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ARTICLES

THE SAGA OF UNFULFILLED BUSINESS INCOME TAX REFORM

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*“You can always count on Americans to do the right thing, after they’ve tried everything else.”*¹

*“Liberals think it’s regressive and conservatives think it’s a money machine.’ If they reverse their positions, the V.A.T. may happen”*²

ABSTRACT

This Article provides a detailed description of why the U.S. taxation of business income needs to be reformed, reviews prior proposals, and describes why they have not been enacted. Then, this Article puts forth its own proposal—reducing the corporate tax rate to 15% financed by a credit-invoice value-added tax (VAT) in order to achieve a business income tax structure that enhances the competitiveness of U.S. businesses, reduces U.S. base-erosion incentives, and is consistent with the tax structures of other countries.

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1. This quotation is often attributed to Winston Churchill. *See, e.g.*, JOHN BLACKWELL, REFLECTIONS: THOUGHTS WORTH PONDERING ONE MOMENT AT A TIME 44 (2009).

2. Jan M. Rosen, *Tax Watch; The Likely Forms of New Taxes*, N.Y. TIMES (Dec. 19, 1988), <http://www.nytimes.com/1988/12/19/business/tax-watch-the-likely-forms-of-new-taxes.html> [<http://perma.cc/P9LD-DV5A>] (quoting Lawrence Summers).

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INTRODUCTION

For at least the last five years, we have heard the business community complain about the current business income tax structure.³ The Obama administration acknowledged the problem,⁴ as has President Trump.⁵ Prominent scholars have produced serious policy analyses.⁶ Commissions have made

3. See, e.g., *Offshore Profit Shifting and the U.S. Tax Code—Part 2 (Apple Inc.): Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. and Governmental Affairs*, 113th Cong. 35–38 (2013) (statement of Timothy D. Cook, CEO of Apple, Inc.) (“Apple has always believed in the simple, not the complex. You can see this in our products and in the way we conduct ourselves. It is in this spirit that we recommend a dramatic simplification of the corporate Tax Code. This reform should be revenue neutral, eliminate all corporate tax expenditures, lower corporate income tax rates, and implement a reasonable tax on foreign earnings that allows the free flow of capital back to the United States.”); Deepanshu Bagchee, *Cisco CEO: US Tax System Is Broken*, CNBC (June 20, 2013, 4:46 AM), <http://www.cnbc.com/id/100830545> [<http://perma.cc/V7DQ-6CA8>] (“Cisco would instead look to make investments in different countries in the coming years, especially in emerging markets and Asia-Pacific.”); Rebecca Ballhaus, *Carl Icahn to Invest \$150 Million in Super PAC*, WALL ST. J. (Oct. 21, 2015, 12:10 PM), <http://www.wsj.com/articles/carl-icahn-to-invest-150-million-in-super-pac-1445441825> [<http://perma.cc/6WZ3-MJJK>] (explaining that the super PAC will be an advocate for corporate tax reform); Ellen Davis, *Matthew Shay Tells Neil Cavuto: Corporate Tax Code Is “Badly Broken”*, NAT’L RETAIL FED’N (Sep. 23, 2011), <http://nrf.com/news/public-policy/matthew-shay-tells-neil-cavuto-corporate-tax-code-is-badly-broken> [<http://perma.cc/R6X2-44TZ>] (“NRF President and CEO Matthew Shay appeared yesterday on Neil Cavuto’s afternoon program to discuss corporate tax reform, calling the current system ‘badly broken.’”); Michael DiRoma, *RATE WATCH: 5.12.16—Highest Rate in the World*, RATE COALITION (May 12, 2016), <http://ratecoalition.com/2016/05/12/rate-watch-5-12-16-highest-rate-world/> [<http://perma.cc/S96Y-97UU>] (“The U.S. corporate tax rate is already the highest in the world at 35 percent. We believe that The RATE Plan to fix the tax code—set the corporate tax rate at a globally competitive 25% or less, close tax loopholes, keep American companies in America, and to enable the U.S. economy to grow resulting in a higher standard of living for American workers—is the best path forward.”); Paul Ryan & House Ways & Means Comm. Blog, *Why Do We Need International Tax Reform? Let Us Count the Ways*, LIFT AMERICA COALITION (Aug. 13, 2015), <http://www.liftamericacoalition.com/2015/08/why-do-we-need-international-tax-reform-let-us-count-the-ways/> [<http://perma.cc/XYX8-4UE5>] (“As we’ve said before, more than \$2 trillion of American capital is now parked outside the United States. This is money that could be used to boost our economy and create American jobs. But instead, it’s locked out of the United States by our flawed tax code.”).

4. See THE WHITE HOUSE & THE DEP’T OF THE TREASURY, THE PRESIDENT’S FRAMEWORK FOR BUSINESS TAX REFORM: AN UPDATE (2016) [hereinafter PRESIDENT’S FRAMEWORK: AN UPDATE]; THE WHITE HOUSE & THE DEP’T OF THE TREASURY, THE PRESIDENT’S FRAMEWORK FOR BUSINESS TAX REFORM (2012) [hereinafter PRESIDENT’S FRAMEWORK].

5. See *Bringing Back Jobs and Growth*, THE WHITE HOUSE, <http://www.whitehouse.gov/bringing-back-jobs-and-growth> (last visited Feb. 15, 2017) [<http://perma.cc/5QNN-Z3HN>] (“The President’s plan will . . . reduce the U.S. corporate tax rate, which is one of the highest in the world. Fixing a tax code that is outdated, overly complex, and too onerous will unleash America’s economy, creating millions of new jobs and boosting economic growth.”). President Trump has stated that he is aiming for a reduction of the corporate tax rate to between fifteen and 20%. Robert Costa & Amy Goldstein, *Trump Vows ‘Insurance for Everybody’ in Obamacare Replacement Plan*, WASH. POST (Jan. 15, 2017), http://www.washingtonpost.com/politics/trump-vows-insurance-for-everybody-in-obamacare-replacement-plan/2017/01/15/5f2b1e18-db5d-11e6-ad42-f3375f271c9c_story.html?utm_term=.9900762027f7 [<http://perma.cc/2DJ5-MQ77>].

6. See, e.g., ALAN J. AUERBACH, CTR. FOR AM. PROGRESS & THE HAMILTON PROJECT, A

proposals.⁷ Congressional hearings have been held.⁸ And politicians have

MODERN CORPORATE TAX 7 (2010), http://www.hamiltonproject.org/papers/a_modern_corporate_tax [<http://perma.cc/9GJJ-8GMB>] (“The system I propose addresses these two important economic changes with two main sets of reforms, each directed at one of the key problems just identified: a shift in the corporate tax from equity to debt, to deal with the tax incentive to borrow, and a change in the treatment of crossborder flows, to alter fundamentally the terms of international tax competition.”); JANE G. GRAVELLE, CONG. RESEARCH SERV., R44220, ISSUES IN A TAX REFORM LIMITED TO CORPORATIONS AND BUSINESSES 1 (2015) (discussing “a number of options and issues that might be considered for business-only tax reform”); TOWARD FUNDAMENTAL TAX REFORM 2–3 (Alan J. Auerbach & Kevin A. Hassett eds., 2005) (discussing the political and social complexities of corporate tax reform); Rosanne Altshuler & Harry Grubert, *Formula Apportionment: Is It Better than the Current System and Are There Better Alternatives?*, 63 NAT’L TAX J. 1145, 1147–48 (2010); Harry Grubert & Rosanne Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax*, 66 NAT’L TAX J. 671, 672–74 (2013) (“Taking these developments into account, we evaluate proposals for reform of the U.S. tax system for taxing cross-border income including dividend exemption, full inclusion, and a Japanese-type version of dividend exemption with an effective tax rate test and an exception for active business.”); Stephen E. Shay et al., *Designing a 21st Century Corporate Tax—An Advance U.S. Minimum Tax on Foreign Income and Other Measures to Protect the Base*, 17 FLA. TAX. REV. 669, 672–73 (2015) (“We outline a minimum tax that would substantially increase the effectiveness of the CFC [controlled foreign corporation] rules in protecting the United States against erosion of its corporate income tax base and in combatting tax competition by low-tax intermediary countries.”); Harry Grubert & Rosanne Altshuler, *Shifting the Burden of Taxation from the Corporate to the Personal Level and Getting the Corporate Tax Rate Down to 15 Percent* 3 (Rutgers University, Department of Economics Departmental Working Paper No. 2016-06, 2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2802109 [<http://perma.cc/NRF3-YLWW>] (“We propose a third alternative that attempts to incorporate some of the desirable features of the other proposals without their shortcomings. It lowers the corporate tax rate to 15 percent, not zero. It finances this reduction by taxing all dividends and capital gains as ordinary income. By itself, this would lead to large behavioral responses.”); Eric Toder & Alan D. Viard, *Major Surgery Needed: A Call for Structural Reform of the U.S. Corporate Income Tax*, TAX POL’Y CTR. 1 (Apr. 3, 2014), <http://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/413090-Major-Surgery-Needed-A-Call-for-Structural-Reform-of-the-US-Corporate-Income-Tax.pdf> [<http://perma.cc/WG86-4STC>] [hereinafter Toder & Viard, *Major Surgery*] (“In this report, we describe the challenges facing the corporate income tax and discuss two structural reform options that could address them. One option would seek international agreement on how to allocate income of multinational corporation among countries. The other option would eliminate the corporate income tax, but would tax American shareholders of publicly traded companies at ordinary income tax rates on their dividends and accrued capital gains.”); ERIC TODER & ALAN D. VIARD, TAX POLICY CTR., A PROPOSAL TO REFORM THE TAXATION OF CORPORATE INCOME 12, 14 (2016), <http://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000817-a-proposal-to-reform-the-taxation-of-corporate-income.pdf> [<http://perma.cc/D6NM-S3XZ>] [hereinafter TODER & VIARD, TAX POLICY CTR., A PROPOSAL] (funding a reduction of the corporate tax rate to 15% with a market-to-market tax on shareholder income with taxation of dividends and capital gains at ordinary rates).

