U.S. Corporate Tax Reform And Jean-Paul Sartre

by H. David Rosenbloom and Peter A. Barnes

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In this article, Rosenbloom and Barnes discuss the destination-based cash flow tax favored by House Republicans for corporate tax reform, which contains a border adjustment feature that looks familiar but is untested in the real world. Will it work? The authors expect the answer is no and explain why it would be unwise to build income tax reform around this untried principle.

In Washington, tax professionals are enjoying a fascinating new intellectual toy — the destination-based cash flow tax (DBCFT). OK, the acronym needs a little work. The more important point is that this replacement for the existing corporate income tax presents the most exciting opportunity to bat around economic theory in the tax field for many decades.

The proposal — which draws on tax elements that are familiar but have not been assembled in this manner before — calls for ''border adjustments.'' Under these rules, income earned by a U.S. taxpayer from exports is exempt from U.S. income tax (although the costs of producing goods and services for export are deductible), and payments for imported goods and services are nondeductible in computing U.S. taxable income. The proposal also contains a ''cash flow'' feature: capital expenditures for, say, a building or a machine are immediately deducted from the tax base, rather than deductible over years, as under current law. On the other hand, the deduction for interest expense is eliminated for many taxpayers in the DBCFT, although not, we assume, for the financial services industry. Finally, the proposal would lower the rate of tax from the present 35 percent to something like 20, or perhaps even 15, percent.

There is a great deal to say about this proposal, which has been supported firmly by House Ways and Means Committee Chair Kevin Brady, R-Texas, and House Republicans. It is a bit early to predict whether the Senate will join the parade. Senate Finance Committee Chair Orrin G. Hatch, R-Utah, has been proceeding in a somewhat different direction, focused on integrating U.S. corporate and individual taxes.

The most entertaining aspect of the DBCFT stems from the border-adjustment feature. This harkens back to an essential, and often discussed, aspect of the VATs that many countries have had in place for decades. The term VAT is enough to send most U.S. politicians running for the exit because Republicans see it as a money machine, and Democrats believe it is regressive. (Former Treasury Secretary Lawrence Summers once observed — not entirely in jest — that when Democrats realized the VAT was a money machine and Republicans understood that it was regressive, it would be enacted immediately, but that has yet to occur.) The border adjustment is designed and intended to encourage exports and deter imports. And on its face, it certainly seems well tailored to achieve those goals.

Advocates of the DBCFT say the border adjustment will also eliminate transfer pricing controversies. If a U.S. company pays ''too much'' for a good produced by its foreign affiliate, the high price simply increases the expense that is nondeductible. Likewise, if the U.S. company sells a product too cheaply to its foreign affiliate, the U.S. company forgoes the chance to earn tax-free income. But, there will still be transfer pricing risks, of course; the incentives will simply be reversed. In particular, a U.S. company may sell its product to a foreign affiliate at an unduly high price, earning higher tax-exempt income in the United States and depressing the taxable income of the foreign affiliate. And a U.S. company may pay too low a price for goods or services imported from a foreign affiliate, reducing the nondeductible expense in the United States and reducing the foreign taxable income of its foreign affiliate.

It appears that the DBCFT will dramatically increase the cost of foreign-made goods and services. If a U.S. importer cannot deduct those costs in computing its U.S. taxable income, the additional expense will have to be passed along to consumers, will reduce profits, or both.

Not to worry, say economists. U.S. producers will step into the vacuum and supply U.S. products to substitute for those currently purchased from abroad. Moreover, the U.S. dollar will strengthen, and the dollar cost to consumers for imports will revert to something like the current level because the dollar will buy a lot more foreign goods.

We are skeptics. And the U.S. retail community, not to mention experienced currency traders, seems to agree with us. U.S. alternatives for foreign-made goods sounds right in theory, but there are many foreign-made goods — low-cost clothing, shoes, TVs, bananas — for which there may be no realistically available U.S. alternative at any time in the near future. Currency adjustments, on the other hand, will require time, and what happens to importers in the interim?

Further, a strengthening U.S. dollar may be good for importers, but it is going to be bad, indeed very bad, for exporters. A principal goal of the DBCFT is to bolster exports. A stronger dollar operates in precisely the opposite direction.

It is not possible for the United States to have it both ways. Even the most advanced economic textbooks have not figured out how to strengthen the dollar for importers while leaving it unchanged for exporters.

The border adjustment also creates peculiar incentives for U.S. producers of products transacted in worldwide markets, with unknowable consequences for those markets. Consider, for instance, a U.S. producer of crude oil. If the producer exports the oil, the revenue is free of U.S. tax, and the costs are deductible — creating a very attractive financial return. If the producer sells the oil to a U.S. refiner, the income is fully taxable to the producer. So the producer will have an incentive to export, even if there are additional expenses in moving the product to a foreign customer. Do we really want to ask U.S. customers to pay more for U.S. goods than the U.S. producer charges its foreign customers? Would the U.S. producer be liable for "dumping" if it sells goods to foreign customers for less than it sells to U.S. customers?

It is also likely that some foreign customers of U.S. producers will successfully bargain prices down, so that the benefit of the tax-free treatment of exports goes to the foreign customers. U.S. procurement teams know this trick. When a U.S. company buys from a Chinese producer, for instance, the company knows that the Chinese producer will receive a rebate of its VAT costs, so the U.S. customer insists on purchasing the goods for substantially less than the Chinese company would sell the goods (including the VAT cost) to its Chinese customers.

Those consequences of the proposed income tax border adjustment tend to undermine — and certainly complicate — the DBCFT proposal. Moreover, almost all growth for large U.S. companies is outside the United States. Other countries often insist on some local manufacturing, dampening demand for U.S. exports. And the DBCFT seems to have been formulated with the manufacturing sector in mind. Yet the largest growth in U.S. exports has been in services and intangible property, not manufacturing.

Analysis supporting the DBCFT appears to assume a static world, in which the United States enacts legislation to spur U.S. production, and the rest of the world makes no response. That seems very unlikely. As Jean-Paul Sartre observed regarding football, "Everything is complicated by the presence of the other team." The same is true for international tax.

The administrative advantages of the DBCFT are not likely to hold up under close examination. The proposal allows companies to deduct expenses related to exports without recognizing income from those exports. That creates structural tax losses, which can be used to shelter income derived from U.S. production for U.S. purchasers. That result cannot be justified and would be political suicide because it would give large exporting companies a huge tax advantage over companies that operate solely within the United States. There is no reason to eliminate tax on domestic income from domestic production. Once taxpayers are required to allocate and apportion expenses between their export business and their domestic business, there will be controversies comparable with those relating to transfer pricing.

The risks of the DBCFT might be worth taking if no alternatives were available. But there are other, well-developed proposals for international tax reform all over Washington.

The United States could adopt a territorial system in which income earned by U.S.-owned companies operating outside the United States would be exempt from U.S. tax, if the foreign income were subject to some reasonable level of foreign tax. Or, foreign income could be subject to U.S. tax currently, but at a lower rate than U.S. earned income. The most conventional approach — though probably the most difficult option politically — would be for the United States to adopt a true VAT, as other countries have done, and use the revenue to reduce income tax rates. All these alternatives have been thoroughly discussed by government staffs and outside economists.

The DBCFT might usher in a new era of U.S. economic glory and the export achievements of the past. On the other hand, it might drive numerous businesses into bankruptcy, create domestic economic chaos, and initiate a trade war. With the U.S. economy presently functioning pretty well (unemployment down, wages up, stock markets bumping against records, growth higher than almost all other developed countries), does rolling the dice make sense? ■