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Destination-Based Taxation in the House Republican Blueprint

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In late June, the House Republican Task Force on Tax Reform released its Blueprint for tax reform,² at the center of which is a destination-based cash-flow tax to replace the current federal income tax on corporations. To scholars of international taxation, this is a fascinating development, because the destination-based cash-flow tax (abbreviated below as “DCFT”) on business entities has been advocated in the last decade by some of the most sophisticated economists in the field.³ It was outlined as a tax reform option in the President’s Advisory Panel on Federal Tax Reform in 2005,⁴ and has attracted the attention of policy analysts in the United Kingdom, Canada, and elsewhere.⁵ Yet the House GOP Blueprint represents the first time that the tax has been promoted by political leaders. Initial commentators have stressed the capacity of such a tax (if adopted in the U.S.) to reduce U.S. companies’ incentives for international tax planning and profit shifting, and to allow the U.S. to “leapfrog to the front of the pack” in its tax competitiveness.⁶

In this essay I discuss certain issues that are crucial for understanding the DCFT.⁷ For my purposes it is significant not only that an intellectually stimulating idea has been given political reality,

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² A Better Way: Our Vision for a Confident America, <http://abetterway.speaker.gov/assets/pdf/ABetterWay-Tax-PolicyPaper.pdf> (hereinafter “A BETTER WAY”). For initial reports and commentaries, see, e.g. Martin A. Sullivan, “Border Adjustments Key to GOP Blueprint’s Cash Flow Tax,” 152 TAX NOTES 303 (JULY 18, 2016); Ryan Finley, “Replace Corporate Tax With A Cash Flow Tax, Economists Say,” TAX NOTES, July 18, 2016, pp 330-1; Kyle Pomerleau and Stephen J. Entin, The House GOP’s Destination-Based Cash Flow Tax, Explained (available at <http://taxfoundation.org/blog/house-gop-s-destination-based-cash-flow-tax-explained>); Kyle Pomerleau, Details and Analysis of the 2016 House Republican Tax Reform Plan (available at <http://taxfoundation.org/article/details-and-analysis-2016-house-republican-tax-reform-plan>); Dylan F. Moroses, Tax Foundation’s Score of Tax Reform Blueprint Questioned, TAX NOTES.

³ See Alan Auerbach & Michael Devereux, *Consumption and Cash-Flow Taxes in an International Setting*, National Bureau of Economic Research Working Paper No. 19579/Oct. 2013. There is also an important body of U.S. literature that discusses implementing consumption taxation through a cash-flow tax on businesses, either on a destination or an origin basis. See, e.g., David Bradford, *The X Tax in the World Economy* (Griswold Centre for Economic Policy Studies, Working Paper 93/Aug., 2003), available at <https://www.princeton.edu/ceps/workingpapers/93bradford.pdf>; Harry Grubert & T. Scott Newlon, *The International Implications of Consumption Tax Proposals*, 48 NATL TAX J. 619 (1995).

⁴ See Report of the 2005 President’s Advisory Panel on Federal Tax Reform (hereinafter “2005 PANEL REPORT”), Chapter 7 (The Growth and Investment Tax Plan).

⁵ See, Alan Auerbach et al., *Taxing Corporate Income*, in DIMENSIONS OF TAX DESIGN: THE MIRRLEES REVIEW 837, 837-93 (Stuart Adam et al. eds., 2010) [hereinafter *ADS 2010*]; Robin Boadway & Jean-François Tremblay, *Corporate Tax Reform: Issues and Prospects for Canada* (Mowat Centre Research Paper No. 88/May 7, 2014), available at <http://mowatcentre.ca/corporate-tax-reform>; and INTERNATIONAL MONETARY FUND, SPILLOVERS IN INTERNATIONAL CORPORATE TAXATION 42 (2014).

⁶ Sullivan, *supra* note 2, at 304-5.

⁷ For a more extended discussion of different varieties of DCFT proposals and their relationship to the OECD’s BEPS project, readers are referred to my working paper, “Destination-Based Cash-Flow Taxation: A Critical Appraisal,” available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2614780. Among other things, the paper

but also that, even just in Blueprint form, the U.S. tax reform proposal offers a number of implementation details that the scholars advocating the DCFT have previously not sketched out. For example, the Blueprint suggests that business losses under the DCFT would be carried forward with an interest factor, instead of generating a refundable tax credit.⁸ It also states that the DCFT would apply to non-corporate entities such as sole proprietorships and partnerships.⁹ Last but not the least, the DCFT is presented in the Blueprint as part of a package that contains a policy framework for taxing individuals. Examining the DCFT in light of the implementation details of the Blueprint is not only necessary for assessing the likely impact of the proposed business tax reform, it may also help clarify some of the theoretical controversies that the DCFT has generated.

