The Destination-Based Cash Flow Tax Is a VAT?

by Peter A. Barnes and H. David Rosenbloom

Peter A. Barnes is of counsel at Caplin & Drysdale Chtd. and a senior fellow at the Duke Center for International Development at Duke University. H. David Rosenbloom is a member of Caplin & Drysdale in Washington and serves as director of the international tax program at New York University School of Law.

In this article, Barnes and Rosenbloom explain why it is misleading to analogize the border feature in the House Republicans' destination-based cash flow tax with the border adjustment found in most VATs.

In the tale of ''Little Red Riding Hood,'' the big bad wolf disguises himself by wearing a lamb's skin. The fluffy white wool cannot, however, hide the wolf's sharp teeth.

Likewise, supporters of the destination-based cash flow tax (DBCFT) — the House Republicans' favored vehicle for corporate income tax reform — try to soften the appearance of the proposal by claiming that its ''destination'' feature is just a variation on the border adjustment that is common in VATs.

No.

If U.S. taxpayers get in bed with the DBCFT, they will quickly learn that the border adjustment in a traditional VAT and the border feature in the proposed DBCFT are as dramatically different as Red Riding Hood's grandmother and the wolf.

Here are three big differences:

With a VAT, the border adjustment on exports refunds a tax that was previously collected by the government. In a simple example using a 10 percent rate of tax, a U.S. producer would purchase $80 of inputs (from either U.S. or foreign suppliers), on which it would pay $8 of VAT. If the goods or services are exported, the U.S. government would refund the $8 that the government previously collected. The government does not collect a VAT on exports but also does not refund tax in excess of what it has already been paid.

With the DBCFT, the result is entirely different. Purchases from foreign suppliers are not tax deductible to a U.S. producer, but purchases of goods and services from U.S. suppliers, as well as the costs of self-production, are fully deductible. If the U.S. producer incurs expenses of $80 and then exports the goods or services, the U.S. government will allow the producer to recognize a loss of $80 (or some lesser amount, if some inputs were imported). The loss entitles the producer to tax savings of $16 (if the full $80 is deductible and the United States adopts a 20 percent rate), which can be used to reduce or eliminate other taxes the producer owes or that will be paid to the producer as a refund in cash from the U.S. government.

That $16 tax savings or refund represents money never collected by the U.S. government, at least not from this taxpayer and not in connection with this transaction.

Think about the consequences. Suppose a major U.S. exporter — Boeing, General Electric, Caterpillar — has $10 billion in deductible expenses related to exports. At a 20 percent tax rate, the company is entitled to $2 billion in tax savings or refunds from the government.

- Today, if a company has tax losses that it cannot use currently, it may carry those losses back (two years) or forward (20 years), but the government does not send the taxpayer a check for the tax value of the losses.
- To make the DBCFT work — as the economists behind this proposal acknowledge — the government will likely need to refund the value of tax losses related to exports in the event the taxpayer cannot use the tax value of the losses to reduce other taxes it owes. Substantial exporters will never be able to absorb all their losses with other income and therefore will likely be entitled to cash refunds.
- How will taxpayers demonstrate which losses relate to exports? That's a difficult task and will lead to numerous tax audit battles closely resembling today's fights over transfer pricing and the allocation of expenses under reg. section 1.861-8. So much for the argument that the DBCFT will provide administrative simplicity.
- Will the government send quarterly (or monthly) refund checks to major exporters? Delaying refund checks until after an annual

return is filed and an audit is completed — a period that could easily take three years or more — could be a major problem for exporters who need the cash flow from the refund to survive. (The value of the tax exemption for exports will largely have been spent in the form of price reduction to make the exports more competitive.)

- Politically, will voters accept a tax system in which the U.S. government cuts periodic checks in millions of dollars for major exporters while consumers see at least some price increases because no tax deduction is allowed for imported goods? The protest signs write themselves: ''My extra dollar to buy guacamole my children's clothing is being sent to Major Multinational.''

With a VAT, the amount of tax refund owed to an exporter is easily established and reflects tax payments that the government received at earlier stages in the production chain. Tax refunds under the DBCFT are of an entirely different character and complexity.

