they did before the enactment. In that case, the shareholders who receive equal distributions from equally profitable start-up companies should be taxable the same, regardless of whether the companies are importers, exporters, or wholly domestic. Shareholders would be taxable on an income tax basis with respect to their investment income under the DBCFT, and so dividends should be determined under the same rules as today.

However, to achieve this result under the DBCFT, corporations would have to keep two tax books. One set of books would be kept on a cash flow basis to determine corporate-level tax. The second would be on an income tax basis to determine earnings and profits. ⁹ As explained in the next part, the retention of the earnings and profits concept permits tax planning opportunities that do not exist under a “pure” DBCFT.

E. Using Corporate Inversions

Corporate inversions will still have benefits under the Blueprint. For example, an Irish parent could raise debt financing (and deduct the interest) to fund its U.S. subsidiary’s deductible capital investments. The U.S. subsidiary could develop intellectual property and sell the foreign rights to the Irish parent on a tax-free basis, and the Irish parent would amortize the purchase price and deduct the interest to reduce its earnings and profits. For example, assume that the Irish parent borrows $1,000 to buy its U.S. subsidiary’s intellectual property. Assume the U.S. subsidiary has more than $100 of earnings and profits. In a taxable year, the Irish parent has $100 of original issue discount and the U.S. subsidiary pays a dividend of $100 to its Irish parent which, in turn, pays the amount to its U.S. shareholders. Had the Irish parent not existed, the dividend would have been taxable

⁹ Of course, this begs the questions about how earnings and profits would be determined under a DBCFT. Would today’s rules be used, would the rules measure earnings and profits based on an economic income basis, or would investments be expensed and interests denied?
to the U.S. subsidiary’s U.S. shareholders, or subject to U.S. withholding tax on payment to its foreign shareholders. However, in the year of the dividend, the Irish parent has no current or accumulated earnings and profits (the $100 dividend received is offset by the $100 of original issue discount expense) and so the dividend it pays its shareholders would be a nontaxable return of capital.

In fact, this strategy is equally available to a nonconsolidated U.S. parent company that receives a dividend from its U.S. subsidiary. The U.S. parent would have no net income by reasons of the dividends-received deduction, and the original issue discount deduction would offset its dividend income for earnings and profits purposes. The U.S. parent could distribute the dividend it receives to its U.S. shareholders without income tax or to its foreign shareholders without U.S. withholding tax.\(^\text{10}\)

F. Using Transfer Pricing to Import at a Low Cost

One of the principal benefits of a DBCFT would be to remove the incentive for U.S. multinationals to sell intellectual property at low-transfer pricing rates to affiliated Irish (or other low-taxed treaty-eligible) companies. However, for those U.S. multinationals that had previously transferred U.S. intellectual property to their offshore subsidiaries and would need to license it back, under the DBCFT, the royalty payments would be nondeductible import expense and, to add insult to injury, the income of the subsidiary would be Subpart F income. These U.S. multinationals would seek to pay a low transfer-pricing royalty rate. Therefore, the DBCFT does not avoid transfer pricing; it merely changes the situations where transfer pricing matters.

G. Generating and Using Export Losses

Under the DBCFT, exporters would generate losses that they will be unable to use. Exporters will therefore become acquisition targets for importers that are denied deductions for their imports (and vice versa).\(^\text{11}\) These would be acquisitions principally for tax reasons – the DBCFT’s version of an inversion. Also, the DBCFT would encourage exporters to buy importers’ goods directly from abroad, and

\(^{10}\) I thank Michael Schler for this example.

sell them to the importer. Because the exporter would not receive a deduction (or basis) for the imported goods, this strategy would allow the exporter to use its tax losses and effectively sell those losses to the importer.

H. Converting Carry from Foreign Investors into Tax-Exempt Export Income

A DBCFT would also provide a windfall for managers of Cayman Island funds. Currently, fund managers receive a relatively small fixed management fee (say 2%) of assets under management and a larger carried interest (say 20% of gains) that potentially benefit from long-term capital gains rates. Under a DBCFT, a U.S. hedge fund manager would seek to restructure its compensation entirely as contingent fees for services provided to foreign investors. All of these fees would be excludible exports (and not at all at taxed). Additionally, unlike consumer goods, this exported service would not reflect any dollar appreciation because both parties would be transacting in dollars.