As many commentators have stressed,¹⁰ understanding the border adjustments required by the DCFT is key to evaluating its viability as well as its attractions relative to other reform proposals, such as introducing a federal value added tax (VAT) in the U.S.. I start off by examining this aspect of the DCFT, presenting the problems others have identified in a different form. I argue that we should not see the “perennial question” concerning the DCFT as being about whether it is in violation of World Trade Organization (WTO) agreements. Instead, the question should be whether we truly understand the DCFT’s potential impact on trade, aside from WTO legal concerns. I identify a couple of ways in which objections that can be raised against the DCFT have arguably not been adequately answered. I then examine how the loss carryforward aspect of the Blueprint interacts with the DCFT’s border adjustments, and how things get even more complex when non-corporate entities are also taxed on a destination basis. The implementation issues for the DCFT I highlight would not arise if the U.S. were to adopt a VAT instead. Therefore I conclude by comparing the DCFT with the VAT in respect of the issue of progressivity, and considering the question of how other countries would respond to a U.S. DCFT.

1. Does the DCFT Create Distortionary Export Subsidies and Import Tariffs?

Much of the U.S. policy discussion regarding border adjustments under the DCFT gives the impression that a very good U.S. reform idea is hampered by an arbitrary legal rule imposed by the WTO: border adjustments are permitted for “indirect” taxes like the VAT but prohibited for “direct” taxes. The rationale for the WTO rule is rarely explained. Since few believe that a distinction with any substance can be maintained between direct and indirect taxes, whether any tax reform proposal can qualify as an “indirect tax” seems to be a completely fortuitous matter. According to this way of looking at the issues, we are confronted with another instance where lawyers erect senseless barriers to sensible policy—or, worse, another instance where the U.S. is bound by some arbitrary international rule imposed by foreigners.

But perhaps this way of presenting the DCFT’s WTO-compatibility problem is not the most helpful.¹¹ Consider a simple example illustrating the border adjustment aspects of the DCFT.¹² Suppose that Corporation Y, incorporated and operated in the United States, produces and exports widgets to

distinguishes between different versions of DCFT proposals, which have led to frequent confusions. See Martin Sullivan, “GOP Plan Not So Easily Gamed,” 152 TAX NOTES 1060 (August 22, 2016).

⁸ A BETTER WAY, at 26.

⁹ Id, at 28.

¹⁰ See Sullivan, *supra* note 2, at 304-5; Wolfgang Schön, “Destination-Based Income Taxation and WTO Law,” Max Planck Institute for Tax Law and Public Finance Working Paper 2016-03.

¹¹ The following discussion is agnostic about the intent, logic, or structure of this aspect of WTO rules, of which I am not an expert.

¹² The example replicates the cost structure of the chain of production described in the example in Sullivan, *supra* note 2, which Sullivan uses to illustrate the import tariff effect of the DCFT.

Canada. In the terminology of both the VAT and the DCFT, the U.S. is the country of “origin” and Canada the country of “destination”. Suppose that each unit of the widget that Y exports to Canada sells for \$100 (before taking into account the Goods and Sales Tax (GST) that Canada imposes on imports¹³). Assume that this price reflects a cost of \$50 of wages that Y pays to its employees and \$20 of a necessary intermediate service, which Y acquires from another U.S. domestic producer, corporation X. Moreover, suppose that X itself incurs a labor cost of \$10 in producing the intermediate service sold to Y and no other cost. With these simple assumptions, X has a cash flow profit of \$10, and Y has a cash flow profit of \$30. In Table 1 below, Rows 1-3 display these stipulated facts. Row 4 illustrates the tax bases in the U.S. under an origin-based cash flow tax for X, Y and the two in the aggregate.¹⁴ Row 5 illustrates the respective tax bases under a destination-based VAT, and Row 6 illustrates such tax bases if the U.S. adopts the DCFT.

Table 1: Tax Base under Three Alternative Taxes

		Domestic supplier X	Exporter Y	Aggregate of X and Y
1	Sales	20	100	120
2	Cost of input purchase	0	20	20
3	Labor cost	10	50	60
4	U.S. tax base under an origin-based cash flow tax	10	30	40
5	U.S. tax base under VAT	20	-20	0
6	U.S. tax base under the DCFT	10	-70	-60
7	Canadian tax base under the GST/VAT or a DCFT	0	100	100

Under an origin-based cash flow tax, X and Y’s aggregate tax base in the U.S. is \$40, the sum of X and Y’s profits. Under the VAT, because the production of X and Y ultimately ends in exported goods, their aggregate tax base in the U.S. is \$0. This result is achieved by Y not including the exported sales in its tax base but still deducting the cost of input purchases (but not labor cost).¹⁵ Note that even though Y gets to deduct the \$20 cost of input purchase, the \$20 has already been included in the tax base of X, Y’s supplier. The aggregate tax base of X and Y in the U.S. is thus zero, not negative. What this means is that there is no subsidy provided to the export: the price of export to Canada simply is free of any U.S. tax.

