The House Republican Blueprint: A destination-based cash-flow tax

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In brief

The increased potential for comprehensive tax reform in 2017 has put a spotlight on the House Republican Blueprint, released by House Speaker Paul Ryan (R-WI) and Ways and Means Committee Chairman Kevin Brady (R-TX) last June. The Blueprint is the likely starting point for drafting tax reform legislation in the House. The business provisions of the Blueprint would radically transform the existing corporate income tax and individual income tax on pass-through business income into a consumption-based tax by providing for "cash-flow" taxation and border adjustability. This *Tax Insight* provides more detail on these business provisions and discusses the impact the Blueprint would have on US competitiveness, the potential market impact of border adjustability, and the change it would represent in the taxation of cross-border income.

For an earlier description of the individual and business provisions of the House Blueprint, see our June 24 *Tax Insight*. For an analysis of the November election results and their implications for tax reform in 2017, see our November 9 *Tax Insight*.

In detail

Background

The House Blueprint was released on June 24, 2016 in the form of a 35-page report on tax reform that proposes to lower individual and business tax rates and move toward adopting "cash flow" tax principles for business taxation. The cash flow principles include immediate expensing of all depreciable and amortizable new business investment and denying a deduction for net interest expense. In addition, the Blueprint proposes a territorial tax system with a 100-percent exemption for active foreign business income. Finally, it proposes to make the business tax "border adjustable" by exempting the gross receipts from export sales and imposing tax on imports, which could be achieved through the denial of a deduction for the cost of the imports.

For corporations, income would be taxed at a 20-percent tax rate. Sole proprietors and owners of pass-through businesses would be subject to tax at ordinary rates on their compensation (at rates of 12 percent, 25 percent, and 33 percent), but active business income would be capped at the 25-percent rate. Both the individual and corporate alternative minimum taxes would be repealed.

Investment income of individuals (dividends, capital gains and interest income) would be taxed at half the ordinary rate through a 50-percent exclusion, resulting in a top individual rate of 16.5 percent.

The Blueprint proposes to eliminate "special-interest deductions and credits," including the domestic production activities deduction, in favor of lower tax rates for all businesses. The Blueprint would retain a credit for research and development, similar to the current law research credit, which was made permanent in 2015.

Business taxation (destination-based cash-flow tax)

Cash-flow taxation

The Blueprint adopts many features of a cash-flow tax. Under a *pure* cash-flow tax, businesses would immediately deduct the cost of investments as well as wages and supplies. Businesses would not deduct interest expense, thereby treating debt finance on par with equity finance. Investment income of individuals and businesses would not be subject to tax under a pure cash-flow tax.

Elements of cash-flow taxation have previously been included in tax reforms proposed by Presidential commissions and academics, including the Growth and Investment Tax option proposed by the President's Advisory Panel on Federal Tax Reform in 2005 and a version introduced as legislation, H.R. 4377, by Rep. Devin Nunes (R-CA) in 2016.[i]

Expensing has the effect of exempting from tax the portion of the return earned on an investment that compensates investors for their opportunity cost. As a result, a pure cash-flow tax removes the tax disincentive to save for future consumption. Consequently, pure cash-flow taxes are viewed as consumption rather than income taxes.[ii]

In contrast to a pure cash-flow tax, the Blueprint retains personal income tax on investment returns in the form of dividends, capital gains, and interest income (with a 50-percent exclusion for each) and applies corporate income tax to net interest income and certain other passive income of corporations.

Destination-basis taxation

Under present law, the US taxes domestic income under a source-based principle and taxes US residents on their foreign income under a residence-based principle. By contrast, the Blueprint is a "destination-based" tax, meaning that the tax is imposed based on the place of consumption of goods and services rather than source of income or the residence of the taxpayer. Destination-based taxation is achieved through "border tax adjustments," exempting gross receipts from exported goods and services while taxing goods and services imported into the United States.[iii] Border tax adjustments are a standard feature of the value added taxes employed in 167 countries, including all 34 other OECD countries. Border tax adjustments in the United States are also commonly employed in federal excise taxes.