The question then arises whether the Blueprint will treat services provided to a Cayman Islands fund that is entirely owned by U.S. pension plans as provided to a foreigner (so entirely exempt) or to the beneficial U.S. owners (so fully taxable). Compensation received from taxable domestic investors would remain structured as carried interests (unless the income would be exempt if restructured as fees received from a Cayman Islands corporation owned by these investors). All expenses from salaries and overhead (used to generate both excludable and taxable amounts) could be used to offset taxable amounts.

In addition, under the DBCFT, lawyers who set up funds for U.S. money managers would no longer be paid by the managers but instead would be paid by the foreign funds to avoid tax on their fees (or at least the portion attributable to the foreign investors). Likewise,

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12 Michael Schler originally suggested this strategy.
13 If the DBCFT does not look through entities, then this strategy would be equally effective for tax-exempt or taxable investors that invest through a Cayman corporation.
15 For more examples, see Hariton, supra note 8.
if a foreign parent purchases a U.S. corporation, the law firm will prefer to be paid by the foreign parent, rather than the target.


Because the DBCFT applies a cash-flow tax to physical and intangible assets but an income tax to financial assets, taxpayers would be able to expense their purchase of capital assets (like equipment) but not financial assets. Therefore, a financial investor might be expected to shift his investments from financial assets to physical and intangible assets (at least until the difference in potential return offsets the tax savings).

Likewise, a U.S. corporation considering the purchase of a domestic target will have an even greater incentive than under current law to structure the acquisition as an asset purchase rather than a stock purchase because of the immediate deduction for equipment and improvements.

J. Using Affiliate Sales to Achieve a Tax-Free Step-Up

The entirety of the U.S. international income tax system is based on taxing outbound transactions and exempting inbound ones. That system would be upended by the Blueprint. If a DBCFT is enacted, most outbound transactions would become exempt (as exports), but the rules would have to be changed to tax what are now tax-free inbound contributions (as imports). Otherwise, a U.S. subsidiary could sell inventory to its foreign parent, and the foreign parent could contribute the inventory to another U.S. subsidiary in a section 351 transaction. If the second U.S. subsidiary received the parent’s fair market value basis in the inventory, the second subsidiary could then sell the inventory in the United States and pay no tax. A similar opportunity may exist for land, which is not subject to the DBCFT. Conversely, an inbound section 351 transaction would have to be treated as an import for which the subsidiary could not receive basis or claim a deduction. Under a pure DBCFT, these changes would not be necessary because basis does not exist under a pure DBCFT. But the Blueprint’s DBCFT does retain the LIFO method of accounting for inventory, and excludes land.

K. Using Partnerships to Sell Export Losses to Importers

Assume that a domestic partnership has two businesses: A domestic sales business and an exporting business. Each business earns revenues of $100, pays wages of $20, and purchases domestic inventory of $30.
Each business has pre-tax profits of $50. However, the export business generates a tax loss of $50, which is worth $10 based on a 20% tax rate. The domestic business has taxable income of $50 and pays tax of $10. On a combined basis, the partnership earns after-tax profit of $100. However, the domestic business pays tax of $10 and the export business generates a loss of $50 (worth $10), so the combined business pays no tax.

<table>
<thead>
<tr>
<th></th>
<th>Revenues</th>
<th>Wages</th>
<th>Inventory</th>
<th>Pre-Tax Profit</th>
<th>Tax</th>
<th>After-Tax Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic</td>
<td>100</td>
<td>-20</td>
<td>-30</td>
<td>50</td>
<td>10</td>
<td>40</td>
</tr>
<tr>
<td>Foreign</td>
<td>100</td>
<td>-20</td>
<td>-30</td>
<td>50</td>
<td>-10</td>
<td>60</td>
</tr>
</tbody>
</table>

Let’s assume that one partner is allocated all of the pre-tax economic income from the domestic business and the other is allocated all of the pre-tax economic income from the export business, and they agree to share the tax in accordance with relative profits. Since each business had the same pretax profit and, as a whole, the business paid no tax, they distribute 50 to each partner.