Finally, under the DCFT’s border adjustment mechanisms, Y would exclude its \$100 export sale to Canada from its U.S. tax base, while at the same time deducting \$70 of (labor plus other input) costs. It thus has a negative tax base of \$(-70). The aggregate tax base of X and Y in the U.S. is also negative, \$(-60), which corresponds to X and Y’s total wage payments. If the DCFT’s rate is 20%, then the U.S. government must be able to give effect to \$12 tax benefit ($=\$60*20\%$) in connection with the export.

To complete the picture, Row 7 shows that in the country of destination, Canada, the import from Y falls within Canada’s GST tax base¹⁶ (and the base of a Canadian DCFT if Canada were to adopt the

¹³ The GST is the Canadian version of the VAT.

¹⁴ This example illustrating the issues of border adjustments does not involve capital outlays or borrowings of either firm, and therefore the cash flow profits of both firms are as they would be under the income tax.

¹⁵ Under the invoice-credit VAT adopted by most countries, this result would be achieved by “zero-rating” exports and offering refunds of input VAT previously charged to Y.

¹⁶ Although this is usually collected from and even nominally charged to the importer in Canada, the point is that Y’s export sale is taxable in Canada.

DCFT as well). When Canada and the U.S. are considered together, X's and Y's production that ends in the export to Canada gives rise to a tax base of \$100 under the VAT (\$0 in the U.S. and \$100 in Canada) but a tax base of \$40 under the DCFT (\$(-60) in the U.S. and \$100 in Canada). The difference reflects the narrower tax base of the cash flow tax, which, unlike the VAT, allows the deduction of labor costs.¹⁷

What Table 1 suggests is that, from the U.S.'s perspective, the export to Canada is subject to the most U.S. tax under the origin-based cash flow tax (which, when firms' capital outlays and financial transactions are put aside, operates just like the current corporate income tax). It is subject to less—more precisely, zero—tax under a VAT if the U.S. were to adopt the VAT. And if the U.S. were to adopt the DCFT, the export would actually receive a subsidy, if the negative tax base gives rise to a tax benefit.¹⁸ The concern that such a subsidy would raise for the U.S.'s trading partners seems immediate. Under the DCFT, not only would Y recover all previous tax borne by its non-labor inputs, thus ensuring that the material cost is \$20 and no more, but it should also get a grant for its labor cost. If the U.S. DCFT rate is 20%, Y would get \$10 of grant from the U.S. government per unit produced, implying that Y's net production cost is only \$60. The magnitude of the grant would be even larger if the proportion of labor cost in the exported widget is larger. Intuitively, this seems unfair to the U.S.'s trade partners as well as distortionary (welfare-impairing).¹⁹ A U.S. DCFT can also have the effect of import tariffs, with the magnitude of the tariff increasing as the proportion of labor cost in the imported goods increases.²⁰

If this intuition is justified, then there may be more sense to the WTO's prohibition of border adjustments for direct taxes than the U.S. policy discussion has acknowledged. Table 1 identifies real differences among the VAT, the origin-based and the destination-based cash flow tax. Labels about direct and indirect taxes are irrelevant.

DCFT advocates, however, have generally dismissed this intuition. The first explanation they tend to offer to counter the intuition is that *any* import tariff or export subsidy (i.e. not just implicit tariffs and subsidies such as one finds in the DCFT) will only have the effect of changing real exchange rates, if one assumes balanced trade in the long run.²¹ That is, any export subsidy or import tariff would be neutralized in the long term by exchange rate adjustments.²² This is an important idea to learn from

¹⁷ The origin-based cash-flow tax (shown in Row 4 of Table 1) also has this narrower tax base, but in that case all net profits are taxed in the U.S., the country of origin.

¹⁸ See Section 2 *infra* for further discussion of the loss carryforward mechanisms under the House GOP Blueprint.

¹⁹ Suppose that the world producer price of the widget that Y exports, before capital costs (i.e. the required return to Y's capital), is \$60. Y's production of the good in the U.S., which incurs a cost of \$70, is thus unprofitable and loses \$10 per unit in a competitive market. The U.S. subsidy of \$10 would allow it to break even.

²⁰ To see this through Table 1, consider what if Canada, the country of destination, imposes a DCFT on the full \$100 of import from Y. If an independent chain of production and sale similar to the one depicted in Table 1 took place purely domestically in Canada, then like Row 4 depicting the origin-based cash flow tax, Canada would have had a tax base of \$40. (Origin- and destination-based taxes are identical in effect for purely domestic transactions without imports and exports.) It follows that imported goods are taxed more heavily in Canada under the DCFT, with the effect of an import tariff. See also Sullivan, *supra* note 2 at 304.

²¹ For a good popular explanation of this idea, see Alan D. Viard, *Keynes at the Border?* April 15, 2009, The American Enterprise Institute (<http://www.aei.org/publication/keynes-at-the-border/>). For a more detailed explanation, see Jagdish N. Bhagwati, et al, 1998 *Lectures on International Trade*, 2nd Edition, MIT Press, at 215-19 (Sect. 12-6, Lerner Symmetry Theorem).

