Fiscal Affairs Department

THE DESTINATION-BASED CASH FLOW TAX

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Views and opinions should not be attributed to the management or Executive Board of the IMF

Context

- Centerpiece of Republican "*A Better Way*"('Brady-Ryan plan', 'Blueprint')
- Proposed by President's Panel 2005
  - "Growth and investment tax'
- Academics, Alan Auerbach and Michael Devereux
- This presentation is about DBCFT, not US proposals!
  - Draws on Auerbach et al (2017)

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Outline

- How it Would Work
- Effects and Properties
- Spillovers
- Financial Flows
- Other (Big) Issues

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HOW IT WOULD WORK

The cash flow tax (CFT) part…

Means:

- Immediate expensing of investment
  – instead of depreciation
- No interest deduction
  – At least for 'R-base' formulation; discuss financial transactions and 'R+F'-base later

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…which has the attractions:

From the elimination of interest deductions:

- No debt bias—so improves financial stability
- No 'debt shifting'—so alleviates a BEPS concern

No distortion of investment decisions, because base is 'rents' (= profits over minimum required)

– as best seen by example:

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Why CFT is a tax on rents (closed economy)

- Investor can earn 5 percent holding government debt
- Investment costs 100, yields 105 next year
- Tax rate 20 percent

So present value of tax paid is

$$-20 + \frac{21}{1.05} = 0$$

and after-tax profits positive if and only if pre-tax profits are

NB: CFT is not the only form of rent tax

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The destination-based (DB) part

'Border tax adjustment' (BTA), meaning:

- Receipts from exports are not taxed
- Imports are taxed
  - For consumers, this is final
  - For business, if imports taxed they would be deductible; equivalent to not taxing and not deducting

Return to implications later

- For moment, note similarity with VAT!

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DB+CFT: An example

	Country A	Country B	Total
Tax rate	20%	30%	
Labour costs	60	0	60
Other costs	40	0	40
Sales	150	150	300
DBCFT tax base	50	150	200
DBCFT charge	10	45	55

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Key things to remember

- Not a tariff, in that domestic sales taxed like imports
- To get to DBCFT from 'standard' corporate tax:
  – Remove tax on normal return
  – Border adjust: move tax base from production to consumption
- And:

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Equivalent to VAT+ wage subsidy

$$\text{DBCFT base} = \underbrace{\text{Domestic sales} - \text{domestic costs}}_{\text{VAT base}} - \text{wages}$$

	Country A	Country B	Total
Tax rate	*20%*	*30%*	
Labour costs	60	0	60
Other costs	40	0	40
Sales	150	150	300
DBCFT tax base	50	150	200
DBCFT charge	10	45	55
VAT tax base	110	150	240
VAT charge	22	45	67
Relief for labour costs	-12	0	-12
VAT + relief for labour costs	10	45	55

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Financial flows (1): The 'R + F' base

- As under VAT, financial flows pose challenges
- To tax associated rents, tax all financial inflows—principal as well as interest—and deduct all outflows: 'F' base
- Why not just tax net interest?
  - E.g., bank borrows from non-taxpayer, lends to taxpayer
    - If apply to both bank and borrower, aggregate base negative
    - If apply to bank only, taxes bank's rent from transactions with borrower without reducing taxable rent of borrower

Under F, base is PV of rent on flows with depositor

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Financial flows (2): Integrating into a DBCFT

- F flows between taxpayers net out
  - so apply only to flows with non-taxpayers
- BTA by excluding cross-border financial flows involving taxable entities
  - Like excluding exports and denying deduction for imports
- In principle, need F treatment for financial flows between domestic non-taxpayers and non-residents

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EFFECTS AND PROPERTIES

Exchange rates and prices

Neutrality of BTA

- Effects of BTA widely studied in VAT literature
  – Equivalent to move from origin to destination-based VAT

"Lerner symmetry"

An import tax is equivalent to an export tax,…

– Both discourage trade

...BTA is equivalent to import tax + export subsidy,...