7. See NAT’L COMM’N ON FISCAL RESPONSIBILITY & REFORM, THE MOMENT OF TRUTH (2010); PETE DOMENICI & ALICE RIVLIN, BIPARTISAN POLICY CTR., DOMENICI-RIVLIN DEBT REDUCTION TASK FORCE PLAN 2.0 (2012).

8. See, e.g., STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION BEFORE THE SENATE COMMITTEE ON FINANCE HEARING ON NAVIGATING BUSINESS TAX REFORM (Comm. Print 2016) (statement of Thomas Barthold, Chief of Staff, J. Comm. on Taxation) (explaining “some of the business tax reform issues raised by the Committee’s bipartisan Business Income Tax Working Group”); *Impact of the U.S. Tax Code on the Market for Corporate Control and Jobs: Hearing Before the Permanent Subcomm. on Investigations of*

emphasized reform, with some releasing discussion drafts and policy papers.⁹ Yet, no significant legislation has been enacted, except for an expensive, revenue-losing extension of expiring corporate tax benefits.¹⁰ This Article will attempt to explain why this has happened, but more importantly, it will suggest that a national consumption tax, in the form of a credit-invoice VAT, is the obvious way to finance necessary changes to an utterly broken business income tax system.¹¹

I have written twice before about various aspects of this issue, and selections from those articles are referenced where indicated.¹² In summary,

the S. Comm. on Homeland Sec. and Governmental Affairs, 114th Cong. (2015) [hereinafter *Impact of the U.S. Tax Code*] (examining three case studies of corporations escaping the U.S. tax net: the merger of Burger King and Tim Hortons, the acquisition of Anheuser-Busch by InBev, and the Valeant acquisitions of Medicis, Bausch & Lomb, and Salix).

9. See, e.g., H. COMM. ON WAYS AND MEANS, 11TH CONG., THE INNOVATION PROMOTION ACT OF 2015 DISCUSSION DRAFT § 250 (Comm. Print 2015) (proposing a deduction for U.S. corporations for up to 71% of profits derived from intellectual property held in the United States); Progressive Consumption Tax Act of 2014, S. 3005, 113th Cong. (2014); The Tax Reform Act of 2014, H.R. 1, 113th Cong. (2014) (advocating for comprehensive tax reform, led by Dave Camp, the former Chairman of the House Ways and Means Committee); The Bipartisan Tax Fairness and Simplification Act of 2011, S. 727, 112th Cong. (2011) (proposing to decrease the statutory rate on corporate income to 24%, increase the allowance for capital expenditures, eliminate certain tax preferences for corporations, and provide incentives for U.S. corporations to reinvest foreign earnings in the United States); JAMES B. RENACCI, SIMPLIFYING AMERICA'S TAX SYSTEM (2016); TAX REFORM TAX FORCE, HOUSE REPUBLICANS, A BETTER WAY: TAX 15-31 (2016) [hereinafter A BETTER WAY] (proposing a move toward a cash flow-based model, which includes reduction in individual and corporate income tax rates, a shift to a territorial system, and lower taxes on capital income); REPUBLICAN STAFF OF S. COMM. ON FIN., COMPREHENSIVE TAX REFORM FOR 2015 AND BEYOND (2014) [hereinafter COMPREHENSIVE TAX REFORM] (diagnosing issues with the tax code, and proposing to lower corporate and individual income tax rate cuts, shift to a territorial system, and simplify the tax code); PRESIDENT'S FRAMEWORK: AN UPDATE, *supra* note 4, at 17-29 (detailing President Obama's framework for business tax reform); Press Release, U.S. Senate Comm. on Fin., Baucus Unveils Proposals for International Tax Reform (Nov. 19, 2013), <http://www.finance.senate.gov/chairmans-news/baucus-unveils-proposals-for-international-tax-reform> [<http://perma.cc/DX84-WDDL>] (proposing to eliminate the deferral of earnings of U.S. corporations' foreign subsidiaries, to subject all unrepatriated earnings of U.S. corporations' foreign subsidiaries to a onetime tax at a reduced rate, and to eliminate both the check-the-box rule for international use and measures to guard against base erosion); Press Release, U.S. Senate Comm. on Fin., Baucus Works to Overhaul Outdated Tax Code (Nov. 21, 2013), <http://www.finance.senate.gov/chairmans-news/baucus-works-to-overhaul-outdated-tax-code> [<http://perma.cc/E9TB-8ZUQ>] (proposing to adjust the § 179 allowance to \$1 million for small businesses, simplify the accounting method requirements, require businesses to amortize certain intangible assets over five years, and institute a simplified, pooled cost recovery system that aims to approximate economic depreciation).

10. See Protecting Americans from Tax Hikes Act of 2015, H.R. 2029, 114th Cong. (2015).

11. Including a VAT in a business tax reform package will also fund changes to the individual income tax. See S. 3005 (proposing a 10% VAT, which would not only provide a reduction to the statutory rate on corporate income but also a reduction of the top individual marginal tax rate to 28% with exemptions of \$50,000 for single filers, \$75,000 for heads of household, and \$100,000 for families); see also RENACCI, *supra* note 9 (proposing to replace the corporate income tax with a 7% VAT, to shift to a territorial tax system with a one-time tax on assets held abroad, and to simplify the individual income tax by reducing the number of brackets and by expanding the standard deduction).

12. Harry L. Gutman, *Cardin's Key to the Tax Kingdom: Where Is the Business Community?*, 147 TAX NOTES 341 (2015) [hereinafter Gutman, *Cardin's Key*]; Harry L. Gutman, *How to Think*

while there is a consensus that our business income tax system needs reform, there is no agreement on what form it should take or how it should be financed. The major goals of the business community are to lower the corporate tax rate and to devise an acceptable system of taxing business income earned outside the United States that would enhance the international competitiveness of U.S. business—and make our system look like “the rest of the world.”¹³ The goals of policy analysts are to create a system that will increase our national standard of living, meet the country’s need for revenue, and satisfy the traditional tax policy criteria of equity, efficiency, and administrability. However, these criteria are not self-defining, and, as discussed below, equity considerations often conflict with efficiency objectives.¹⁴

The inability of politicians to agree upon revenue objectives presents another obstacle. Former President Obama’s last budget called for business tax reforms that would raise \$850 billion over ten years.¹⁵ It did not expressly include a corporate rate reduction but cited his desire to lower the corporate tax rate as provided in his tax reform framework.¹⁶ Most recently, House Republicans have called for a revenue-neutral reduction of the corporate rate from 35% to 20%, accomplished by replacing the existing corporate tax base with a “border adjustable” business cash flow tax and a territorial tax system.¹⁷ However, Republicans have found that revenue neutrality is difficult to achieve using traditional scoring.¹⁸ Moreover, the “border adjustment” has raised

About Real Tax Reform, 136 TAX NOTES 695 (2012) [hereinafter Gutman, *Real Tax Reform*].

13. John M. Samuels, *John Samuels Addresses Inversions and Tax Reform*, TAX ANALYSTS (Feb. 24, 2015), <http://www.taxanalysts.org/content/john-samuels-addresses-inversions-and-tax-reform> [<http://perma.cc/W4ZC-P6FH>].

14. See *infra* Part III.C for a discussion of the efficiency criterion.

15. OFFICE OF MGMT. & BUDGET, BUDGET OF THE U.S. GOVERNMENT: FISCAL YEAR 2017, at 51, 118 tbls.S-3 & S-9 (2016).

16. *Id.* at 51; PRESIDENT’S FRAMEWORK, *supra* note 4, at 9.