²² See, e.g., David Bradford, *The X Tax in the World Economy* (Griswold Centre for Economic Policy Studies, Working Paper 93/Aug., 2003); Transcript of the Conference on "Tax Reform in an Open Economy", held at The Brookings Institution and organized by the Urban-Brookings Tax Policy Center and International Tax Policy Forum, December 2, 2005.

economists, but it is not clear that it offers a full answer to potential concerns about the DCFT's trade effects. All examples that seek to show that tariffs (or export subsidies) can be neutralized through exchange rate adjustments assume that the tariffs and subsidies are imposed/granted at a uniform ad valorem rate. It is this assumption that ensures that the relative prices of a country's exports (or imports) are not affected by border adjustments—which therefore can be countered by a single exchange rate adjustment. But what if the border adjustments are not made at a uniform rate? As the example in Table 1 shows, the amount of subsidy Y receives for its widget export depends on the proportion of labor cost in the product. Different producers thus could receive different amounts of subsidies for the same product, and different sectors will be subsidized to different extents, depending on the intensity of their labor usage. At best, one could see an exchange rate adjustment countering the average subsidy a country offers to its exported products (or the average tariff imposed on imports). Even after the adjustment, however, some U.S. products and industries will enjoy residual, above-average subsidies, and others will gain advantage against imports that face above-average tariffs. The U.S.'s trade partners may be concerned about these products and industries, even though other U.S. products and industries (facing below-average subsidies and competing with imports subject to below-average tariffs) are penalized by the exchange rate adjustment.

Non-uniform tax rates matter a lot to the assessment of the efficiency of border adjustments. In academic studies of the VAT, for example, many economists have examined whether destination- and origin-based VATs are equivalent, an idea that involves similar intuitions.²³ And they have concluded that the most fundamental reason why the equivalence fails to hold is that all commodities are not taxed at the same rate under real world VATs (because of the prevalence of VAT exemptions). Consequently, the choice between destination- and origin-based VATs must rest on a range of pragmatic (and uncertain) policy judgments, with the destination-based VAT being preferred in practice.²⁴ Given that the acknowledgment of non-uniform tax rates has so importantly shaped policy analysis in the VAT area, it seems insufficient for DCFT proponents to reply to questions about the proposed tax's trade effect simply by pointing to a textbook theorem with demonstrably invalid assumptions.

DCFT proponents have occasionally suggested a different mechanism by which the effect of export subsidies may be neutralized in the long term. Perhaps the subsidy that the DCFT offers to labor employed in producing exported goods and services may cause the wage in the export sector (and those sectors that supply to the export sector) to rise.²⁵ That is, in the example given above, the wage subsidy would cause X's cost of labor to rise from \$50 to \$60, and X thus would ultimately suffer losses and exit from the market notwithstanding the export subsidy. In effect, the suggestion seems to be that labor claims the entire benefit of the subsidy/grant for wage payments—it bears the full incidence of such a subsidy. However, the theoretical and empirical validity of such an assumption about the incidence of a tax benefit on labor is again likely to be controversial. Without justifying such assumptions, it is not clear how DCFT proponents can dispel concerns about distortionary trade impacts.

²³ See e.g. Lockwood et al, When are origin and destination regimes equivalent? *International Tax and Public Finance* 1(1): 5-24 (1994).

²⁴ See, e.g. Michael Keen & Walter Hellerstein, *Interjurisdictional Issues in the Design of a VAT*, 63 *TAX L. REV.* 359, 363-7 (2010). This may be seen as the obscure and technical intellectual justification of the WTO's permission for VAT border adjustments.

²⁵ See Kristen Parillo, *A Destination-Based Corporate Tax: An Alternative to BEPS?* 78 *TAX NOTES INTL* 315 (2015), at 320 (quoting Michael Devereux as responding to the objection that the DCFT gives rise to an export subsidy by claiming “prices would adjust — just like under a VAT[.]”)

In summary, even in the absence of WTO legal prohibitions, distortionary trade subsidies presumably should be viewed as undesirable, just as distortions of corporate decisions on locations of production and the intensity of capital investments are. The objection that the DCFT may run afoul of WTO law, therefore, should not be seen as an extraneous obstacle, but as a relevant critique in economists' own terms. Many economists and policy analysts have objected to the DCFT on the ground of its WTO incompatibility.²⁶ If the WTO rule was purely arbitrary, perhaps this controversy would not have remained so "perennial".

