The Most Significant Proposed Change in the History of U.S. Corporate Taxation

Author : Theodore P. Seto

Date : August 2, 2017

Alan Auerbach, Michael P. Devereux, Michael Keen & John Vella, Destination-Based Cash Flow Taxation (Oxford Ctr. for Bus. Tax'n, Working Paper No. 17/01, 2017).

The House Republican Blueprint for corporate tax reform would replace our century-old corporate income tax, which we all know and love (or hate), with a "destination-based cash flow tax" (DBCFT), which for many of us remains a mystery. The academic foundation upon which the House proposal is built is a working paper by Alan Auerbach (UC Berkeley), Michael Devereux (Oxford), Michael Keen (IMF), and John Vella (Oxford) (collectively "the authors"), entitled "Destination-Based Cash Flow Taxation." Given the current turmoil in Washington, it seems unlikely that a DBCFT will be enacted any time soon. Problems with our current system for taxing business income with an international dimension, however, are unlikely to go away on their own. If you want to get up to speed on a radical solution with substantial academic and political support, this paper is an absolute must-read.

The DBCFT has two components: a cash flow tax, which alters the timing and sometimes the substance of includibility and deductibility, and the destination-based "border tax adjustments" that have already found their way (sometimes incoherently) into the popular press.

As to the first, the most obvious difference between cash flow and income taxation is that under a cash flow tax capital assets are expensed, not depreciated. As E. Cary Brown teaches us, expensing has the effect of taxing normal returns to capital at an effective rate of zero. Leverage can then drive effective rates of tax negative. *See* Theodore P. Seto, **Federal Income Taxation: Cases, Problems And Materials** 263-75 (2d ed. 2015). The authors do not view taxing returns to capital at an effective rate of zero as a disadvantage; consistent with optimal tax theory, they call it "neutrality."

What happens next depends on whether the jurisdiction implements an R (real) or R+F (real plus financial) tax base. "Under the R base, transactions involving financial assets and liabilities are ignored – so, for example, interest receipts would not be taxed and interest expenses would not be deductible." (P. 9.) "By contrast, under the R+F base, all cash inflows, including borrowing and the receipt of interest, would be taxable; all cash outflows, including lending, repaying borrowing and interest payments would be subtracted in calculating the tax base." (P. 10.)

The House Republican Blueprint adopts a hybrid: interest is not deductible but borrowings are not includible. What this means, however, is that a taxpayer can zero out any tax liability, anytime, simply by borrowing (not includible) and using the proceeds to buy a capital asset (fully expensible). I understand that the most recent House implementation (not publicly available) attempts to limit this form of arbitrage by denying expensing for land and inventory, but can see many ways around this clearly inadequate bandaid.

The second part of a DBCFT, the so-called "border tax adjustments," are not adjustments at all. The unfortunate label refers instead to the fact that a DBCFT is "based on sales of goods and services in the country less expenses incurred in the country." (P. 14.) Revenues derived and expenses incurred outside the taxing jurisdiction are neither includible nor deductible. As a result, revenues from imports are taxed on a gross basis – no deductions are allowed for the offshore costs of production. And exports are heavily tax-subsidized – domestic costs of production are deductible but the resulting revenues are not includible.

You may be forgiven if your first reaction is that this sounds like the kind of import tariff/export subsidy system that many believe helped trigger the Great Depression. The authors postulate that currency markets would respond by making the dollar more valuable, exactly offsetting the tariff/subsidy-type effects of the tax. The net effect, they argue, would be trade neutrality. If so, this would represent a significant improvement over the current U.S. system, which penalizes domestic production by exempting foreign production profits from current taxation.

Overall, the authors assert, "[t]he DBCFT has several highly attractive properties: it does not distort the scale and location of investment, assures neutral treatment of debt and equity as sources of finance, is robust against avoidance through inter-company transactions, and provides long term stability due to its incentive compatibility and its resistance to tax competition among states. The DBCFT thus addresses many of the ailments afflicting current tax systems in both purely domestic and international settings." (P. 7.)

Among the tasks the authors do not purport to undertake is to explore either the legal difficulties of implementing a DBCFT in particular jurisdictions or many of the collateral economic consequences of the transition to such a tax, particularly by the United States.

With regard to the first, it is unclear whether the House Republican implementation would apply to partnerships as well as corporations. Choice of entity has always been a significant part of U.S. tax planning because of small but consequential differences between corporate and individual taxation. Regardless of how the partnership issue is resolved, any implementation would have to deal with the massive arbitrage possibilities created by the much greater differences between income and cash flow taxation. What will prevent a taxpayer from borrowing through an entity subject to the income tax and spending through an entity subject to the DBCFT? How will we determine whether allocations have substantial economic effect if a partnership has both corporate and individual partners? The possibilities boggle the mind.

As to the second, one of the projected consequences of U.S. adoption of the tax would be a sharp rise in the dollar vis-à-vis other currencies. This, the authors assure us, would offset its other effects on trade neutrality and would therefore be a plus. But what about the estimated $3 trillion of dollar-denominated debt owed by non-bank debtors in emerging economies? *See* Lisa Abramowicz, The Emerging Markets' Dollar Problem (2016). Both these debtors' net worths and their cash flows, as measured in their home currencies, would be devastated by the projected change in exchange rates. Expect many such debtors to default. Hope that their defaults do not tip us back into another Great Recession. And this is only one non-obvious possible consequence.

It is impossible adequately to summarize a 98-page paper in a Jotwell review. The authors deal with many more issues, far more thoroughly, than I possibly could in the space available here. Read the paper.

Cite as: Theodore P. Seto, *The Most Significant Proposed Change in the History of U.S. Corporate Taxation*, JOTWELL (August 2, 2017) (reviewing Alan Auerbach, Michael P. Devereux, Michael Keen & John Vella, *Destination-Based Cash Flow Taxation* (Oxford Ctr. for Bus. Tax'n, Working Paper No. 17/01, 2017)), http://tax.jotwell.com/the-most-significant-proposed-change-in-the-history-of-u-s-corporate-taxation/.