Although a border tax adjustment has been characterized as a protectionist measure that subsidizes exports and discourages imports, most academic economists believe either prices or exchange rates would adjust quickly to offset these effects. With a complete price or exchange rate offset, a uniform and symmetric border tax adjustment on all goods and services will not change domestic consumption, domestic production, or the nation's trade balance.[iv] This is true at the individual company level as well as for the overall economy. When complete exchange rate and price adjustments are factored in, a company's after-tax income on US production would be the same in real (inflation-adjusted) terms whether or not a border adjustment applies.[v]

Some market participants are concerned that to the extent the US dollar and price adjustments do not fully compensate for the border adjustment, net importers will be adversely impacted by border adjustments. Many analyses by financial market analysts take the view that there is likely to be less than a full adjustment in the short run due to lags in the adjustment process that could result in lower profits for net importers at least in the near term.

The case for a rapid market response can be demonstrated by considering the incentive effect of exempting export receipts and losing a deduction for import costs. Without changes in prices or exchange rates, the loss of a deduction for imports would discourage imports by US businesses, increasing their reliance on US-produced supplies. Similarly, an exemption for exports would encourage US producers to increase their sales to foreign customers and reduce their sales to US customers. But the incentives are incompatible—US suppliers would prefer to sell to foreign customers (because receipts would be exempt) while US producers would prefer domestic suppliers (because the cost would be deductible). The consequence without changes in prices or exchange rates would be a surge of exports from the United States to foreign customers but too few dollars to purchase them because US businesses would not be importing their products.

The market imbalance—an export surge from the United States to the world and a plunge in imports into the United States—would lead either to an adjustment in the dollar exchange rate or in the relative prices of foreign and domestic products in order for supply and demand to balance. Market equilibrium would require a decline in the relative (pre-tax) price of imports or alternatively an increase in the value of the dollar relative to foreign currencies. An increase in the value of the US dollar, for example, would lead to a lower dollar price for imports and exports, restoring market equilibrium. With flexible prices or exchange rates, the trade impact of uniform and symmetric border tax adjustments is completely offset for all businesses with the result that there would not be a change in profits or trade flows relative to the same tax system without border adjustments.

Example

Consider a company with only domestic sales that relies on imports for some of its supplies. Assume the company has $1,000 of sales (all domestic) and input costs of $600 (half domestic and half imported). Its pre-tax income is $400.

Column 1 of the table below assumes no border adjustment so that, at a 20-percent tax rate, its tax is $80 (20% of $400) and after-tax income is $320 ($400 less $80).

In Columns 2-4, border tax adjustments apply, with a resulting loss of the deduction for the cost of imported inputs.[vi] In Column 2, there are assumed to be no price or currency adjustments; in Column 3, the dollar is assumed to appreciate by 25 percent; and in Column 4, the domestic price level is assumed to increase by 25 percent.

In Column 2, absent price or exchange rate changes, pre-tax income is still $400 but taxable income is $700. At a 20-percent rate, tax is $140 and after-tax income is $260.

In Column 3, the dollar appreciates by 25 percent following the imposition of border tax adjustments (e.g., the dollar increases from 1.0 to 1.25 euros), reflecting the 20-percent tax rate. With this appreciation, the pre-tax cost of foreign inputs declines by $60 from $300 to $240 ($300/1.25), and pre-tax income increases by $60 from $400 to $460. Taxable income remains $700 (the same as in Column 2), so tax is $140. After-tax income is $320 ($460 less $140), the same result as in the case where no border tax adjustment applies (see Column 1).