17. See Concurrent Resolution on the Budget—Fiscal Year 2017, H.R. Con. Res. 114-470, 114th Cong. 179–82 (2016) (“Most countries operate under a so-called ‘territorial’ system of international taxation, whereby their businesses operating abroad are only subject to the tax of the country where they do business. The U.S. has an antiquated ‘worldwide’ system of international taxation, in which U.S. multinational businesses operating abroad pay both the foreign-country tax and U.S. corporate taxes when profits are repatriated. They are essentially taxed twice. This puts them at an obvious competitive disadvantage.”); A BETTER WAY, *supra* note 9, at 25–27 (“This Blueprint will lower the corporate tax rate to a flat rate of 20 percent.”); Martin A. Sullivan, *Economic Analysis: Border Adjustments Key to GOP Blueprint’s Cash Flow Tax*, 152 TAX NOTES 303, 306 (2016) [hereinafter Sullivan, *Border Adjustments*] (“A perennial question concerning business cash flow taxes is whether border tax adjustments would be considered export subsidies and import penalties in violation of international trade agreements. Under WTO rules, border tax adjustments are allowed for indirect taxes like a VAT or retail taxes. These rules are intended to prevent the double taxation of consumption.”).

18. The Republicans would determine the revenue consequences of the change by using “dynamic” scoring, which purports to account for changes in the macroeconomy and is viewed by Republicans as producing more favorable results than traditional scoring. See Martin A. Sullivan, *Economic Analysis: 3 Critical Issues with Dynamic Scoring*, TAX NOTES TODAY, Nov. 10, 2014, LEXIS, 2014 TNT 217-1 [hereinafter Sullivan, *3 Critical Issues*] (“Even business-only tax reform, which would encounter one fewer hurdle than across-the-board reform, faces extremely long odds.

potential issues with respect to compatibility with World Trade Organization (WTO) prohibitions on trade subsidies and penalties as well as questions regarding its economic effect on businesses that are heavily reliant on imports. During his campaign, President Trump took a different approach. He proposed reducing the corporate tax rate to 15%, optional expensing of capital investments, and taxing the worldwide income of multinational corporations currently.¹⁹ The Trump proposal has been estimated to reduce revenue by \$6.2 trillion over the ten-year budget window using conventional scoring.²⁰ As more

Given this gloomy outlook, conservative tax reformers are hoping that favorable dynamic scoring can break the logjam. But it is by no means certain that the hoped-for estimates will materialize. . . . If . . . the JCT's official score of the Camp draft incorporated dynamic effects that were an average of MEG and OLG estimates (shown in the table), an otherwise revenue-neutral tax reform bill would be estimated to increase revenues by approximately \$ 40 billion per year.”); Staff of Joint Comm. on Taxation, *The Joint Committee on Taxation Revenue Estimating Process* 23 (Jan. 2017) (discussing dynamic scoring). One problem with this approach, as illustrated by the Joint Committee on Taxation's macroeconomic analysis of Chairman Camp's 2014 draft legislation, is that there is no agreement on the methodology to be used to ascertain the “dynamic” response. *See* STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., *MACROECONOMIC ANALYSIS AT THE JOINT COMMITTEE ON TAXATION AND THE MECHANICS OF ITS IMPLEMENTATION* (Comm. Print 2015). Nonetheless, the House adopted a rule requiring dynamic scoring to be used for “major legislation.” H.R. Res. 5, 114th Cong. § 2(c) (2015); *see also* STAFF OF JOINT COMM. ON TAXATION, 113TH CONG., *MACROECONOMIC ANALYSIS OF THE “TAX REFORM ACT OF 2014”* 8–11 (Comm. Print 2014) (using two different models for estimating the macroeconomic effects of the former Rep. Camp's legislation, and finding that the models came out with two sets of results); STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., *OVERVIEW OF WORK OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION TO MODEL THE MACROECONOMIC EFFECTS OF PROPOSED TAX LEGISLATION TO COMPLY WITH HOUSE RULE XIII.3.(H)(2)*, at 16–14 (Comm. Print 2003) (“A succession of rules passed by the House of Representatives, the latest in 2003, have directed the Joint Committee staff to supplement conventional revenue estimates with an analysis of the macroeconomic impact of certain tax legislation.”); N. Gregory Mankiw & Matthew Weinzierl, *Dynamic Scoring: A Back-of-the-Envelope Guide*, 90 J. PUB. ECON. 1415, 1415–16 (2004) (“In 2002 the staff of the Joint Tax Committee, prompted by several members of Congress, started work on the difficult task of dynamic scoring of tax policy. That is, they started developing a set of economic models that might be used to estimate the feedback effects of tax proposals.”); Sullivan, 3 *Critical Issues*, *supra* note 18, at 2 (“In 2003, under a new House rule put in place by Republicans, the JCT produced and published a dynamic estimate of actual legislation passed by the Ways and Means Committee.”).

19. *Tax Plan*, DONALD J. TRUMP FOR PRESIDENT, <http://www.donaldjtrump.com/policies/tax-plan/> (last visited Feb. 15, 2017) [<http://perma.cc/V59P-X4YC>].

20. *See* JAMES R. NUNNS ET AL., TAX POLICY CTR., *AN ANALYSIS OF DONALD TRUMP'S REVISED TAX PLAN 5–6* (2016), <http://www.taxpolicycenter.org/publications/analysis-donald-trumps-revised-tax-plan/full> [<http://perma.cc/3MZY-XWLN>] (“The revenue losses understate the effect on the national debt because they exclude the additional interest that would accrue because of increased debt. Including interest, the proposal would add \$7.2 trillion to the national debt by 2026.”); *see also* ALAN COLE, TAX FOUND., *DETAILS AND ANALYSIS OF DONALD TRUMP'S TAX PLAN 4* (2015), http://taxfoundation.org/sites/taxfoundation.org/files/docs/TaxFoundation_FF482_0.pdf [<http://perma.cc/VG3G-WCW7>] (“Overall, the plan would reduce federal revenue on a static basis by \$11.98 trillion over the next ten years. Most of the revenue loss is due to the reduction in individual income tax rates, which we project to reduce revenues by approximately \$10.20 trillion over the next decade. The changes to the corporate income tax will reduce revenues by an additional \$1.54 trillion over the next decade, with the remaining static cost (\$238 billion) due to the elimination of the estate tax. However, if we account for the economic growth that the plan would produce, the plan would end up lowering revenue by \$10.14 trillion over the next decade.”).

fully described below, however, the practical reality is that the Trump proposal will have to be revised because deficit concerns will require that the revenue lost by any reform proposal will most likely have to be substantially offset.²¹

The fact that revenue lost by reform will have to be offset limits what can be done. As many have recognized, significant revenue-neutral reform utilizing traditional scoring methods within the existing business tax structure is impossible.²² First, there are insufficient business tax expenditures—also called business tax preferences or “base broadeners”²³—that can be eliminated, as a practical matter, to fund a major rate reduction.²⁴ This is a simple math problem. Second, eliminating business tax expenditures to fund a corporate rate cut would result in a tax increase for those doing business in noncorporate form, which makes this a political nonstarter.²⁵ Third, the business community cannot agree on which base broadeners should be used to finance a rate reduction because that form of financing produces winners and losers within the business community.²⁶ Fourth, the largest business tax expenditures are timing provisions.²⁷ And utilizing timing changes to finance permanent rate reductions

21. Naomi Jagoda, *Mnuchin: Tax Reform Shouldn't Add to the Deficit*, THE HILL (Jan. 19, 2017, 2:52 PM), <http://thehill.com/policy/finance/315124-mnuchin-tax-reform-shouldnt-add-to-the-deficit> [<http://perma.cc/GJ7B-46WT>]. See *infra* Part II for a discussion of the federal budget and its impact on corporate rate reform.

22. See, e.g., Gutman, *Cardin's Key*, *supra* note 12, at 341; Gutman, *Real Tax Reform*, *supra* note 12, at 703, 706–07; Robert Goulder, *Renacci's VAT: The Shape of Things to Come*, TAX ANALYSTS BLOG (Aug. 2, 2016), <http://www.taxanalysts.org/tax-analysts-blog/renacci-s-vat-shape-things-come/2016/08/02/194451> [<http://perma.cc/J5SP-3ME6>]; Martin A. Sullivan, *Should We Give Up on Reagan Style Tax Reform?*, TAX ANALYSTS BLOG (Sep. 22, 2014, 3:19 PM), <http://www.taxhistory.org/taxcom/taxblog.nsf/Permalink/MSUN-9P7MBW?OpenDocument> [<http://perma.cc/AZ3H-KDH5>].

23. See *infra* notes 101–09 and accompanying text; TODER & VIARD, TAX POLICY CTR., A PROPOSAL, *supra* note 6, at 12, 14 (funding a reduction of the corporate tax rate to 15% with a mark-to-market tax on shareholder income and with taxation of dividends and capital gains at ordinary rates). See *infra* note 27 for a comprehensive list of tax expenditures. See also Gutman, *Real Tax Reform*, *supra* note 12, at 703.