Although this allocation would appear to have substantial economic effect under current law, I suspect that it wouldn’t be allowable under the Blueprint. This partnership is a “splitter”. The tax benefit (exclusion of export income) is intended for exporters. Exporters are not entitled to refunds of their tax losses, and they must have income under the DBCFT in future years to use them. Presumably, the drafters of the Blueprint didn’t intend for exporters to be able to sell their losses.16 In this case, only the partner who is allocated the economic income from exporting should be entitled to the tax benefits from that activity. The domestic partner should be distributed $40 and the exporting partner $60. It also becomes clear from this example that tax does not follow book under the DBCFT. Capital accounts are an economic income concept; the DBCFT is not. Likewise, the allocation of an exporting tax loss to a partner should not reduce that partner’s basis. Otherwise the exclusion would become a mere deferral.

L. Tax-Exempt Entities

Under our current income tax system, tax-exempt entities avoid tax on income from the activities that are related to their tax-exempt status. However, under the DBCFT, exporters would pay no

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16 This is another example where a “pure” DBCFT varies from the Blueprint’s version. A pure DBCFT would allow exporters a refund or, at the very least, allow the loss to offset payroll taxes.
tax and would receive deductions for their costs. For tax-exempt organizations that are also exporters, under a DBCFT, it would be better to be taxable than tax-exempt.

Assume that a U.S. university develops a video-based degree for which it receives tuition and fees from foreign students. Because under current law the tuition and fees are exempt from tax, it makes more sense for the university to operate the video-based degree business as tax-exempt and neither pay tax nor generate deductions.

Under the DBCFT, the university would have an incentive to contribute the business to a taxable subsidiary. The taxable subsidiary would not pay any tax and would generate tax losses from the export business, even if the business were profitable. The university could also contribute to the taxable subsidiary assets that generate unrelated business taxable income and the subsidiary’s losses could be used to help to shelter what would otherwise be taxable to the university.

M. Using U.S. Corporations as Tax Shelters

Under a DBCFT, U.S. corporations would become a tax shelter for wealthy shareholders. First, under the rates proposed by the Blueprint, there would be an increase in the disparity between the corporate rate and the top individual rate (13 percentage points as compared to under 9 percentage points today). Second, exporters would be in perennial loss positions. Shareholders could contribute their investment assets to their export companies and use the export losses to reduce the tax rate on their investment earnings to zero. The personal holding company rules and accumulated earnings tax attempted to prevent this practice, but were notoriously unsuccessful.

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17 See I.R.C. § 512 (2015) (excluding royalties from definition of “unrelated business taxable income” on which an otherwise exempt organization may be subject to tax).

18 I thank Richard Upton for his comments on this section.

19 The top marginal rates under the Blueprint for individuals and corporations, respectively, are 33% and 20%. See supra note 1, at 17, 25.

N. Preserving Interest Deductions

Under the DBCFT, net interest deductions are denied. However, if the DBCFT were simply incorporated into our existing income tax system, taxpayers would be able to achieve the functional equivalent of a deduction for interest.

Assume that an individual investor holds an interest in a domestic feeder fund that is treated as a partnership for U.S. federal tax purposes. The domestic feeder fund, in turn, invests in a leveraged hedge fund that is also treated as a partnership. Under the DBCFT, interest deductions would be denied for the hedge fund’s interest expense. However, if the taxpayer were instead to invest in a foreign feeder fund that is a controlled foreign corporation (“CFC”) or a passive foreign investment corporation (“PFIC”) that has made a qualified electing fund (“QEF”) election, and the foreign feeder fund invests in the hedge fund partnership, then the interest expense of the hedge fund partnership would reduce the earnings and profits of the foreign feeder fund, which could include interest, dividend income, and capital gains. Through this mechanism, interest expense, which is only supposed to offset interest income, could offset other income as well.