In Column 4, all domestic prices (and wages) increase by 25 percent. The increased price level implies that domestic sales increase from $1,000 to $1,250 (1.25 x $1,000) and domestic input costs (including wages) rise from $300 to $375 (1.25 x $300). Foreign input costs remain at $300, the same as in Column 1. Because foreign inputs are not deductible, taxable income of $875 ($1,250 less $375) exceeds pre-tax income of $575 ($875 less $300). Tax increases to $175 (20% of $875), leaving after-tax income of $400 ($575 less $175). However, because all domestic prices have increased by 25 percent, $400 of income has the same purchasing power as $320 ($400/1.25) at the pre-reform prices. As a result, inflation-adjusted after-tax income is the same as in Column 1, with no border adjustment.

Profit and Loss Statement: Import example

Item	Tax with no border adjustment (1)	Tax with border adjustment		
		No economic response (2)	25% dollar appreciation (3)	25% domestic price level increase (4)
Revenues				
Domestic Sales	$1,000	$1,000	$1,000	$1,250
Foreign Sales	$0	$0	$0	$0
Costs				
Domestic inputs	$300	$300	$300	$375
Foreign inputs	$300	$300	$240	$300
Pre-tax income	$400	$400	$460	$575
Taxable income	$400	$700	$700	$875
Tax @ 20%	$80	$140	$140	$175
After-tax income	$320	$260	$320	$400
Pre-reform prices				$320

In a similar fashion, it can be seen that either exchange rate or price adjustments would offset the impact of border tax adjustments for exporters, with no change in (inflation-adjusted) after-tax income.

How quickly might exchange rates or prices adjust?

Some analysts have suggested the forward-looking nature of exchange rates would lead to rapid adjustment in response to the anticipated adoption of a destination-based tax system.[vii] Others have questioned whether exchange rates would fully respond to a border tax adjustment, so that some increase in the domestic price level would be required to bring about the same trade balance and after-tax profits as in the absence of a border adjustment. To the extent changes in the price level lead to equivalent increases in nominal wages, the impact of the border adjustment for workers and companies ultimately would not depend on how much of the response occurs through exchange rates or the domestic price level. However, if nominal wages lag price increases, then margins would increase but consumer purchasing power would be adversely impacted.

There is evidence from other events that exchange rates adjust rapidly to changes in expected political and economic environments. For example, the day the results of the UK vote to leave the European Union were announced last year, the British pound depreciated by approximately 8 percent relative to the dollar, and by an additional 5 percent over the next seven trading days. The suddenness of the decline in the value of the pound is notable given the prolonged process required for the UK to negotiate the terms of its exit from the EU.

Whether currency markets would incorporate the impacts from adoption of border tax adjustments as rapidly as other political and economic changes has been the subject of considerable discussion. The Growth and Investment Tax of the 2005 President's Advisory Panel on Federal Tax Reform proposed a four-year phase in of border adjustments in case exchange rates did not adjust as rapidly as predicted by economic theory. With transition relief, it is possible for exchange rate adjustment to more than compensate net importers for higher taxes resulting from the border adjustment with the result they would earn higher after-tax profits during the transition period.

World Trade Organization and border tax adjustments

Border tax adjustments are permitted under WTO rules provided they neither subject imports to taxes in excess of those borne by like domestic products nor subsidize exports. The border tax adjustments of value added taxes and excise taxes are interpreted as satisfying these restrictions. The destination-based cash-flow tax is economically equivalent to a subtraction-method value added tax and an employer wage credit, both of which should be permissible under WTO rules.

Nevertheless, the WTO has not previously ruled on a destination-based cash-flow tax and some have questioned whether this novel tax would be determined to be compliant if subject to a challenge.

International implications of destination-based taxation

In many respects, the international consensus regarding the taxation of cross-border income appears to have dissolved. While intended to forge agreement, the Organisation for Economic Cooperation and Development's Base Erosion and Profit Shifting (BEPS) project did not achieve meaningful consensus among participating governments. There was agreement that change was required to close gaps, but the final action items left ambiguous which government should have the right to tax income that fell into those gaps. The consequence is that BEPS has provided countries with arguments with which to advance claims for higher taxes on cross-border income, without agreeing to a set of rules that can be readily applied to determine the amount appropriately taxed within each jurisdiction. Even before the BEPS project had concluded, participating governments had enacted changes to their laws under which they have asserted claims to increased shares of cross-border income. This trend will likely result in increased disputes, many of which already are playing out on a retroactive basis, including the ongoing European Commission's State Aid cases.