24. See *infra* note 47 and accompanying text for a discussion of previous attempts at eliminating base broadeners to finance a reduction in the statutory corporate rate. See also John L. Buckley, *Tax Expenditure Reform: Some Common Misconceptions*, 134 TAX NOTES 1122, 1123 (2012) (“[A] review of the largest tax expenditures indicates that few are special interest provisions, and most survived the scrutiny of TRA 1986. The large tax expenditure cost estimates have created unrealistic expectations about the potential revenue that could be raised through tax expenditure reform.”).

25. Almost 44% of U.S. business income is earned by the noncorporate sector (S-corporations, partnerships, and nonfarm sole proprietorships). STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., BACKGROUND ON BUSINESS TAX REFORM 21 fig.5 (Comm. Print 2016) [hereinafter STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., BACKGROUND ON BUSINESS TAX REFORM].

26. See *infra* notes 53–85 and accompanying text for a discussion of the issues of equity surrounding business tax reform. Indeed, one has to question whether the multinational community really wants tax reform that results in a 25% rate. Most U.S.-based multinationals have effective tax rates below 17%. Why would they support a comprehensive tax base that produces a uniform 20% rate? One suspects that their real motivation is to achieve a tax holiday for their unrepatriated earnings as a part of business tax reform.

27. See STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2016–2020, at 22–23 (Comm. Print 2015) [hereinafter STAFF OF

would lead to long-term deficits; when the timing benefit disappears, revenues must be enhanced either through additional base broadening or rate increases. Fifth, there is no agreement on how our international system should be reformed or how non-U.S. income should be taxed. Sixth, and of critical practical importance, there has been no groundswell of public support for reform, and President Obama did not make it a priority.

I. IDENTIFYING THE REAL PROBLEMS

Lamenting a broken system is one thing; understanding the intricacies of its problems and solutions is quite another. To begin generally, the very existence of a corporate tax creates inherent economic distortions. Second, assuming the existence of a corporate tax, a high nominal corporate rate discourages direct foreign investment. More significantly, it encourages erosion of the U.S. tax base through a number of techniques including (1) “inversion transactions”;²⁸ (2) “royalty stripping transactions,” in which intangible intellectual property is transferred to low-tax jurisdictions; (3) supply chain manipulation, resulting in the creation of income in low-tax jurisdictions through aggressive transfer pricing mechanisms;²⁹ (4) “interest stripping transactions” by which a company with

JOINT COMM. ON TAXATION, 114TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES]. The largest business tax expenditures relate to accelerated cost recovery. Changing cost recovery deductions to economic depreciation reduces depreciation deduction in early years, thus producing a revenue increase. However, that result reverses in later years, producing a revenue loss. Thus, the change is simply in the timing of the deduction. But if the revenue increase occurs within the ten-year budget window and the loss occurs later, the loss is not taken into account for “scoring” purposes.

28. A typical inversion transaction occurs when a smaller foreign corporation (residing in a jurisdiction with a lower tax rate) acquires a U.S. corporation because the U.S. corporation desires to secure the foreign corporation’s low tax residency. *See Impact of the U.S. Tax Code, supra* note 8, at 35 (“[O]n the issue of *how* to execute the merger and whether to locate the new headquarters in the United States or elsewhere, tax considerations were dispositive. . . . Burger King management . . . considered a number of potential jurisdictions for headquarters, including the UK, Canada, Belgium, and Ireland—but did not seriously consider the United States.”).

29. The “transfer price” is the price charged by one related party to another for the use or purchase of a service or asset. The transfer price is meant to replicate the price that would be charged for the good or service in an “arm’s length” transaction between unrelated parties. Sienna C. White, *Cost Sharing Agreements & the Arm’s Length Standard: A Matter of Statutory Interpretation?*, 19 FLA. TAX REV. 191, 195 (2016) (“The arm’s length standard aims to establish the price related parties would have agreed to for the sale of goods or services if they had dealt with one another at ‘arm’s length’—that is, as a negotiation between unrelated parties in the same circumstances.”). Aggressive transfer pricing would attempt to shift income to low-tax jurisdictions by inflating the cost of a good or service to an affiliate in the low-tax jurisdiction. Limiting transfer-pricing abuse was a principal incentive for the European Union’s Base Erosion and Profit Shifting (BEPS) initiative. BEPS is an international effort to prevent the use of aggressive cross-border tax planning to avoid taxation in higher-tax jurisdictions by shifting income into lower-tax jurisdictions. *See* Bret Wells, *International Tax Reform by Means of Corporate Integration*, 19 FLA. TAX. REV. (forthcoming) (manuscript at 7–8) (on file with author) (“The low-tax affiliate then licenses the valuable intangibles to high-tax affiliates and charges those affiliates a royalty under related party licensing agreements.”). The European Union’s BEPS initiative requires that multinational corporations report certain information to their home governments and that those governments share that information with their counterparts in other countries. *See* Council Directive 2016/881 of May 25, 2016 Amending Directive 2011/16/EU as

high interest intra-company debt obligations in the United States takes advantage of the interest deduction at the high U.S. tax rate; (5) “lease stripping transactions” that allow a related party in a low-tax jurisdiction to recognize income from a rental property and a related party in a high-tax jurisdiction to claim the deduction for the rental payment; (6) “service stripping transactions”; and (7) reinsurance transactions with foreign affiliates to strip revenue reserves.³⁰ A third problem is the plethora of tax expenditures that produce wildly different effective tax rates on business income.³¹ And a fourth problem is the ability to defer the payment of U.S. tax on foreign active business income until the earnings are repatriated to the United States. This system of deferring tax until repatriation has encouraged U.S. multinational companies to keep more than \$2 trillion in earnings offshore.³² It cannot be defended.

These are the real problems that must be addressed in order to evaluate the solution proposed in this Article. To set the context, I will first address the federal budget. It is critical to understand the extent to which the budget situation constrains lawmakers’ freedom to enact structural reform. Next, I will outline the fundamentals by which tax policy analysts evaluate a tax structure, and then I will assess our business income tax structure against those fundamentals to show that our system needs serious restructuring. Further, I will briefly describe and discuss the reforms that have been suggested and conclude that they are inadequate to redress the real problems. Finally, I will propose a structure that addresses the current problems. This proposal is premised on my belief that neither discretionary nor mandatory expenditure reduction provides a practical method of financing business tax reform. Consequently, a new revenue source is required.³³ The most obvious is the one that over 160 other countries have adopted—the credit-invoice VAT.³⁴ In the final substantive section, I will describe a credit-invoice VAT and examine a number of the issues surrounding

Regards Mandatory Automatic Exchange of Information in the Field of Taxation, 2016 O.J. (L146) 8, 9.

30. See Wells, *supra* note 29, at 6–9 (defining and explaining royalty stripping transactions, supply chain transactions, interest stripping transactions, lease stripping transactions, and service stripping transactions); see also KIMBERLY A. CLAUSING, PROFIT SHIFTING AND U.S. CORP. TAX POLICY REFORM 9, 15–16 (2016) (estimating that the United States loses \$100 billion in revenue annually, that 98% of the lost revenue shifts to countries with rates less than 15%, and that 82% of the revenue loss is sheltered by seven countries).

31. See Martin A. Sullivan, *Economic Analysis: New Corporate Coalition Accepts that Reform Won't Be Painless*, 139 TAX NOTES 1462, 1463 (2013) [hereinafter Sullivan, *New Corporate Coalition*] (finding that FedEx Corp. had an estimated effective tax rate of 36%, while pharmaceutical giant Abbott Laboratories had an effective tax rate of 11%).

32. Richard Rubin, *U.S. Companies Are Stashing \$2.1 Trillion Overseas to Avoid Taxes*, BLOOMBERG (Mar. 4, 2015, 5:00 AM), <http://www.bloomberg.com/news/articles/2015-03-04/u-s-companies-are-stashing-2-1-trillion-overseas-to-avoid-taxes> [<http://perma.cc/CST3-NMKP>].

33. While a carbon tax or financial transactions tax could provide revenue, these taxes would likely direct the revenue to climate change or shoring up the financial system.

34. ORG. FOR ECON. COOPERATION & DEV., CONSUMPTION TAX TRENDS 2014: VAT/GST AND EXCISE RATES, TRENDS, AND POLICY ISSUES 14 (2014). For a study of the potential use of a VAT in the United States, see generally MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES (2008).

its implementation. Then, I will recommend a path to enactment, including the critical role of the business community and the extremely important educational steps required to dispel misinformation about a VAT.

II. FEDERAL BUDGET

The January 2017 Congressional Budget Office (CBO) Budget and Economic Outlook: 2017 to 2027³⁵ presents a grim picture of the country's long-term fiscal situation.