2. Loss Carryforward under the Blueprint's DCFT

In the House GOP Blueprint, the net operating losses of a business are carried forward, with an interest factor to compensate for inflation and ensure that the normal rate of investment return is not subject to tax.²⁷ Thus, generally, net losses in the current period can only offset future earnings, but do not lead to any cash transfers from the U.S. Treasury. Yet for an exporting business, one presumably has to allow deductions of costs to currently offset other sources of taxable profit of the business, since the business's revenue from export will always be excluded from the tax base. Therefore the export subsidy (shown in Table 1 of Section 1) comes in the form of tax benefits reducing the tax liability on the business' other taxable profit. By contrast, the issue does not arise under the destination-based VAT (Row 5 of Table 1), because any rebate an exporter (e.g. Y) gets under the VAT only corresponds to the VAT that it has been charged on its input purchase (and which has been paid to the vendor, e.g. X, who in turn remits it to the government).

The Blueprint's loss carry-forward approach is one respect in which the particular legislative proposal has already clarified the past, purely academic discussions of destination-based taxation. Economists who advocate the cash flow tax (or other similar taxes on corporate rent), whether of the destination- or origin-based variety, have traditionally insisted on a full cash subsidy for corporate losses. They have done so for two reasons.²⁸ First, the asymmetrical treatment of profit and loss resulting from risk taking (i.e. profits from lucky outcomes are taxed but losses from unlucky outcomes are disregarded) discourages risk taking. Second, it is difficult to distinguish economic rent from returns to risk taking for particular firms and investments. When a firm realizes an outsized return, it is generally hard to say how much this is because the firm seized on a unique opportunity, and how much it is just good luck (it is usually both). Only by taking full account of losses in the tax system—by allowing full offset of losses against profit and the refund of negative tax liabilities of individual firms—can one address these two problems.

However, almost no real world tax systems offer refundable tax credits or cash subsidies for losses. The reason is not mysterious: it is much easier to lose money than to make money, and any government should be loath to partake in all the loss opportunities out there. This approach is true not

²⁶ See especially Bradford, *supra* note **Error! Bookmark not defined.**, at 12-13; Boadway & Tremblay, *supra* note 5 at 47.

²⁷ A BETTER WAY, at 26.

²⁸ See, e.g. Bradford, *supra* note **Error! Bookmark not defined.** Boadway and Tremblay *supra* note 5. For recent reflections on whether this traditional approach is justified, see Robin Boadway, et al 2015. "Cash-Flow Business Taxation Revisited: Bankruptcy, Risk Aversion and Asymmetric Information." Oxford Centre for Business Taxation Working Papers 15/31.

only of the income tax, but also of the VAT. In this regard, it is easy to be misled by the fact that for a particular firm, it is possible for VAT input tax credits to exceed VAT payable on sales, with the result that the firm gets a VAT refund depending on the excess of its cost of input purchases over its sales. One should not forget that this refund is for the VAT that has previously been charged to the firm on its input purchases. A VAT refund simply ensures that no tax is collected in excess of the value of a firm's taxable sales. It does not require the government to offer a subsidy to any firm when there is a loss. To put it differently, the VAT taxes consumption even if the consumption is produced through processes generating net losses.²⁹

In other words, there existed a large gap between the cash flow tax economists wrote about (in both theoretical and even policy papers) and real world taxes. If the GOP Blueprint's brief statement about loss carryforwards is read to apply to exporting firms as well, the legislative proposal can be seen as beginning to close this gap by eschewing cash grants for losses.³⁰ Nonetheless, there seem to remain some intolerable gaping holes. It seems to follow from the design of the DCFT that, unless "losses" recorded by exporters can be freely traded for cash with other businesses,³¹ no corporation would want to be engaged purely in exports, since its negative tax base would not result in any tax benefit. All exporters would want to acquire businesses generating domestic sales, or enter into group consolidation with corporations that have such sales. This type of behaviors would often be distortionary—they would not occur in the absence of the potential tax benefits enjoyed by exporters. Moreover, if different businesses use their losses from exports to different extents, depending on how much taxable profit is generated by their domestic sales, another dimension of heterogeneity—as well as fluctuation—would be introduced to the amounts of subsidies received by different exporters.³²

²⁹ Cash-flow tax advocates arguably miss this point when they claim similarities—but for the deduction for labor costs—between real-world VATs and the tax they favor in theory. For example, David Bradford suggested that under a VAT, any investment outlays are immediately deducted in the computation of VAT liability. As a result, "the general public shares in the investment and payoffs in proportion to the tax rate [in] making investment decisions, the taxable firm considers its share." Bradford, *Consumption Taxes: Some Fundamental Transition Issues*, in *FRONTIERS OF TAX REFORM* 132, 132 (Michael J. Boskin, ed., 1996). This is incorrect: the government simply does not share the risk of business loss through the VAT.

³⁰ The Report of the 2005 President's Advisory Panel recommended (under the destination-based Growth and Investment Tax or GIT) cash subsidies to exporters with excess deductions, even though businesses making domestic sales would only be able to carry forward losses. 2005 PANEL REPORT, at 171. It acknowledged that "special rules may be needed to police the allocation of expenses between domestic businesses generating losses and export businesses when both are operated within the same firm or through affiliates." I believe this understates the problem: the opportunities for tax avoidance and even fraud associated with cash subsidies to exporters are bad enough in themselves, even without considering the strong incentives for tax planning when exporters and domestic businesses are treated differently.