There has been concern among US policymakers that the high US corporate tax rate and the US worldwide tax system have put US companies at a disadvantage operating in global markets and discouraged investment in the United States. This disadvantage is increasing as many foreign countries assert the right to tax income not traditionally viewed as arising within their jurisdictions, leading to increased likelihood of double taxation of US companies. The destination basis of the House Blueprint relies on a different mechanism for determining jurisdiction to tax. US taxation would be based on the destination of consumption rather than source or residence, as is the case with the goods and services or value added taxes the destination-based cash-flow tax resembles and is intended, in many respects, to replicate. If accepted by other governments, it could provide the mechanism for determining jurisdiction to tax that eluded the governments participating in the BEPS project.

The border tax adjustment is intended to allow US companies to compete on a level playing field in global markets while ensuring that the United States retains its ability to tax companies on their economic profits arising from the large US consumer base. The border adjustment eliminates any tax incentives of US companies to shift income or activities abroad: there are no tax savings from moving operations abroad to sell to US customers because imports sold to US customers are subject to tax. Likewise, there is no tax incentive to move operations abroad to sell to foreign customers because exports would not carry the corporate tax.

For decades, other developed countries have been engaging in tax competition by providing for a more hospitable environment for their global companies – and seeking to entice the headquarters and operations of foreign companies – through lower corporate rates and territorial tax systems. The average combined central and local corporate tax rate of other OECD countries in 2016 stood at 24.2 percent – 20 percentage points less than the average in 1988 and nearly 15 percentage points below the 38.9 percent US federal and average state corporate income tax rate. At the same time, other OECD countries rely significantly more on consumption-based taxes than the United States. In 2014, these taxes accounted for approximately one-third of all revenues in other OECD countries, but only 17 percent in the United States, including state and local taxes. These trends are likely to continue with several OECD countries already having enacted or planning additional corporate rate reductions in coming years.

The House Blueprint, combining the border adjustment with expensing for US investment and a territorial tax system, can be viewed as taking the competitive actions of other countries to their logical endpoint. The business tax system under the Blueprint is economically similar to repealing the corporate income tax and replacing it with a consumption tax and employer wage credit. The border adjustment removes US tax considerations from all locational decisions, including decisions about where companies locate their headquarters. Taken together, the changes would allow the United States to leapfrog its historical tax disadvantages and become one of the most competitive locations for headquarters and production activities of both domestic and global multinational companies.

A destination-based cash-flow tax represents a bold proposal for US tax reform. It provides strong incentives to invest in the United States for both US and foreign businesses. It could be more progressive than a traditional corporate income tax because it encourages investments that increase the productivity of labor, making workers more valuable and lifting wages.[viii]

The takeaway

The Ways and Means Committee is continuing its development of the Blueprint and is expected to release more details on the proposal early in 2017, including legislative language. In recent interviews, Chairman Brady has reaffirmed his intent to maintain border adjustability as part of the Blueprint, stating, “It became clear we needed border adjustability to eliminate all the incentives for companies to move jobs, innovation and headquarters overseas.” House Speaker Ryan has said that tax reform will be a key priority of Congress and one that that he has been trying to accomplish his entire time in Congress. He has also repeatedly signaled his support for the Blueprint’s destination-based cash-flow tax approach to reform.

Senate Finance Committee Chairman Orrin Hatch had spent much of 2016 developing tax reform plans based around corporate tax integration to address the double taxation of dividends. However, in a Senate floor speech in December Chairman Hatch indicated an interest in undertaking more comprehensive reform: “Right now, we are seeing more momentum for comprehensive tax reform .... And, if we’re going to do right by our economy and the American people, we need to think in those comprehensive terms.”

