A LOOK AT THE HOUSE G.O.P.'S "DESTINATION-BASED CASH FLOW WITH BORDER ADJUSTMENT"

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Last June, the House Ways and Means Committee[1] released its tax reform plan (sometimes referred to as the "House Blueprint"),[2] which includes sweeping changes to the U.S. corporate income tax.

With the Republicans now controlling both Houses of Congress and the presidency, there is a significant chance that the U.S. corporate income tax will undergo major changes. The chairman of the House Ways and Means Committee, Kevin Brady (R-T.X.), and the speaker of the House, Paul Ryan (R-W.I.), favor repealing the current corporate income tax and replacing it with a new regime referred to as the "destination-based cash flow with border adjustment." They believe that this new corporate tax will encourage corporations to stay in the U.S., incentivize exports, and discourage imports.

The following are some key features of the new corporate tax proposal:

- The tax rate would be lowered to 20%.
- Businesses could fully and immediately expense capital investments in the current year, rather than depreciate them over the useful life.
- Businesses would no longer pay U.S. corporate income tax on profits earned outside the U.S.
- Businesses would no longer be able to deduct interest as a business expense.
- The corporate tax would be "border adjusted."

THE CURRENT U.S. CORPORATE INCOME TAX SYSTEM

To understand the destination-based cash flow with border adjustment proposal and its potential impact, it is worth reviewing the current U.S. corporate income tax system.

The U.S. corporate income tax is a known as a "direct" tax because it is levied on the income of the person who pays it, rather than on the value of goods or services acquired from others.

The corporate income tax rules that are currently in effect impose a tax on the

[1] Under the Origination Clause of the U.S. Constitution, tax bills must originate in the House of Representatives. See U.S. Const. art. I, §6, cl. 1.

[2] See "A Better Way Forward on Tax Reform," Ways and Means.

income of a corporation that is realized during the tax year. The starting point for computing the tax is the corporation's total gross income for the tax year. This consists of sales, less the cost of goods sold, plus other income. From that gross income, trade or business expenses, such as wages and occupancy costs for leased space, and expenses that are specifically identified as deductions, such as depreciation, amortization, and interest expenses, reduce gross income to arrive at the corporation's net taxable income for the tax year. The net taxable income is subject to the corporate income tax rate of 34%/35% plus applicable state and local tax.

The corporate income tax is imposed on a U.S. corporation's worldwide income during the tax year. Thus, income earned through operating a business outside the U.S. is subject to the corporate income tax. If the business is operated by a subsidiary that is a controlled foreign corporation ("C.F.C."), income from operations generally is taxed only when repatriated. However, if the income falls within an anti-deferral provision of U.S. tax law, the U.S. shareholder of the C.F.C. is tax immediately. To illustrate, if the earnings of a C.F.C. arise from operations carried on with unrelated parties in the country of residence of the C.F.C., the U.S. shareholder does not pay tax until the income is repatriated, generally in the form of a dividend. In comparison, if the earnings of the C.F.C. arise from items of passive income (*e.g.*, interest and dividends) or from certain purchases and sales of inventory property involving a related party in a third country and a sale for use, consumption, or disposition in a third country, the earnings generally are subject to immediate tax in the hand the U.S. corporation under Subpart F. Should the earnings be actually repatriated in a subsequent year, they generally are not taxed a second time at the level of the U.S. shareholder.

"To understand how the destination-based cash flow with border adjustment proposal works, it is useful to discuss its component parts."

THE DESTINATION-BASED CASH FLOW WITH BORDER ADJUSTMENT, IN PARTS

To understand how the destination-based cash flow with border adjustment proposal works, it is useful to discuss its component parts.

"Destination-Based"

As discussed above, under a worldwide system of income taxation, a corporation is taxed on the income it earns anywhere in the world. An alternative to the worldwide tax system is the territorial system of income taxation, under which a corporation is subject to income tax on domestic income but not on foreign income.