Increasing deficits, totaling approximately \$10 trillion, are projected for the conventional ten-year budget window if current law remains in effect.³⁶ While revenues as a percentage of GDP are expected to rise slightly and discretionary spending is expected to decrease, outlays for health care, social security, and interest on the government's debt are expected to increase substantially.³⁷ By 2027 the annual deficit is projected to be \$1.404 trillion.³⁸ Debt held by the public would rise to \$24.893 trillion, or 88.9% of projected GDP.³⁹

The CBO warns that high and rising debt would have "significant consequences,"⁴⁰ including:

- Substantially increased spending on federal interest costs. If interest rates increase by 1% from the 2027 rates currently assumed by the CBO, the deficit would increase by \$249 billion in 2027.⁴¹
- Federal borrowing would reduce total saving in the economy, thus reducing the nation's capital stock, productivity, and income.⁴²
- There would be "less flexibility to use tax and spending policies to respond to unexpected challenges such as significant economic

35. See CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: 2017 TO 2017 (2017); see also Alan J. Auerbach & William G. Gale, *Once More unto the Breach: The Deteriorating Fiscal Outlook*, BROOKINGS (Feb. 2016), http://www.brookings.edu/wp-content/uploads/2016/07/galeaurbach_oncemoreuntobreach_022216final.pdf [<http://perma.cc/29NN-A2TJ>] (asserting that "[e]ven under a low interest rate scenario, the long-term budget outlook is unsustainable"); William G. Gale & Benjamin H. Harris, *A VAT for the United States: Part of the Solution*, 2011 TAX ANALYSTS 64, 64 (advocating for the VAT as part of a solution to the problems of a "large medium-term federal budget deficit and an unsustainable long-term fiscal gap").

36. CONG. BUDGET OFFICE, *supra* note 35, at 2 tbl.1.

37. See Xiaotong Niu & Julie Topoleski, *Spending for Social Security and Major Health Care Programs in The Long-Term Budget Outlook*, CONG. BUDGET OFF. (Aug. 1, 2016), <http://www.cbo.gov/publication/51840> [<http://perma.cc/XS5Q-PTGS>] ("CBO projects that spending for Social Security would increase noticeably as a share of the economy—from 4.9 percent of gross domestic product (GDP) in 2016 to 6.3 percent in 2046—if current laws generally remained unchanged. Spending for the major health care programs is projected to grow even faster: Net outlays for those programs would increase from 5.5 percent of GDP now to 8.9 percent in 2046.").

38. CONG. BUDGET OFFICE, *supra* note 35, at 2 tbl.1.

39. *Id.*; see also Auerbach & Gale, *supra* note 35, at 2 (estimating that the public debt will equal 91% of the GDP in 2025).

40. CONG. BUDGET OFFICE, *supra* note 35, at 5–6.

41. *Id.* at 2.

42. *Id.*

downturns or financial crises.”⁴³

- The likelihood of another fiscal crisis would increase, especially if investors demanded higher interest rates to purchase federal debt.⁴⁴

This picture—particularly the projections that discretionary spending will fall and that the prospects for serious mandatory expenditure reduction are illusory—forms the basis for my view that any tax reform must produce revenues that are at least equal to the current projections and indeed, that there will be pressure to increase revenue.

These budgetary projections severely limit the prospect of meaningful corporate tax rate changes within the current revenue structure. The Joint Committee on Taxation has estimated that a single percentage point reduction in the corporate rate would cost roughly \$100 billion over ten years.⁴⁵ Thus, a reduction in the corporate rate from 35% to 25% would require an offset of \$1 trillion over the ten-year budget window.⁴⁶ As a practical political matter, individuals are unlikely to give up personal tax benefits—such as a home mortgage interest deduction or a deduction for charitable contributions—to finance a corporate rate reduction. Thus, the funding for a corporate rate reduction must come from the corporate tax base. Unfortunately, there are insufficient potential corporate tax expenditure reductions to fund a rate reduction of more than ten percentage points even if *all* were immediately eliminated.⁴⁷ Finally, as noted earlier, eliminating all business tax expenditures

43. *Id.*

44. *Id.*

45. U.S. S. COMM. ON FIN., THE BUSINESS INCOME TAX BIPARTISAN WORKING GROUP REPORT 18, 58–59 n.12 (2015) (noting that while it uses an estimate of the revenue effects of a 1% increase in the corporate rate, this is an appropriate proxy for the revenue effects of a 1% reduction in the corporate rate).

46. *See id.* at 18.

47. Recognizing this deficiency, Sander Levin, a member of the Ways and Means Committee, asked the Joint Committee on Taxation to calculate the lowest possible corporate rate where all business tax expenditures were immediately eliminated. The answer was 28%. Memorandum from Thomas A. Barthold, Chief of Staff, Joint Comm. on Taxation, to Sander Levin (Oct. 27, 2011) (on file with author). Eliminating accelerated cost recovery and the research and experimentation tax credit were the largest elements of the estimate. The latter was just made permanent—good luck getting it repealed. The former is a timing issue, the short-term benefits of which will reverse over time.

The number reported to Mr. Levin is a creature of budget scoring rules that measure effects over a ten-year period. The most significant positive revenue effects come from the alteration of timing provisions, such as the abolition of accelerated cost recovery. Because these revenue increases reverse outside the budget window, the numbers do not present a true picture of the long-term revenue effects. Moreover, this estimate explicitly ignored interactive effects and did not provide any transition relief.

In 2014, Ways and Means Committee Chairman Dave Camp produced a revenue-neutral draft for corporate reform legislation that lowered the corporate rate to 25% and proposed a “territorial” system for taxing income earned outside the United States. Tax Reform Act of 2014, H.R. 1, 113th Cong. §§ 3001, 4001–04 (2014); *see also* Edward D. Kleinbard, *Throw Territoriality Taxation from the Train*, 114 TAX NOTES 547, 547–48 (2007) [hereinafter Kleinbard, *Throw*] (“Territorial income tax systems are designed to exempt the ‘active’ income of a U.S. firm’s foreign branches or foreign

would result in a tax increase on those doing business in noncorporate form.⁴⁸ Pass-through entities and sole proprietorships account for almost 44% of all U.S. business income.⁴⁹ It defies belief that these business owners would accept a tax increase to finance a corporate rate reduction.⁵⁰ This observation provides another explanation for the lack of progress on business tax reform through the elimination of business tax expenditures. Because of this interaction between income earned in corporate and noncorporate businesses, business income tax reform necessarily implicates consideration of individual taxation, which as politicians recognize, can quickly become a no-win political nightmare.

III. THE FUNDAMENTALS

We now turn to an examination of our business tax system in light of tax policy fundamentals.

1. Revenue

The first fundamental, described above,⁵¹ is that the tax system must produce enough revenue to fund a specified level of government expenditure.⁵²

2. Equity⁵³

The second consideration is equity. A fundamental principle of income tax theory is that taxpayers with equal incomes should bear equal tax burdens. This is called horizontal equity. Horizontal equity, as a principle, is violated in at least two ways by the current business tax structure.

First, as noted earlier, the tax burden differs depending on whether income

subsidiaries from U.S. income tax when that income is repatriated to the United States.”). The rate reduction was principally financed by timing changes. H.R. 1 §§ 3001, 4001–04 (2014). Chairman Camp performed an extraordinary service by producing a comprehensive plan that demonstrates what would have been required to lower the corporate rate to 25%. Not surprisingly, the proposal garnered no political support from his own party, illustrated by then-Speaker Boehner dismissing it with the endearing “[b]lah, blah, blah, blah.” See Ed O’Keefe, *Boehner on Tax Reform: “Blah, Blah, Blah Blah,”* WASH. POST: POST POLITICS (Feb. 26, 2014), <http://www.washingtonpost.com/news/post-politics/wp/2014/02/26/boehner-on-tax-reform-blah-blah-blah-blah/> [<http://perma.cc/Q7YL-W2S7>].

48. See *supra* notes 22–27 and accompanying text for a discussion of the impact of tax expenditures on revenue-neutral reform.

49. See STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., BACKGROUND ON BUSINESS TAX REFORM, *supra* note 25, at 21 fig.5.

50. Recognizing this problem, the Republican *A Better Way* proposal calls for a maximum tax on pass-through business income of 25%. See *A BETTER WAY*, *supra* note 9, at 23–24. Business income eligible for the 25% rate is calculated by deducting an amount equal to the reasonable compensation to ensure that wage income, taxed at a higher rate, does not escape the tax base. *Id.* The proposal poses a nightmare for a woefully underfunded Internal Revenue Service. In the absence of an arbitrary rule—such as defining business income eligible for the 25% rate as a specified percentage of capital invested in the business—the provision is utterly unadministrable.