While major policy changes like tax reform are difficult to achieve at any time, the alignment on tax reform between the Republican-controlled Congress and President-elect Trump gives 2017 the greatest potential for major business tax reform since the Tax Reform Act of 1986 over 30 years ago.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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Endnotes

[i] *Report of the President's Advisory Panel on Federal Tax Reform*, ch. 7, 2005. The Growth and Investment Tax plan was also proposed to be border adjustable, while the Nunes legislation is not. For other cash-flow tax proposals, see Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation*, Report of a Committee chaired by Professor J. E. Meade (London: Allen and Unwin, 1978); Robert Hall and Alvin E. Rabushka, *The Flat Tax* (Stanford: Hoover Institution Press, 1995); David F. Bradford, "The X-Tax in the World Economy," NBER working paper no. 10676 (Cambridge, MA: National Bureau of Economic Research, 2004); Alan J. Auerbach, *A Modern Corporate Tax*, (Washington, DC: Center for American Progress, 2010).

[ii] A cash-flow tax *does* collect tax on returns in excess of the opportunity cost of investment, referred to as "excess" returns, economic profit or economic rent.

[iii] Not all cash-flow taxes are destination based. For example, the Nunes bill is source based, while the 2005 Growth and Investment Tax plan is destination based.

[iv] For early explanations of this result, see Harry Johnson and Mel Krauss, "Border Taxes, Border Tax Adjustments, Comparative Advantage, and the Balance of Payments," *The Canadian Journal of Economics*, (Nov., 1970); James E. Meade, "A Note on Border-Tax Adjustments," *Journal of Political Economy*, (Sept-Oct. 1974). More recent discussion of this result includes Martin Feldstein and Paul Krugman, "International Trade Effects of Value-Added Taxation," in *Taxation in the Global Economy* (eds. Assaf Razin and Joel Slemrod), 1990; Alan D. Viard, "Border Tax Adjustments Won't Stimulate Exports," *Tax Notes*, March 2, 2009; Alan J. Auerbach and Doug Holtz-Eakin, "The Role of Border Adjustments in International Taxation," American Action Forum, November 30, 2016; and Martin Feldstein, "The House GOP's Good Tax Trade-Off," *Wall Street Journal*, January 6, 2017.

[v] While the exchange rate adjustment leaves domestic after-tax income the same as in the absence of a border adjustment, the appreciation of the dollar will reduce the dollar value of foreign earnings of US businesses assuming no change in their foreign earnings as measured in foreign currency. Similarly, a price level adjustment in the US will reduce the real (inflation-adjusted) value of the foreign earnings.

[vi] For a taxable business with positive taxable income, disallowing a deduction for imports is the same as imposing tax on imports at the business tax rate while allowing a deduction for import costs.

[vii] For example, Auerbach and Holtz-Eakin (2016) state "exchange rates should react immediately to offset the initial impact of these adjustments."

[viii] The business tax base of the House Blueprint is limited to value added from capital income. This is a more progressive tax base than traditional consumption taxes that include the value added by labor. It is also likely a more progressive tax

base than the current corporate income tax system, which is generally believed to be borne in part by labor in the form of reduced wages due to a lower level of capital investment that reduces labor productivity. The Joint Committee on Taxation, for example, estimates that 25 percent of corporate income tax is borne by domestic labor and 75 percent is borne by owners of domestic capital. *See*, Joint Committee on Taxation, *Modeling the Distribution of Taxes on Business Income* (JCX-14-13), October 16, 2013. An analysis by staff of the Congressional Budget Office estimates that domestic labor bears approximately 70 percent of the burden of the corporate income tax. *See*, William Randolph, "International Burdens of the Corporate Income Tax," Congressional Budget Office, August 2006. An evaluation of the impact of the House Blueprint on the overall progressivity of federal income taxes additionally requires consideration of any distributional changes from reforms to the individual income tax.

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