Under a destination-based tax system, tax is imposed based on where a corporation's goods end up (*i.e.*, their destination), rather than where they are produced or where the corporation's intellectual property is located (*i.e.*, their origin). Sales and use tax is an example of a destination system, as is a value-added tax ("V.A.T.") that zero rates exports and provides for a reverse charge on imports.

A destination-based system essentially starts in the same place as a territorial tax system. So, for example, overseas profits earned by U.S. multinationals that are repatriated as dividends would be exempt from U.S. corporate tax. However, unlike a territorial system, a destination system does not encourage overseas production by U.S. multinationals because all production for U.S. consumption would be taxable, no matter where the production occurred.

“Cash Flow”

As discussed above, the current U.S. corporate income tax is a direct tax on a corporation’s income, A corporation is required to compute its net income for the tax year, which requires it to determine the expenses attributable to the tax year. For example, it must determine the portion of the salaries paid during the tax year to generate taxable income year in order to compute its net taxable income for the tax year.

The new proposal would move toward an indirect tax in which consumption, rather than income, is subject to tax. An indirect tax follows the flow of cash because consumption is measured by cash to determine the tax base. Examples of indirect taxes are the sales tax and the V.A.T. The proposed system is not a true indirect tax because certain costs reduce the tax base.

Under the new proposal, a corporation would be allowed to deduct its asset acquisitions through full and immediate expensing, and the cost of goods sold but not expenses necessary to compute income such as depreciation and interest. There is one exception to the disallowance on deducting expenses to produce income: corporations would be allowed to deduct wages paid to employees. This appears to reflect a political compromise to promote job growth. However, it comes at a risk. If the new corporate tax is viewed as a direct tax, the border adjustments component (discussed below) will likely not be allowed under the World Trade Organization (the “W.T.O.”) rules because border adjustments are only allowed on indirect taxes. Possible solutions could include, dropping the deduction for wages, and thus making the new corporate tax a true V.A.T., or dropping the border adjustment component.

Under the cash-flow system, the incentive to shift profits would generally be eliminated. U.S. corporations would no longer be tempted to overstate costs in the U.S. and overstate profits outside the U.S. in order to avoid the relatively high U.S. corporate income tax rate. Further, since the interest expense deduction would no longer be permitted, there would be no incentive to use cross-border loans to shift profits.

“Border Adjustment”

The destination-based cash flow proposal would move the U.S. corporate tax system in the direction of becoming an indirect tax, like a V.A.T. A border adjustment is a typical and necessary component of a V.A.T. since the tax is imposed on consumption.

A border adjustment applies a tax on imports, but exempts exports from the tax. A U.S. corporation’s sales to U.S. customers would be taxed but its sales to foreign customers would not be taxed and the cost of inputs imported would no longer be deductible. U.S. customers would be taxed but sales to foreign customers would be exempt. In effect, the corporate tax would ignore revenues and costs associated with cross-border transactions and solely focus on raising revenue from business transactions from sales of goods in the U.S.

Since the U.S. imports much more than it exports, the border adjustment component of the new corporate tax proposal has the potential to raise tax revenues significantly. However, the lowering of the tax rate to 20% might offset any tax revenue increases.

Proponents of the border adjustment have argued that it will reduce the U.S. trade

deficit. However, economists point to the fact that the border adjustment is a component of the V.A.T. of every country that imposes a V.A.T. Thus, the border adjustment imposed by the U.S. would be counterbalanced by the border adjustment imposed by a foreign country that has a V.A.T. However, for a customer who is itself a vendor for V.A.T. purposes, the input V.A.T. is a disguised loan to the government because the input is recoverable from the output V.A.T. collected from customers of the government in the form of a refund. In comparison, the border adjustment tax is a final tax.

THE REAL IMPACT

Most countries that impose a V.A.T. also impose a corporate income tax. The new corporate tax proposal would repeal the U.S. corporate income tax and replace it with the above-described V.A.T.-like tax. The U.S. would become one of the few countries without a corporate income tax. This could make the U.S. a very attractive place to do business from a tax perspective.

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