51. See Section II for a discussion of the federal budget.

52. This does not necessarily imply a “balanced budget.” Sound fiscal policy requires flexibility to engage in deficit spending as well as to create budget surpluses.

53. See STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., BACKGROUND ON BUSINESS TAX REFORM, *supra* note 25, at 54–57.

is earned by a corporate or a noncorporate entity.⁵⁴ This difference has four major distortive elements:

- It creates a bias against corporate investment.⁵⁵
- It creates an incentive for corporations to finance by debt or retained earnings.⁵⁶
- It creates an incentive to retain or distribute corporate earnings depending upon fact-specific relationships of corporate, individual, and capital gains tax rates.
- It creates incentives to distribute corporate earnings in tax-preferred forms.⁵⁷

These long-recognized distortions could be eliminated or mitigated by the adoption of a system of “integration”⁵⁸ in which corporate income is taxed once, but only once, through one of the following mechanisms:

- A shareholder credit for corporate taxes paid⁵⁹
- A corporate deduction for dividends paid⁶⁰
- A shareholder exclusion for dividends received⁶¹
- Accrual taxation of corporate owners⁶²
- A business cash flow tax⁶³

54. See *supra* notes 49–50 and accompanying text for a discussion of the difference between income earned through entities in corporate and noncorporate forms and that difference’s implication on the prospects for business tax reform.

55. See Jonathan Talisman, *Do No Harm: Keep Corporate Interest Fully Deductible*, 141 TAX NOTES 211, 218 (2013).

56. *Id.* at 214–16.

57. TAX ANALYSTS, INTEGRATION OF THE U.S. CORPORATE AND INDIVIDUAL INCOME TAXES: THE TREASURY DEPARTMENT AND AMERICAN LAW INSTITUTE REPORTS 5 (1998).

58. DEP’T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 4 (1992) [hereinafter DEP’T OF THE TREASURY, INTEGRATION].

59. *Id.* at 186. The Australian tax system, for example, requires shareholders to include amounts received in distributions from corporations in income and then provides credits in an amount equal to the amount received in distributions. *Id.* at 159. However, these credits are only available to shareholders for what are called “franked distributions.” *Id.* Distributions from foreign corporations, which have not paid Australian tax at the corporate level, are not franked distributions, and Australian shareholders in foreign corporations will not receive credits along with a distribution. *Id.* at 162.

60. *Integrating the Corporate and Individual Tax Systems: The Dividends Paid Deduction Considered: Hearing Before the S. Comm. on Fin.*, 114th Cong. (2016) [hereinafter *Integrating the Corporate and Individual Tax Systems*] (statement of Michael J. Graetz, Professor of Law, Columbia Law School).

61. DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2004 REVENUE PROPOSALS 11–22 (2003).

62. Toder & Viard, *Major Surgery*, *supra* note 6, at 29–41.

63. See, e.g., DEP’T OF THE TREASURY, INTEGRATION, *supra* note 58, at 192 n.39 (“Under a corporate cash-flow tax, corporations would be taxed on the net cash flow from their business activities.”); A BETTER WAY, *supra* note 9, at 23, 25–28 (“This Blueprint will bring historic reductions in the tax rates for businesses of all sizes and greater parity in the tax treatment of all businesses regardless of size or legal form. Instead of having some of the highest tax rates on entrepreneurship

Each of these alternatives has advantages and disadvantages that have been thoroughly studied.⁶⁴ While most analysts agree that the classical corporate tax structure should be eliminated, there is no consensus on which alternative is preferred. Moreover, while an integrated system would eliminate many of the distortions mentioned earlier, the tax treatment of foreign earnings and exempt organizations would have to be addressed.

The current dialogue about reforming U.S. taxation of business income has revived the integration debate. Integration was extensively discussed in the December 2014 Senate Finance Committee Republican Staff Report, *Comprehensive Tax Reform for 2015 and Beyond*.⁶⁵ It was also addressed in the Senate Finance Committee's *Business Income Tax Bipartisan Tax Working Group Report* of July 2015.⁶⁶ More recently, Orrin Hatch, the Chairman of the Senate Finance Committee, indicated that he will propose partial integration, and the Finance Committee held hearings on the subject on May 17 and May 24, 2016.⁶⁷ This renewed congressional interest has led to a number of new academic analyses.⁶⁸

Reports indicate that Hatch's proposal will be a deduction for dividends that are paid, limited by the amount of income that is subject to full taxation.⁶⁹ The limitation disallows 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 30% would be imposed on the deductible dividend.⁷⁰ As a

and business activity in the world, the United States will leapfrog many of its trading partners and offer globally competitive rates. . . . The new tax system will be a move toward taxation based on business cash flow."); ROBERT CARROLL & ALAN D. VIARD, PROGRESSIVE CONSUMPTION TAXATION: THE X-TAX REVISITED (2012); Ryan Finley, *Replace the Corporate Tax With a Cash Flow Tax, Economists Say*, TAX NOTES TODAY, July 15, 2016, LEXIS, 2016 TNT 136-7 ("[T]he tax base under a cash flow tax is generally equal to revenue minus deductions for labor costs, with some variants taking into account financial flows as well.").

64. A recent review of the literature is contained in the December 2014 report, prepared by the Republican staff of the Senate Finance Committee. See COMPREHENSIVE TAX REFORM, *supra* note 9.

65. *Id.* at 122–238.

66. STAFF OF S. COMM. ON FIN., THE BUSINESS INCOME TAX BIPARTISAN TAX WORKING GROUP REPORT 33–38 (2015).

67. See *Debt Versus Equity: Corporate Integration Considerations Before the S. Comm. on Finance*, 114th Cong. (2016) (statements of Alvin C. Warren, Ropes & Gray Professor of Law, Harvard Law Sch.; Jody K. Lurie, CFA, Janney Montgomery Scott, LLC; John Buckley, Former Chief Tax Counsel, Comm. on Ways & Means; and John D. McDonald, Partner, Baker & McKenzie, LLP); *Integrating the Corporate and Individual Tax Systems*, *supra* note 60 (statements of Michael J. Graetz, Professor of Law, Columbia Law Sch.; Bret Wells, Professor of Law, Univ. of Houston Law Ctr.; Judy A. Miller, Am. Retirement Assoc.; and Steven M. Rosenthal, Senior Fellow, Urban-Brookings Tax Policy Ctr.).

68. See, e.g., Edward D. Kleinbard, *The Trojan Horse of Corporate Integration*, 152 TAX NOTES 957 (2016); Wells, *supra* note 29, at 2–6; Michael J. Graetz & Alvin C. Warren, Jr., *Integration of Corporate and Shareholder Taxes*, 69 NAT'L TAX J. (forthcoming) (manuscript at 23–28).

69. *Senator Hatch's Statement on Tax Reform, Corporate Integration*, KPMG (Dec. 12, 2016), <http://home.kpmg.com/us/en/home/insights/2016/12/tnf-senator-hatch-statement-on-tax-reform-corporate-integration.html> [<http://perma.cc/EM5F-2HZN>].

70. *Hatch Defends Corporate Integration Proposal at Pair of Hearings*, GRANT THORNTON (May 31, 2016), <http://www.grantthornton.com/issues/library/newsletters/tax/2016/hot-topics/May->

consequence of the deduction limitation, the portion of the distribution that was not subject to tax at the corporate level would be taxed at the recipient level.⁷¹ The amount of the withheld tax would be included in the income of the recipient and would be a nonrefundable tax credit for U.S. taxpayers. Foreign taxpayers and exempt organizations would not be eligible for the credit. Thus, the withheld tax would become a final tax for those entities and would ensure that the corporate income would be subject to tax at one level.

To illustrate, assume a corporation pays a dividend of \$100 out of fully taxed income. The corporation would deduct \$100, thus eliminating the corporate tax on that amount. The corporation would, however, pay a withholding tax of \$30 that would be imputed to the recipient. The recipient would include \$130 in income (the \$100 dividend plus \$30 of withheld tax). A domestic taxable recipient would get a nonrefundable tax credit of \$30. Foreign taxpayers and exempt organizations would not receive a credit.⁷²

To equate the tax treatment of dividends with that of interest, a 30% withholding tax would be imposed on interest payments. The interest withholding tax would be treated the same as the dividend withholding tax, thus assuring at least one level of tax on interest income.⁷³

Practically every integration study has identified foreign taxpayers and foreign income as topics that require particular attention. With respect to the former, while lip service is paid to theoretical norms (for example, if the objective of the system is capital export neutrality, integration should be extended to foreign investors),⁷⁴ governmental studies have rejected the suggestion that integration should be extended by statute to all foreign investors.⁷⁵ The 1992 Treasury Department report recommended “that foreign shareholders [should] not be granted integration benefits by statute, but instead that this issue be addressed through treaty negotiations in order to achieve

31/Hatch-corporate-integration.aspx [http://perma.cc/L64E-A958].