…which cancel out, leaving no effect on relative prices

NB: Uniform tax rate critical to this

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This neutrality can be achieved by:

Either:

- An appreciation of the exchange rate (ER)
  – Offsets tax put on imports and tax removed on exports

or

- An increase in domestic consumer prices and wages
  – Leaving real wage unchanged

or some combination

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Issues

- Theory is silent on price vs. ER adjustment
  – Depends on relative speed of adjustment
- Views differ on likely speed/extent of offset
- Appreciation could be large, with large spillovers
  – Liabilities (including of sovereigns) and contracts denominated in currency of adopter
  – Unwanted appreciation of currencies pegged to dollar

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Level and location of investment

Undistorted, so long as ALL adopt DBCFT

- Obvious if countries A and B have DBCFTs at same rate
  - Just like earlier closed economy

- But if A now raises its rate, won't firms want to shift costs to A and sales to B?

  No: Price/ER adjustment means offset by
  - Higher consumer prices, wages and input costs in A and/or
  - Reduced A-currency value of sales and costs in B

(Example in Auerbach et al (2017))

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BEPS issues

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Are substantially mitigated if ALL adopt

Transfer pricing:

Currently, incentive to over-state price of exports from high tax country to low

—but under DBCFT, export price irrelevant in both A (not taxed) and B (not deductible)

Intellectual property

Currently, incentive to pay royalties from high tax country to low

—but under DBCFT, royalties paid a non-deductible 'import' and royalties received non-taxable export

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Tax Revenue

Impact clearer in short than in long run

- Immediate revenue gain for net importer
- Some argue this is a temporary effect, on grounds that BoP deficit cannot be sustained for ever
  - Net imports zero in present value, hence so too is revenue gain
- But some views of the world do allow for permanent deficits
  - E.g. Japanese save when young, Americans consume when young, and both populations are growing

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Who bears the burden?

Depends (a bit) on nature of the adjustment

If consumer prices and wages adjust:

- Burden is on those spending in the adopter other than from wages there
  - E.g. shareholders, those on fixed nominal incomes

If ER appreciates:

- Burden is on those spending in adopter from income/assets arising in foreign currency
  - E.g. Shareholders in firms with earnings abroad

  With impact on foreigners too:
  - Gain (loss) if assets (income/liabilities) in currency of adopter

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But, remember!

Most relevant comparison is not DBCFT in isolation but as replacement for standard CIT

Additional distributional considerations then from:

- Removal of tax on normal return to capital
- Removal of origin-based element of corporate tax

Key issue: To what extent does burden of initial corporate tax fall on labor, capital and consumers

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SPILLOVERS

BEPS problems amplified for non-adopters

- Adopting country has a standard corporate tax but at a zero statutory rate
- So incentive to shift profit into the adopter, by e.g.
  - Borrowing from affiliate in the adopting country
  - Under-pricing sales to affiliates there
  - Placing IP there
- Options:
  - Protective measures
    - Withholding/denial of deductions?
  - Adopt DBCFT too?

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Options for non-adopters?

- Links with WTO and treaty issues (below)
- Take protective measures?
  - Withholding?
  - Denial of deductions?
- Adopt DBCFT too?
  - Perhaps by reducing ‘standard’ corporate tax rate, more reliance on VAT while aiming to reduce labor taxes

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OTHER (BIG) ISSUES

Legal issues

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World Trade Organization Rules

- DBCFT almost certainly WTO-inconsistent
  - Problem in giving wage deduction for domestic production but not imports
- VAT and wage subsidy, however, are individually WTO consistent
- Doubtless smart lawyers work-in on this!

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Tax treaties

Would DBCFT be

- Covered by treaties?
  - if so, seems in violation: e.g. liability on imports even if not provided from a permanent establishment
- Out of scope?
  - Non-adopters operating credit system would not be obliged to provide credit for tax paid in adopter

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Implementation issues

Treatment of losses

- Losses even more likely than under VAT
  - because wages deductible
- Failure to provide full refund or equivalent:
  - Undermines neutrality properties
  - Invites avoidance: mergers, import through loss-makers
- Options?
  - Carry forward at interest? Not enough for exporters
  - Credit against other taxes

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Defining 'destination'

Little examined, but not clear there are new issues

- Enough to follow e.g. OECD VAT/GST Guidelines?
- Bringing B2C imports into tax
  - Practical problems familiar from VAT

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Further reading

Auerbach, A., M. Devereux, M, Keen and J. Vella (2017), "Destination-based cash flow taxation," Oxford University Centre for Business Taxation Working Paper WP 17/01.

Auerbach, A.J. M.P. Devereux and H. Simpson (2010) "Taxing Corporate Income", in J. Mirrlees *et al* (eds.), *Dimensions of Tax Design: The Mirrlees Review,* Oxford: Oxford University Press, 837-893.

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