³¹ For the government, this would be just as bad as giving cash directly to the exporters. The Report of the 2005 President's Advisory Panel acknowledges the risks of allowing loss trading under any cash flow tax: "Allowing tradable or refundable losses may encourage tax avoidance schemes in which the taxpayers make investments that would not have been worth undertaking in a no-tax setting. The value of tax losses created by such an investment may be a key component of its appeal. In addition, allowing loss trading could make it much more important to police so-called "hobby losses" and losses generated by various forms of disguised consumption, rather than investment, because those losses could generate tax savings even when the person incurring them would never realize offsetting positive cash flow." 2005 PANEL REPORT", at 167.

³² In this context, it would become even harder to see how (as DCFT proponents would want us to believe) the subsidy/tariff apparently present in the DCFT can be neutralized by exchange rate adjustments or labor moving

The problem of loss utilization would not be nearly as dramatic under an origin-based cash flow tax that also adopts the loss carryforward with interest. A firm's sales would always be included in the base of such a tax. An interest factor attached to losses carried forward would often be adequate to preserve the value of losses realized, except when a firm liquidates without earning a profit. The non-refundability of firms' terminal negative tax liability still deters risk taking to an extent, but this is a matter of degree, and is not different in kind from the treatment of losses under the current income tax (which theorists view as non-ideal). By contrast, there has to be *some* way to give effect to the negative tax liability associated with *all* exporters under a DCFT: otherwise it would not be a destination-based tax. But the choices among direct cash grants for current excess deductions, costless ("safe harbor") loss trafficking, and more limited loss utilizations through tax planning all seem to be unpalatable, as well as unprecedented.

3. Taxing Non-Corporate Entities on a Destination Basis

"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."³³ This statement in the GOP Blueprint confirms what seems an inevitable implication of DCFT proposals, namely that it must be applied to corporations and non-corporate business entities alike. As a practical matter, it is hard to imagine corporations being taxed on a destination basis but non-corporate entities on an origin basis. If corporations are not allowed to deduct the cost of imports but partnerships are, imports would all be done through partnerships. Partnerships would then on-sell the imported goods to corporations, defeating the tax on imports. Conversely, all non-corporate entities making export sales—think of law, accounting, consulting and financial management firms providing services to foreign clients—would all try to make such sales through corporations, if corporations can exclude export sales from its tax base but non-corporate entities cannot. Moreover, corporations entering into joint ventures that involve making sales of goods and services across borders would have to rethink whether they would want to do so using non-corporate vehicles.

Although applying the DCFT to corporations makes it practically necessary to apply the same treatment to non-corporate entities, this fundamental change to the taxation of non-corporate entities seems otherwise to be lacking in motivation. Because individual owners of sole-proprietorships, partnerships, etc. are taxed currently on such entities' income, American taxpayers cannot engage in deferral planning through such entities. And both because of the United States' foreign tax credit regime and because individuals cannot manipulate their tax residence as easily as can corporations, distortions of residence- and source-based taxation either do not arise or are minimized. Therefore international tax planning and profit shifting by non-corporate entities taxed on a pass-through basis is not an issue of serious concern. Consequently, although cash flow taxation does make a difference to all businesses because of the benefit of immediate expensing (and the detriment of interest non-deductibility), the destination aspect of DCFT introduces no efficiency gain in the treatment of pass-through entities. Indeed, according to other tax reform proposals advanced in the U.S., the corporate tax system should be reformed to align more with the current regime for pass-through taxation, not the other way around.³⁴

across firms and sectors. How flexible does the exchange rate have to be to adjust even on average to such fluctuations, and how wages reach equilibrium?

³³ A BETTER WAY, at 28.

³⁴ See ERIC TODER & ALAN D. VIARD, MAJOR SURGERY NEEDED: A CALL FOR STRUCTURAL REFORM OF THE U.S. CORPORATE INCOME TAX 1 (2014).

One may even question whether the destination-based tax treatment of non-corporate entities is not positively base-eroding (as well as regressive). Under the DCFT, U.S. lawyers, business consultants, investment managers and others providing professional services to foreign clients and off-shore companies would no longer be taxed on the profits when earned from such services—not even under the reduced 25% rate that the GOP Blueprint proposes for pass-through entities’ active business income. Instead, they would be taxed on such profits only when, and to the extent, they finance U.S.-based consumption from such profits.³⁵ Moreover, such firms could have negative tax liabilities after the deduction of wage costs. What may happen is that, instead of looking for loss-generating tax shelters as they did in the past, the U.S.’s high income-earning service professionals would be looking to acquire interests in businesses generating active income, so as to make use of their export-related deductions. This adds another layer to the loss trafficking problems generated by corporations discussed in the previous Section. It may also exacerbate pre-existing incentives to convert wages taxed a higher rate (e.g. the 33% maximum under the Blueprint) to active business income (which can be subject to zero tax if offset by loss carryforwards).

