Destination Based Cash Flow Tax

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Problems to Address

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- **Distortions Associated with Existing Systems**
  - Worldwide: Inversions, International Competitiveness and (with deferral) Lock-Out
  - Territorial: Shifting Abroad of Profits and Activities
- **Distortions of Investment and Finance**
  - Income taxation raises the cost of capital
  - Interest deduction favors debt finance
- **Complexity and Information Requirements**

Two Elements of Proposal

- **Cash flow tax**
  - Meade Committee:
    - R base (real flows only), or
    - R+F base (real + financial flows)
- **Destination based**
  - Broadly, location of purchaser
    - Same approach as taken under existing VATs
    - Unlike VATs, aim is to tax business profits, allowing a deduction for labor expense

Steps to Reform

- **Cash flow tax:**
  1. Replace depreciation with immediate expensing
  2. Eliminate net interest deductions (R) or tax net borrowing (R+F)
- **Destination based:**
  3. Ignore foreign activities, as under a territorial tax
  4. But also effectively ignore cross-border activities, by having border adjustments offset business export revenues and import expense deductions

Why Cash Flow Taxation?

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- **Tax falls on economic rent, but not the normal return to capital**
  - Does not discourage investment
  - Neutral between debt and equity finance
- **Simpler to administer**
  - No need to capitalize any expenditures or keep track of asset bases

Why Destination Based?

- **No incentive for profit shifting**
  - With cross-border transactions ignored, no change in US taxes from manipulation of internal transfer prices or strategic location of borrowing
  - Tax based on location of purchases can be avoided only to the extent that location of purchases can be manipulated
- **Simpler to administer**
  - Need information only on domestic transactions

Tax System Properties (1)

- **No business-level tax on US-source income**
  - Cash flow tax imposes no tax on expansion of investment
  - Destination basis ensures that no tax is imposed as a result of <u>production</u> in US; only location of <u>purchasers</u> matters

Tax System Properties (2)

- **No incentive for government to reduce tax rate to attract business or profits**
  - Shifting profits or activities to/from the US has no effect on a company's US tax liability unless the location of its sales changes

Tax System Properties (3)

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- **System is equivalent to the combination of**
  1. A broad-based consumption tax (e.g. a retail sales tax or a VAT)
  2. An equal rate subsidy to payroll
- **Result is a tax on consumption from sources <u>other than</u> wages and salaries**

Tax System Properties (4)

- **System is highly progressive**
  - Exempting wage & salary-based consumption overcomes the standard view of a consumption tax as regressive
  - Inability of companies to avoid tax through shifting of profits and activities eliminates current concern that the corporate tax is being shifted to labor

Tax System Properties (5)

- **Self reinforcing incentives for adoption**
  - If US adopts, then puts pressure on other countries to do so, to avoid shifting of profits and activities to the US
  - Unlike other approaches to “reform” that require coordinated adoption of rules and increased information sharing

Implementation Issues

- **Taxing financial services**
- **Dealing with tax losses**
- **Revenue and transition**
- **Taxing natural resources**
- **WTO**

Taxing Financial Services (1)

- **How can we tax economic rent earned by banks and other financial companies?**
  - VATs do not do this effectively
  - R base cash flow tax ignores financial transactions, and so would not capture financial rents
- **R+F base captures financial rents, by including financial transactions in the base**
  - Continue to tax/deduct interest, but also include net borrowing in the tax base

Taxing Financial Services (2)

- **But R+F base involves greater complexity**
  - All companies would need to keep track of financial transactions
  - Destination basis would require keeping track of whether financial transactions were with foreign or domestic companies, since cross-border transactions would be ignored
- **But full R+F base not needed to capture rents**

Taxing Financial Services (3)

- **For transactions between domestic firms, tax consequences offset**
- **Example: bank loan to industrial firm**
  - Lending by bank receives tax relief
  - Borrowing by firm is taxed
  - Firm's interest & principal payments get tax relief
  - Bank's receipt of such payments are taxed
- **So, by netting can ignore financial transactions, e.g., use R base for transactions between domestic firms**

Taxing Financial Services (4)

- **All that is left to tax under the R+F base are financial transactions between domestic companies and domestic non-business taxpayers**
  - Note: no need for financial companies to allocate nonfinancial costs, as all such costs would be deductible

Dealing with Tax Losses

- **Increased likelihood that profitable firms would have losses**
  - Example: a firm produces domestically for export; has deductible expenses but no taxable revenue
- **Need improved methods of recovering losses**
  - Carrying forward, even with interest, may not suffice, as pattern could remain over time
  - One simple approach would be to allow losses to offset other taxes, e.g., payroll taxes

Revenue and Transition

- **Rough calculations (Auerbach 2010) suggest not a clear reduction or increase in revenue**
  - These ignore border adjustments, which would increase revenues substantially in the short run
  - Extension beyond C corporations would increase revenue
  - Transition relief would reduce revenue
  - But revenue could be raised via a one-time tax on existing offshore earnings

Taxing Natural Resources

- **In some instances, taxation based on source of income may still be attractive**
  - Clear case: natural resource rents, for which source is readily identifiable
  - Destination based approach gives up tax on such rents, so a separate tax will be desirable if they are a large share of existing corporate tax base
  - Can still follow cash flow approach, but on an origin basis (e.g., Henry Review, Australia, 2010)

WTO

- **WTO rules permit border adjustments under a VAT**
- **The destination based tax is equivalent to a VAT plus a equal-rate reduction in payroll taxes, both of which are WTO compliant**
- **Is the destination based tax WTO compliant?**
  - Yes; it’s a tax on consumption
  - No; it’s a direct tax, not an indirect tax

Final Thoughts

- **Tax competition, with falling rates, is likely to continue under existing system**
  - A simple shift to territorial taxation does not help arrest this, nor does strengthening worldwide taxation
- **The approach proposed here would shift the nature of competition from lowering rates to reforming tax systems**