Another major difference between the border adjustment under a VAT and the destination feature of the DBCFT is that under a VAT, but not the DBCFT, buyers and sellers are indifferent about whether they transact with a domestic or a foreign party. Assume the United States adopted a traditional VAT. On the purchase side, a U.S. producer would incur the VAT on all goods and services, regardless of the party from which the purchase is made. On the sale side, the producer would recoup the economic value of all VAT previously incurred. Yes, the producer would collect and remit to the government an additional VAT on domestic sales, but that element in the commercial chain is intended to be passed on to consumers just like any other VAT or sales tax.

With the DBCFT, business complexity increases dramatically. Purchases from foreign suppliers are not tax deductible. Proponents of the DBCFT claim that exchange rates will adjust, so the U.S. dollar cost of imports will be reduced sufficiently to offset the lack of a deduction. Will they? Even if that is not fantastical thinking and exchange rates do adjust, U.S. purchasers will face complex business decisions: Are imports with no tax deduction more or less costly than U.S. purchases with a tax deduction? You can bet consultants will develop software programs to optimize on a minute-by-minute basis the necessary purchasing decisions.

On the sales side, U.S. producers must also weigh dramatically different tax consequences: U.S. sales are taxable, but export sales are not. As noted above, the export sales will generate a tax loss on which a U.S. tax refund will be paid, at least if the loss cannot be claimed to reduce U.S. tax on domestic sales.

Finally, a border adjustment in a VAT would not affect how a foreign seller goes to market with U.S. customers. All sales to U.S. customers would be subject to the VAT except to the extent exemptions are provided for specific goods or services or for sales below some de minimis level.

The DBCFT, in contrast, works its magic by denying a tax deduction for the cost of imported goods and services. There are many U.S. purchasers — individual consumers who purchase for personal use and tax-exempt organizations — that do not care about the tax deduction. Foreign companies that sell to those customers will be motivated to ''go direct'' rather than sell through U.S. distribution companies.

Consider Ikea. Today, Ikea stores in the United States purchase goods from foreign (and some domestic) suppliers and then sell to customers who for the most part cannot claim tax deductions for the purchases. After adoption of the DBCFT, Ikea stores will become showrooms, compensated on a cost-plus or commission basis. Sales will be made from an Ikea entity in Canada or Mexico that ships directly to customers.

Unless the DBCFT includes some kind of reverse charge or use tax on U.S. customers, the Ikea restructuring works. And the U.S. experience with remote sellers and state sales taxes suggests that the United States will find it difficult to impose a surrogate DBCFT tax on individual purchasers. Further, if (as predicted) the DBCFT causes the U.S. dollar to strengthen against foreign currencies, U.S. consumers will be able to purchase foreign direct-supplied goods much more cheaply than U.S.-supplied goods. Is that a goal of the DBCFT?

U.S. producers and retailers will be uncompetitive in this situation, so what will they do? If we are advising them, they will consider exporting their goods to a foreign purchaser (claiming, of course, exemption for the export income). The foreign purchaser — perhaps related to the U.S. producer — will then sell the goods and services directly to U.S. consumers who are indifferent about the tax deduction.

The DBCFT is not a VAT. The economists most closely identified with the proposal, Alan Auerbach and Douglas Holtz-Eakin, are clear on that point. And supporters of the DBCFT work hard to avoid being labeled as VAT proponents. But supporters soft-pedal the consequences of the DBCFT's destination feature by comparing it to the border adjustment in a VAT.

For instance, in a February 21, 2017, letter from a group of corporate CEOs to congressional leaders, the CEOs wrote, "A critical element of the House blueprint is the provision that ensures that goods and services produced abroad face the same tax burden as those produced in the United States. This reform is consistent with the tax policies of nearly every other country in the world."

That is wrong. The border adjustment found in the tax policies of nearly every other country in the world does not require the government to send out refund checks for taxes it never collected. And the border adjustment in VAT systems has a neutral impact on business decisions; it does not dramatically complicate the choices of from whom to purchase and to whom to sell.

One can pretend that the border adjustment feature in the DBCFT is a cuddly lamb, but it has teeth. Those teeth are sharp and will draw blood if the United States adopts this unconventional proposal. ■