Destination-Based Cash-Flow Taxation: Responding to A Changing Global Economic Environment

Alan Auerbach

March 3, 2017

Top Five US Companies

BURCH CENTER
FOR TAX POLICY AND PUBLIC FINANCE
UNIVERSITY OF CALIFORNIA BERKELEY

1964:

1. AT&T
2. GENERAL MOTORS
3. EXXON MOBIL
4. IBM
5. TEXACO

2014:

1. APPLE
2. EXXON MOBIL
3. BERKSHIRE HATHAWAY
4. ALPHABET
5. MICROSOFT

A Changing Economic Setting

In half century ending in 2014 in US:

- Share of IP in nonresidential assets doubled (BEA, Fed)
- Share of before-tax corporate profits of US resident companies coming from overseas operations quadrupled (BEA)

Summary

- A rise in multinational activity
- Increasing importance of intellectual property in value creation
- A weaker link between production and sales locations, and less ability to identify the location of production and value creation
- Implication: Pressure on systems that tax corporate income using residence or source

Outline

- **Major elements of the DBCFT**
- **Its economic effects**
  - Investment and finance
  - Profit-shifting and inversions
  - Exchange rates
  - Trade
  - Asset values
  - Location of production

Major Elements

BURCH CENTER
FOR TAX POLICY AND PUBLIC FINANCE
UNIVERSITY OF CALIFORNIA BERKELEY

- **Cash flow tax**
  - Replace depreciation deductions with expensing
  - Eliminate interest deductions
- **Destination basis**
  - Drop foreign-source income from base, as under a territorial system
  - Border adjustments effectively take export receipts and import costs out of business tax base

Relation to a VAT

- **Like a VAT, but with a deduction for labor costs**
- **Equivalent system:**
  - A VAT (subtraction method)
  - A payroll tax credit at the corporate tax rate
- **Result: a progressive consumption tax**

House Blueprint

- **20% tax rate (25% for pass-throughs)**
  - – In principle, border adjustment should be at same rate for both
- **One-time tax on accumulated offshore earnings**
  - – 8.75 percent on cash/cash equivalents; otherwise 3.5 percent (payable over an eight-year period)
- **Tax on net interest income**
- **Financial services – TBD; various alternatives***

Investment and Finance

- **Expensing**
  - A bigger incentive for domestic investment
- **Loss of interest deduction**
  - Reduces incentive to use debt rather than equity finance and weakens increased incentive for investment
- **Interest rates**
  - Downward pressure from weaker borrowing demand

Profit-Shifting and Inversions

- **Related-party cross-border transactions have no impact on US tax base**
  - But shifting profits out of US means higher profits elsewhere, so reverse direction of profit-shifting
- **Loss of interest deduction encourages borrowing elsewhere**
- **Elimination of tax on foreign source income means no reason to avoid US residence**
  - But residence-based features elsewhere may encourage inversion into US

Exchange Rates and Trade

- **Border adjustments would appear to make US imports more expensive and world prices of US exports cheaper**
  - But border adjustment should lead to dollar appreciation that offsets potential rise in US import prices or fall in world prices of US exports

Exchange Rates and Trade

- **US importer:**
  - Before (at 20% tax rate): dollar-euro parity, so 100 euro import costs 100 dollars before tax and 80 dollars after tax
  - After: euro = .8 dollars, so 100 euro import costs 80 dollars before and after tax
- **Effective tax rate rises; no change in bottom line**

Exchange Rates and Trade

- **US exporter:**
  - Before (at 20% tax rate): dollar-euro parity, so 100 euro export delivers 100 dollars before tax and 80 dollars after tax
  - After: euro = .8 dollars, so 100 euro export delivers 80 dollars before and after tax
- **Effective tax rate falls; no change in bottom line**

Exchange Rates and Trade

- **Symmetric border adjustment: a neutral impact on trade**
  – A different result if only import tariff were imposed – some dollar appreciation, but still an increase in import prices and a decline in imports
  – Providing border adjustment only for revenues less labor costs would also look more like a tariff

Exchange Rate Adjustment

- **The dollar should adjust**
  - Many complications, although not necessarily significant or pointing toward a lower adjustment*
  - Timing: response should anticipate implementation
- **If adjustment is incomplete…**
  - An alternative mechanism through higher domestic wages and prices, but more gradual

Asset Values

- **With dollar appreciation comes decline in dollar value of foreign-currency denominated assets (and liabilities) of US firms, individuals**
  - Estimate: as high as about $2 trillion, but possibly much lower*

Location of Production

- **Lower relative value of foreign operations also has implications for location of new operations**
  - 20 percent relative decline in value of overseas operations – as if US tax were imposed on US and domestic profits, so no additional tax on US operations
  - This logic holds for US companies <u>and</u> foreign companies

Summary

- **A simple, durable and progressive tax system**
  - No distortion of trade
  - Neutral treatment of debt and equity
  - Elimination of incentives for profit shifting and inversion
  - Elimination of tax on US-source profits