71. See *Offshore Profit Shifting and the U.S. Tax Code—Part 2 (Apple Inc.): Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. and Governmental Affairs*, 113th Cong. 19 (2013) (statement of Stephen E. Shay, Professor of Law, Harvard Law School).

72. See Graetz & Warren, *supra* note 68, at 6–7.

73. *Id.*

74. See, e.g., John K. McNulty, *International Aspects of Proposals for Corporate Income Tax Reform in the United States: Integration of the Corporate and Individual Income Taxes*, 3 TILBURG FOREIGN L. REV. 307, 322, 325 (1993).

75. The American Law Institute report took a different approach. See Graetz & Warren, *supra* note 68, at 17–19. The report was “somewhat parallel in its international aspects” to the extent that “foreign shareholders would be entitled to the equivalent of the imputation credit on the same basis as domestic shareholders.” McNulty, *supra* note 74, at 321. However, a new “foreign investors tax” would be created, which would effectively eliminate the dividend and the credit. *Id.* at 321–22 (“This new foreign investors tax would be offset by the foreign investor’s equivalent of the domestic shareholder’s imputation credit for corporate tax paid. The new foreign investor’s [sic] would absorb the imputation credit for foreign shareholders. The credit would offset the U.S. shareholder level tax or dividends paid to foreign shareholders.”). Moreover, the existing withholding taxes would be repealed. *Id.* at 322. It is noteworthy that the Australian imputation-credit system of integration denies the benefit of the withholding credit to non-Australians.

reciprocity.”⁷⁶ Dividends paid to foreign shareholders were not excludible under President Bush’s fiscal year 2004 proposal.⁷⁷ Similarly, the Senate Finance Committee Republican Staff Report, *Comprehensive Tax Reform for 2015 and Beyond*, states the following:

[U]nder the dividends paid deduction method, either a new compensatory withholding tax on both interest and dividends should be enacted to ensure a single level of tax on business income, or Congress can override existing tax treaties, disallowing a reduction in withholding tax rates for interest and dividend payments. The former action would be preferable.⁷⁸

The other issue is the treatment of foreign income. The specific question is whether taxes paid by U.S. corporations to foreign governments should be treated the same as taxes paid to the U.S. government. If so, the foreign tax credit would effectively be transferred to U.S. shareholders, and that income, if taxed at a rate equal to or greater than the U.S. rate, would not be subject to U.S. tax.⁷⁹ The 1992 Treasury Department report recommended that the foreign tax credit remain available but that its benefits not be passed through to U.S. shareholders.⁸⁰ Presumably, the ability of shareholders to utilize the foreign tax credit would be left to bilateral treaty negotiations. The 1992 Treasury Department report, as well as others, concluded that denying the benefits of integration does not constitute a violation of existing double taxation treaties.⁸¹

The reemergence of congressional interest in integration is welcome. Quite apart from eliminating the distortions of the current corporate tax, it has the potential to induce direct foreign investment in the United States.⁸² It should be reemphasized, however, that any integration regime involves the resolution of complicated problems regarding the taxation of foreign investors and foreign income, as well as exempt organizations. In the realm of foreign income, leaving

76. DEP’T OF THE TREASURY, INTEGRATION, *supra* note 58, at 16.

77. STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT’S FISCAL YEAR 2004 BUDGET PROPOSAL 222–23 (Comm. Print 2003).

78. COMPREHENSIVE TAX REFORM, *supra* note 9, at 222–23.

79. DEP’T OF THE TREASURY, INTEGRATION, *supra* note 58, at 74.

80. *Id.* at 77–79.

81. *Id.* at 79; see also Richard L. Doernberg, *Opinion: International Aspects of Individual and Corporate Tax Integration*, 4 TAX NOTES INT’L 535, 537–38 (1992) (“While the United States in its treaties agrees to grant a foreign tax credit for qualifying foreign taxes, the applicable treaty provision does not require the United States to pass through the benefits of the foreign tax credit to a corporation’s shareholders. U.S. treaty commitments will be satisfied under the dividend exclusion proposal if foreign taxes paid on corporate income are credible against U.S. corporate taxes on that same income. There is no further treaty requirement that foreign taxes paid factor into the EDA [Economic Development Administration] calculation to shield shareholders from U.S. taxation on dividends paid out of the foreign-source income.” (footnote omitted)); Wells, *supra* note 29, at 28 (“[A] good argument can be made that the shareholder withholding tax imposed as part of a dividend paid deduction regime can be assessed at the full withholding rate without violating any US treaty obligations.”).

82. Martin A. Sullivan, *Economic Analysis: Corporate Integration Would Tilt Investment to the U.S.*, 150 TAX NOTES 739, 739 (2016).

the ultimate resolution of the availability of integration to bilateral treaty negotiations may not be practical due to the extensive number of tax treaties and the time involved in renegotiation. Moreover, exempt organizations are certain to provide fierce opposition to any proposal that would subject their previously exempt interest income to one level of tax.

Apart from the existence of the corporate tax, the second horizontal equity issue is the presence of over 120 business tax expenditures that are available only to certain taxpayers, thus producing varying effective tax rates depending upon the type of business activity.⁸³ These tax expenditures, when combined with the current law treatment of foreign income, make a mockery of the notion of horizontal equity. While the U.S. nominal corporate tax rate is 35%, the average effective tax rate (taxes divided by taxable income) of large corporations was estimated at 24% in 2013.⁸⁴ Moreover, the disparity in effective tax rates between multinational and domestic corporations is staggering.⁸⁵

Another aspect of equity is the extent to which taxpayers with different levels of income bear different tax burdens. This is called vertical equity. As noted above, the extensive use of the tax system to influence economic and social conduct greatly affects the vertical distribution of the tax burden.

3. Efficiency⁸⁶

The third consideration is efficiency. A normative tax system should be neutral with respect to economic decisions.⁸⁷ As noted in the preceding Section, the U.S. tax system is replete with provisions that are explicitly designed to influence economic and social decisions.⁸⁸

83. See Sullivan, *New Corporate Coalition*, *supra* note 31, at 1463–64 (showing the variation in effective tax rates among corporations resulting from the tax expenditures available to certain corporations); see also Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, § 3(a)(3), 88 Stat. 297, 299 (defining tax expenditures as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or deferral of a tax liability”); STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES, *supra* note 27, at 21–22 (“These IRS statistics show the actual usage of the various tax expenditure provisions. In the case of some tax expenditures, such as the earned income credit, there is evidence that some taxpayers are not claiming all of the benefits to which they are entitled, while others are filing claims that exceed their entitlements.”).

84. See Sullivan, *New Corporate Coalition*, *supra* note 31, at 1643; see also GOV'T ACCOUNTABILITY OFFICE, CORPORATE INCOME TAX: MOST LARGE PROFITABLE U.S. CORPORATIONS PAID TAX BUT EFFECTIVE TAX RATES DIFFERED SIGNIFICANTLY FROM THE STATUTORY RATE 13 (2016) (estimating the average effective tax rate at 16.1% in 2012); JANE G. GRAVELLE, CONG. RESEARCH SERV., R41743, INTERNATIONAL CORPORATE RATE COMPARISONS AND POLICY IMPLICATIONS 3 tbl.1 (2014) [hereinafter GRAVELLE, CONG. RESEARCH SERV., R41743, INTERNATIONAL] (estimating that the average effective tax rate of U.S. corporations was 27.1% in 2008).

85. See Martin A. Sullivan, *Economic Analysis: Tax Reform Goals Differ for Corporate Coalitions*, 134 TAX NOTES 1481, 1481 (2012).

86. See STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., BACKGROUND ON BUSINESS TAX REFORM, *supra* note 25, at 46–51.

87. Extraordinary circumstances, such as market failures, could justify tax intervention.

88. The tax system has increasingly been used in this way, often to avoid the congressional

4. Administrability

The fourth consideration is administrability, a goal that conflicts with the use of the tax system to accomplish nontax objectives. It is difficult enough to draft administrable provisions to measure income accurately—for example, determining what is a capital expense and the period of time over which the cost of a capital expense should be recovered.⁸⁹ Complexity and administrative difficulty increase exponentially when one adds provisions designed to influence conduct or economic decision making.⁹⁰

5. Competitiveness⁹¹

The fifth consideration is competitiveness, a very slippery concept.⁹² The term has different meanings for different constituencies, but the most common are multinational competitiveness, trade competitiveness (measured by the trade deficit), and standard of living competitiveness. Most economists measure

authorization and appropriation process, and generally without any significant cost-benefit or distributional analysis.

89. A capital expense is an expense that will produce income over more than one accounting period. The cost of a capital expense should be recovered in accordance with the income stream it produces. The former is not always obvious and the latter is difficult to determine. *Deducting Business Expenses*, IRS, http://www.irs.gov/publications/p535/ch01.html#en_US_2015_publink1000208608 (last visited Feb. 15, 2017) [<http://perma.cc/F62L-EFS4>].