The preceding discussion assumes that applying the DCFT to non-corporate entities means such entities computing profits or losses in the same way as corporations do, but are nonetheless not subject to the DCFT at the entity level. Instead, the owners of non-corporate entities would be subject to tax (at a maximum 25% rate, according to the GOP Blueprint).³⁶ But arguably this is an incorrect way of thinking about things. The defining feature of pass-through entities is that their owners are taxed currently on the entity’s income. Corporations, by contrast, are subject to an entity-level tax, separate from shareholder-level taxation of dividends and capital gains. This distinction, however, makes sense only in the income tax context: because corporate shareholders enjoy the benefit of deferral (i.e. no current inclusion), an entity level tax is needed to undo this benefit. Under any type of cash flow tax applied to corporations (including the DCFT), however, the entity-level tax no longer has the effect of undoing deferral. This is because any cash flow tax allows the immediate expensing of all of a firm’s capital investments. A firm can thus always earn a normal investment return without being subject to tax, and is indifferent between paying tax earlier and later. Individual shareholders thus enjoy the benefit of perfect deferral on investments in a firm subject to the cash-flow tax.

What this implies is that it would be very artificial to maintain the distinction between corporate and pass-through entities—taxing the former both at the entity and owner levels, and taxing the latter only at the owner levels—if the DCFT were adopted. Indeed all past cash flow tax (or equivalent) proposals advanced in the U.S. do not take this approach. David Bradford’s “X tax”, for example, is simply a consumption tax that does not aim to tax shareholders on corporate income.³⁷ More recently, Edward Kleinbard has proposed the Business Enterprise Income Tax (BEIT), which explicitly taxes only economic rent at the firm level, and only the normal return to capital at the investor level.³⁸ The BEIT serves as a device to measure returns to capital from risk taking and economic rent, instead of the traditional role of preventing the deferral of income by shareholders. Under both Bradford’s and

³⁵ The fact that U.S. taxpayers can earn investment returns at a low tax rate and then migrate to a low-tax jurisdiction when they retire and consume is deemed to be a general problem for a destination-based cash flow tax (as compared with an origin-based income or cash flow tax), and is not specific to owners of pass-through entities. See Bradford, *supra* note **Error! Bookmark not defined.**, at 26-7.

³⁶ This is of course inherently distortionary.

³⁷ Bradford, *supra* note **Error! Bookmark not defined.**

³⁸ Edward D. Kleinbard, *Reimagining Capital Income Taxation* (paper presented at the Annual Symposium of the Oxford University Centre for Business Taxation, Saïd Business School, Oxford, UK, June 22, 2015). The BEIT implements the tax on corporate rent through a cost of capital allowance instead of immediate deductions for capital expenses, a distinction that is irrelevant for the purposes here.

Kleinbard's proposals, owners of corporate and non-corporate entities are taxed alike, as are the two types of entities themselves.³⁹

By contrast, under the House GOP Blueprint, owners of corporate and non-corporate entities continue to be subject to different treatments (i.e. two levels vs. one level of taxation), even though this is no longer justifiable in terms of the entity-level tax that corporations are subject to. An alternative way of implementing the DCFT should therefore be to tax owners of non-corporate and corporate entities alike: partners, for example, should be taxed on both distributions and sales of partnership interests, while the 20% DCFT would be imposed at the partnership level. This would at least improve the U.S. tax system in one way, by eliminating the complexities of pass-through taxations.

4. Progressivity under the DCFT and Possible International Response

The House GOP Blueprint asserts that the DCFT would “allow the United States to adopt, for the first time in history, the same destination-based approach to taxation that has long been used by our trading partners. This will end the self-imposed unilateral penalty for exports and subsidy for imports that are fundamental flaws in the current U.S. tax system.”⁴⁰ The comparison made here is puzzling. Most other OECD countries impose both an origin-based corporate income tax and a destination-based VAT. Although their corporate income tax rates are generally lower than that of the U.S. (and may be more “competitive” in other respects), it is their VATs, not their corporate income taxes, that allow for border adjustments. To say that the DCFT “counters” the U.S.’s trade partners’ VATs at once implies that VATs involve export subsidies and ignores that other countries maintain origin-based corporate income taxes. Neither is correct (as can be seen from Table 1 in Section 1).⁴¹ Whatever “self-imposed” penalty that is implicit in the origin-based corporate income tax is shared by the U.S. and its trade partners, thus by no means “unilateral”. What does distinguish the U.S. is its resistance to adopting the VAT.

