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

Alan Auerbach

March 3, 2017
Top Five US Companies

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

• **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 and 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