Alternatively, the taxpayer could use any of a number of financial instruments that are not characterized as indebtedness (and therefore do not generate interest expense) but contain time value components. For example, a contract that provides an up-front payment for the obligation to deliver commodities or publicly-traded security in the future contains a significant time value component, which would offset income on the delivery but would not be treated as interest. If interest deductions are denied, these and similar arrangements could be used to achieve the effect of an interest deduction.\(^{21}\)

On the other hand, for a taxpayer that does incur interest expense, interest income would be desirable because interest expense could be deducted only against interest income. Under current income

\(^{21}\) It is possible that the Blueprint intends to deny interest expense only for borrowings that are used to buy property that is expensed. This would be consistent with the purpose behind the denial – to treat the marginal effective rate of new investment to be zero. The Blueprint retains an income tax for financial assets, and so it would be consistent to allow interest deductions for debt used to purchase financial assets. Then interest would be entirely disallowed on debt used to purchase expensed property (and not allowable to the extent of interest income), and entirely allowable with respect to other debt (and not limited to the extent of interest income). However, because money is fungible, tracing rules would be easy to avoid.
tax law, taxpayers have quite a lot of flexibility to combine various financial instruments with debt, and create a single debt instrument that generates only interest income.

For example, assume that a taxpayer has excess interest expense. The taxpayer wishes to purchase both a $1,000 bond from a financial institution and a $100 at-the-money option with respect to the stock of a publicly-traded company. The taxpayer could combine the two instruments into a single contingent payment debt instrument (“CPDI”): The taxpayer would advance $1,100 to the financial institution and receive back at maturity $1,000 plus the increase in the value of the publicly-traded company. Although the taxpayer’s economics would have not changed, the taxpayer’s entire return on its combined investment would be interest income, which could be offset by the taxpayer’s excess interest expense. Had the taxpayer instead kept the two investments separate, gain on the option would not be treated as interest income.

O. Foreign Companies Could Move to the United States to Receive a Subsidy

Foreign companies that make goods and sell them abroad and whose employees are in the 15% tax bracket could receive a U.S. subsidy by moving their operations to the United States, claiming a deduction for wages taxable at a 20% rate, and paying workers taxable at 15%.

P. Low-Cost Insurance in the Event of Repeal

Proponents of the DBCFT argue that under the DBCFT, there would be no reason for a U.S. parent to transfer intellectual property to its offshore subsidiary because foreign royalties received directly by the U.S. parent would be exempt. However, the drafters of the DBCFT assume that the DBCFT will remain in effect forever. They are correct that if that were the case, there would be no reason for U.S. multinationals to transfer intellectual property to treaty-eligible, lower-taxed affiliates. However, if a DBCFT is enacted, there would remain a meaningful risk that it will be repealed or modified the next time that Democrats control the government, or when the United States has a trade surplus.22 Even if there would be no immediate benefit to transferring intellectual property to low-taxed foreign affiliates under a DBCFT, doing so would provide low-cost insurance against a future reversal of U.S. tax policy. Therefore, it is no stretch to predict that

22 This would be more likely if the DBCFT sunsets after ten years in order to pass through reconciliation.
enactment of a DBCFT will lead to the largest tax-free exodus of U.S. intellectual property ever.

Because a sale by a U.S. multinational to its Irish subsidiary would be exempt from U.S. tax, the U.S. multinational would seek to maximize the transfer sales price. This would allow the Irish subsidiary to amortize a high purchase price and use the amortization to generate deductions for Irish tax purposes. (Ireland does not have a DBCFT, so the Irish subsidiary could amortize the “import”.) The U.S. multinational might also have the Irish subsidiary borrow to finance the initial purchase of the IP to generate interest deduction. This would also generate deductions for Irish tax purposes. Although the Blueprint would deny a U.S. parent net interest expense deductions, it does not appear to prevent the U.S. parent’s Irish subsidiary from using interest deductions to reduce its own earnings and profits and shelter any Subpart F income.

III. CONCLUSION

The Blueprint promises a simpler tax code.23 This will be a broken promise. A DBCFT won’t be simpler than our income tax, but the complexity will change. The new tax planning strategies will include (i) generating deductions by making capital investments, (ii) exporting goods, services and intangibles to related parties, (iii) selling excess losses, (iv) using the earnings and profits rules to effectively deduct interest expense, (v) using aggressive transfer prices to minimize imports, (vi) converting carry to tax-exempt foreign services income, (vii) using partnerships to sell losses, (viii) using the for-profit the subsidiaries of tax-exempt entities to generate losses, (ix) using a U.S. corporation as a tax shelter, and (x) transferring intangibles abroad in anticipation of the eventual repeal of the DBCFT.

23 Blueprint, supra note 1, at 6, 15, 16, 26, 30, 31, 32, 34.