To put it differently, if the U.S. simply were to replace its corporate income tax with the destination-based VAT, the difference that would matter to the rest of the world would not be the U.S.’s removal of a “self-imposed penalty” (by previously failing to border adjust under an income tax). Instead, it would be that the U.S. would have eliminated its corporate income tax, while others still maintain such taxes in addition to having VATs. As far as the taxation of multinationals are concerned, it is hard for a country to be more competitive than *that*.⁴² By the same token, the phenomenon of U.S.-tax-driven MNC tax planning would certainly end. The business “competitiveness” goals of the GOP Blueprint would all

³⁹ The GIT considered by the Report of the 2005 President’s Advisory Panel applies to corporate and non-corporate entities in the same way, but owners of the two types of entities are still taxed differently. The GIT is thus vulnerable to the same criticism directed at the DCFT here.

⁴⁰ A BETTER WAY, at 15. See also *id.*, at 28 (“For the first time ever, the United States will be able to counter the border adjustments that our trading partners apply in their VATs.”)

⁴¹ To refer back to the example in Table 1, the U.S.’s trade partners each imposes taxes corresponding to Row 4 (except that most of them have origin-based *income* taxes and not cash-flow taxes) and Row 5 (the VAT), whereas the U.S. has only had a tax corresponding to Row 4 (against with the caveat that it is not a cash flow tax). Replacing the corporate income tax with the DCFT would introduce export subsidies (per Row 6 of Table 1) not observed in Row 5, which depicts the neutrality of the VAT.

⁴² As the discussion in Section 1 showed, however, the DCFT has a narrower tax base even than the VAT. Replacing the corporate income tax with a DCFT (without having a VAT at the same time) would certainly be even more business-favorable than replacing it with a VAT.

be thoroughly achieved—and, as it happens, the VAT actually would also be WTO-compatible, and free of the uncertainties of implementability discussed in Sections 2-3.

The new question here is perhaps not why U.S. politicians would not advocate adopting the VAT (even though the House GOP now seems willing to consider the DCFT). It is instead why the DCFT's intellectual proponents would favor it over the VAT. One suggestion that has been aired is that the DCFT may be more progressive than the VAT.⁴³ The reasoning behind this suggestion is probably the following. The VAT taxes all consumption, whether the consumption is financed by wage earnings or supra-normal returns to capital. The DCFT, by contrast, allows wage payments to be deducted from the tax base, and economists have concluded that this means only consumption that is financed out of supra-normal returns to capital investment would be taxed.⁴⁴ If higher income individuals finance a greater proportion of their consumption from returns to investment rather than from wage earnings, then perhaps a tax on investment-financed consumption has a built-in progressivity. (Since money is fungible, presumably a higher proportion of investment-financed consumption simply means a higher proportion of current disposable income that comes from wealth instead of labor.)

This type of consideration could seem relevant when one considers only business tax reform—which is what the DCFT's intellectual proponents have focused on.⁴⁵ However, its relevance is much diminished when set out in a reform package that also addresses individual taxation. This is precisely what the Blueprint has done. According to the Republican proposal, investment income (dividend, capital gain, and interest) would all be taxed at progressive rates, though effectively at half the rates of other types of income in the same brackets (through a 50% deduction). This seems to be a far more direct and effective way of introducing progressivity than modifying the VAT. Whatever progressivity there is in the DCFT relative to the VAT seems to lose policy significance.

Recognizing that the U.S. is unique among OECD countries in not having a VAT is also relevant to the question of how other countries might respond to a U.S. DCFT. A basic reason why that question is presently unanswerable is of course that the DCFT may be WTO-incompatible, and it is unclear, even putting the WTO aside, whether countries can come to terms with the trade effects of the DCFT. Moreover, as Section 2 above suggested, the export subsidies required by the DCFT imply mechanisms for governments to transmit cash to their exporters in ways that are unprecedented in real world tax systems. But suppose that these problems are somehow overcome. Suppose, for example, the U.S. simply allows unlimited trafficking of losses arising from labor cost deductions from exported sales. Would other countries follow suit and adopt the DCFT as well?

My own guess is that the answer is No. The reason is that the DCFT is too much just like the destination-based VAT: the only differences are the deduction for labor costs and the fact that the DCFT operates on a subtraction as opposed to a credit-invoice method. Other countries already have the VAT, and there is little justification to impose a separate subtraction-type tax that is also destination-based. To achieve the effect of the DCFT, they would only have to increase their VAT rates (by the rate of the desired DCFT), while at the same time adopt some mechanism for giving effect to labor cost deductions.

⁴³ Finley supra note 1.

⁴⁴ Auerbach and Devereux, supra note 3.

⁴⁵ The DCFT's scholarly advocates have tended to be reticent on what type of individual-level taxation they assume and how the DCFT relates to such taxation.

They could, for example, offer a deemed input VAT credit (at the rate of the desired DCFT) for all labor costs incurred by VAT taxpayers. This could undermine the integrity of their VAT systems, in the way loss trafficking would undermine the integrity of income tax systems. But at least they would not have to worry about the integrity of their (personal) income tax systems undermined by a substantial new source of business losses.