Tax Reformers Consider Cash Flow Business Taxes, VATs, and Integration

The Expert: Harry L. (Hank) Gutman

In the last Congress, tax reformers considered cash flow business taxes, VATs, and integration as part of potential business tax reform.

What's the Outlook for Congressional Tax Reform?

The second session of the last Congress saw some positive developments in the seemingly never-ending quest for business income tax reform. Dramatic proposals from Republicans in both the Senate and the House have the potential to break the logjam over whether and how to reform business taxation. Change will not happen overnight. However, as the debate unfolds, tax executives and C-suite occupants need to know what is on the table, the prospects for passage, and the potential effects on operations and effective tax rates. They should also be cognizant of how important it is that business should present a unified front and lead the reform effort.

Why Hasn't Tax Reform Happened?

Although there is a consensus that our business income tax system needs reform, there is no agreement on what a reformed system should look like. There is no groundswell of public support for reform, and the president has not made it a priority. Revenue constraints impose an insurmountable mathematical obstacle to a significant rate reduction using the traditional model of financing through eliminating business tax preferences, a method that creates winners and losers in the business community and results in a politically untenable tax increase on the over forty-four percent of business income earned in noncorporate form.

What Are the New Developments?

Lawmakers are well aware of the reasons for the current stalemate. This recognition has produced two major lines of "new" thinking about how to solve the problem. The first is a proposal by Senator Orrin Hatch (R-UT) to eliminate the corporate tax through a dividends-paid deduction, called "partial integration." The second includes proposals by the House Republicans, Senator Ben Cardin (D-MD), and Representative James Renacci (R-OH) to reduce the corporate tax rate or replace it with a consumption tax, either in the form of a credit-invoice value-added tax (VAT) or the economically equivalent business cash flow tax.

The Hatch proposal would allow a deduction for all dividends, limited by the amount that is subject to full taxation. The limitation denies a deduction for dividends paid out of preference income or foreign source income that has been sheltered by foreign tax credits. A withholding tax of thirty percent would be imposed on the deductible dividend. The withholding tax would be included in the income of a dividend recipient and would be a nonrefundable credit for U.S. taxpayers. The credit would not be refundable for foreign taxpayers and exempt organizations. Thus, it would be a final tax for those entities. To equate the tax treatment of dividends and interest, a thirty-percent withholding tax would be imposed on interest payments. The interest withholding tax would be treated the same way as the dividend withholding tax, thus ensuring at least one level of tax on interest income.

The House Republicans' plan would reduce the corporate rate to twenty percent and would tax income derived from noncorporate entities at twenty percent. Capital investments would be immediately deductible, but net interest would not be deductible. This is in substance a subtraction-method VAT.

The Cardin proposal would reduce the corporate tax rate to seventeen percent. The revenue loss from the rate reduction would be financed by a credit-invoice VAT.

Renacci would replace the corporate income tax with a credit-invoice VAT.

Do They Matter?

The proposals matter, because they show that some politicians understand that meaningful tax reform cannot occur using "old" methods and that new approaches are necessary. The irony is that what our politicians consider new approaches are, in reality, the way the rest of the world has financed corporate tax reform. More than 160 countries and thirty-four of the thirty-five members of the Organisation for Economic Cooperation and Development (OECD) have adopted consumption taxes in the form of a credit-invoice VAT.

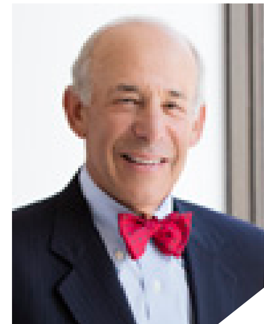
Why Tax Consumption?

Consumption equals income minus savings. Thus, in a consumption tax, savings (in the case of business, capital investments) are currently expensed. This expensing exempts from tax the normal rate of return from the new investment. This feature makes a consumption tax more efficient than an income tax in economic terms. The removal of the tax wedge on new investment, which increases the after-tax rate of return relative to an income tax, should induce more investment than a comparable income tax. A consumption tax is also neutral on the consumption-saving choice, as compared to an income tax, which penalizes saving. A broad-based consumption tax should not distort relative prices of consumer goods. So long as the tax is destination-based (not imposed on exports), it is neutral regarding its effect on trade.

Consumption taxes come in many forms, but their common thread is the exclusion of normal returns on capital investment from the base. That result can be accomplished by an explicit exclusion of capital income from the base or by a deduction for investment. The latter is the House Republicans' plan. The credit-invoice VAT, in which a tax is imposed on the "value added" at every stage in the production or distribution process of a good or service, is a totally transparent consumption tax. Economically they are equivalent.

There are significant noneconomic administrability, enforcement, transparency, and WTO-compatibility differences among the various ways a consumption tax is imposed. The subtraction-method VAT (business cash flow tax) is calculated from corporate accounts. A credit-invoice VAT is calculated on individual transactions and is usually shown on sales invoices. The latter is much easier to police than a subtraction-method VAT. Moreover, the subtraction method lacks transparency. Its common description as a business tax confuses its economic substance and could lead to the incorrect inference that its burden is borne entirely by business. A subtraction-method VAT would likely be administered in a way that would conceal its existence from the public. Thus it would have the potential to hide the true cost of government, an irony in that its proponents often denounce a credit-invoice VAT as a "cash cow."

Another issue is whether the VAT is expressed as "tax inclusive" or "tax exclusive." This is a matter of transparency. The former quotes a total price that includes the VAT, whereas the latter states the VAT separately. Either is acceptable, but the latter is obviously more transparent. Finally, there is the issue of WTO compatibility. Most credit-invoice VATs are "destination-based." VAT is charged on imports but not on exports. Border adjustments are recognized as an important factor in reducing base erosion incentives. While there is no question that a border-adjustable credit-invoice VAT is compatible with WTO rules for export subsidies and import penalties,



Hank Gutman

the situation with regard to border-adjustable business cash flow taxes is much less clear.

Which Approach Is Better?

The answer to this question depends in part on how the problem is defined. The very existence of the corporate tax creates economic distortions. The high nominal corporate rate encourages erosion of the U.S. tax base through inversions, transfers of income-producing property to low-tax jurisdictions, aggressive transfer pricing, and various "stripping" transactions. It also discourages direct foreign investment. When coupled with the ability to defer tax on foreign active business income until the earnings are repatriated, the high rate creates an incentive to keep earnings offshore.

The proposals address each of these concerns to varying degrees. The Hatch and Renacci plans repeal the corporate tax. The others reduce the rate. Even if nothing else is done to address base erosion, the simple reduction in the U.S. rate to one that is internationally competitive is a huge leap forward. Although it is unclear how the Hatch plan would be financed, the others finance the rate reduction through enacting consumption taxes. This is the real breakthrough.

Why Does Business Matter?

There is an irrational resistance to enacting a national consumption tax, particularly in the form of a VAT. Proponents of business tax reform have emphasized time and again that the U.S. business tax system should look like that of the rest of the world. The rest of the world has financed its corporate rate reductions in large part by value-added taxes. It is time for business to take up the reform cudgel by embracing what the rest of the world has done. Active involvement by the business community can help provide the impetus to enact the only practical way for them to achieve their tax objective.

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