90. The research and experimentation credit in I.R.C. § 41 is an example of a provision meant to influence conduct. See I.R.C. § 41 (2015). The credit is available for 20% of the taxpayer's qualified research expenses that exceed the base amount. § 41(a)(1). Coming to this amount requires coming to several legal and arithmetic conclusions. First, the taxpayer must calculate a base amount by finding the ratio of research expenditures to gross receipts for certain past taxable years, then multiplying this ratio by the taxpayer's gross receipts from the four previous taxable years. § 41(c). To calculate the proper ratio, the taxpayer must be sure that the research expenses meet the definition of qualified research expenses. See § 41(b). Moreover, the definition of qualified research expenses contains layers of definitions. For example, § 41 provides a credit for 20% of the taxpayer's qualified research expenses that exceed the base amount. § 41(a)(1)(A). The provision defines qualified research expenses as the sum of "in-house research expenses and "contract research expenses." § 41(b)(1). Next, "in-house research expenses" are defined by I.R.C. § 41 as, among others, the wages paid to an employee for "qualified services." § 41(b)(2)(A)(i). Section 41 proceeds to define "qualified services." § 41(b)(2)(B). A further component of this provision is that taxpayers may elect to determine their credit under an alternative incremental system or an alternative simplified system, each with their own formulas. § 41(c)(4), (5).

91. See generally STAFF OF JOINT COMM. ON TAXATION, 102D CONG., FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES 7–78 (Comm. Print 1991) [hereinafter STAFF OF JOINT COMM. ON TAXATION, 102D CONG., FACTORS]; STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND RECENT GLOBAL DEVELOPMENTS RELATED TO CROSS-BORDER TAXATION 35–45 (Comm. Print 2016) [hereinafter STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., PRESENT LAW]; Reuven S. Avi-Yonah & Nicola Sartori, *Foreword*, 65 TAX L. REV. 313, 314–21 (2012) (introducing the Symposium on International Taxation and Competitiveness, sponsored by the American Tax Policy Institute).

92. See Jane G. Gravelle, *Does the Concept of Competitiveness Have Meaning in Formulating Corporate Tax Policy*, 65 TAX L. REV. 323, 323 (2012) ("Yet it is a concept that is almost always simply asserted and virtually nowhere defined. Indeed, appeals to international competitiveness sometimes seem to be in a tail-biting exercise."); see also Reuven S. Avi-Yonah & Yaron Lahav, *The Effective Tax Rates of the Largest U.S. and EU Multinationals*, 65 TAX. L. REV. 375, 377 (2012) ("The competitiveness issue is primarily about the ability of the largest U.S. multinationals to compete with their counterparts based in other countries, and especially those based in the European Union. . . .").

competitiveness by comparing national standards of living.⁹³ But business entities prefer “multinational competitiveness,” a term that focuses on the ability of U.S.-based multinational corporations to compete in foreign markets.⁹⁴ Commentators advocating business interests vociferously assert that the current tax system creates a competitive disadvantage for domestic businesses when compared to the significantly lower tax burden borne by non-U.S. competitors,⁹⁵ and many of their claims have been uncritically accepted by politicians. In some respects, they are correct. But because so much of their argument regarding multinational competitiveness turns on their generally accepted assertions, those should be examined more carefully.

The first assertion is that the high U.S. rate creates a competitive disadvantage when compared with foreign tax rates. To be sure, the higher U.S. rate encourages movement of economic activity to lower-tax jurisdictions, but that does not mean that U.S.-based companies are disadvantaged. Indeed, because of U.S. companies’ ability to defer tax on income earned in those jurisdictions, they compete on a level playing field with foreign competitors. The high rate is, however, a driver of U.S. tax base erosion, which, as noted earlier, is a major policy concern. But base erosion does not equal noncompetition.

This is not to say that the high rate is irrelevant. The residual domestic taxation of offshore earnings plainly affects business decisions, particularly the extent to which a domestic corporation is willing to make an investment in a foreign market. Subjecting these offshore profits to residual U.S. taxation when a foreign competitor is not subject to home country taxation may be a competitive disadvantage.⁹⁶ The ability under current law to defer paying taxes on foreign

93. STAFF OF JOINT COMM. ON TAXATION, 102D CONG., FACTORS, *supra* note 91, at 3, 7–8, 11.

94. *Id.* at 8.

95. See Samuels, *supra* note 13, at 2–3 (“Simply put, as the business operations of U.S. companies have become more global, the tax stakes of having a U.S. tax home have been raised. Today with more than 50 percent of their income and most of their future growth coming from outside the United States, U.S. companies have a lot more to gain by relocating their headquarters to a foreign country with a more hospitable tax regime. And conversely, they have a lot more to lose by remaining in the United States and having their growing global income swept into the worldwide U.S. tax net and taxed at the 35 percent U.S. corporate rate.”); see also *First in a Series of Hearings on Fundamental Tax Reform Before the H. Comm. on Ways & Means*, 112th Cong. 3 (2011) (statement of Robert McDonald, Chairman, Fiscal Policy Bus. Roundtable) (“The tilted playing field created by the U.S. tax system hurts the competitiveness of American companies in the world’s markets both at home and abroad. Diminished sales around the world directly reduce U.S. exports of goods and services, along with investment and jobs in the United States. High taxes imposed on American companies that bring foreign earnings back to the United States discourage use of these funds to expand U.S. operations. And a high U.S. corporate tax rate on domestic profits discourages investment here in America by both U.S.-based companies and foreign-based companies. The highest price paid for the uncompetitive U.S. corporate tax system is paid by the American worker.”).

96. STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., PRESENT LAW, *supra* note 91, at 43–44 (“[C]onsider a U.S. corporation and foreign corporation that both require an after-tax rate of return of 10[%] on the investments they pursue in a given market outside their home country, which is assumed to have a tax rate of 20[%]. If the earnings of the foreign corporation are exempt from home-country tax, this means that it will pursue investments that yield a required pre-tax rate of return of 12.5[%]. In contrast, the U.S. corporation’s required pre-tax rate of return may be greater than 12.5[%], even

earnings reduces the competitive disadvantage. Moreover, to the extent that the U.S. tax is fully offset by foreign tax credits, there is no competitive disadvantage.

The second claim is that the U.S. system of worldwide taxation coupled with deferral of tax on unrepatriated foreign earnings creates competitive disadvantages and is out of step with the way foreign countries tax the offshore income of their domestic businesses. It is certainly true that Organization for Economic Cooperation and Development (OECD) countries have increasingly adopted some form of exemption system for the taxation of foreign source income.⁹⁷ The U.S. system that discourages the repatriation of offshore earnings cannot be defended. However, the culprit may be the rate and not the structure by which foreign income is taxed.

Finally, to the extent competitiveness is measured by comparing effective tax rates, U.S. multinational corporations are not disadvantaged.⁹⁸ Indeed, by this measure, “there is scant evidence that U.S. multinational firms have a competitiveness problem.”⁹⁹

IV. REFORMS

A. *Assessment of the U.S. System*

Here is what the Obama administration had to say in 2012:

The United States has a relatively narrow corporate tax base compared to other countries—a tax base reduced by loopholes, tax expenditures, and tax planning. This is combined with a statutory corporate tax rate that will soon be the highest among advanced countries. As a result of this combination of a relatively narrow tax base and a high statutory

though it can defer paying residual U.S. tax on its earnings, because it cannot reduce the present value of its U.S. residual tax liability below zero in the absence of cross-crediting. Therefore, the U.S. corporation may forgo investments—such as expansion of its manufacturing facilities or acquisitions of local companies—that it would have pursued if its returns were not subject to U.S. taxation. This may make it more difficult for the U.S. corporation to gain market share relative to the foreign corporation, and also may have an indirect, negative effect on employment and economic growth in the United States to the extent that a U.S. company’s success overseas translates into increased domestic investment and employment. However, if the U.S. corporation is able to fully offset the residual U.S. tax liability on its earnings with credits allowed for income taxes paid in another jurisdiction, it would not be at a competitive tax disadvantage relative to the foreign corporation.” (footnote omitted).

97. *Id.* at 42–43 (noting that fifteen OECD countries have adopted an exemption system since 2000).

98. GRAVELLE, CONG. RESEARCH SERV., R41743, INTERNATIONAL, *supra* note 84, at 3 tbl.1 (2014) (finding that the effective tax rate on U.S. corporations, at 27.1%, is slightly lower than the average effective tax rate on corporations from the rest of the OECD, which is 27.7%); Avi-Yonah & Lahav, *supra* note 92, at 381 (finding that the effective tax rates on European corporations were higher between 2001 and 2010 than the effective tax rates on U.S. corporations).

99. CLAUSING, *supra* note 30, at 7, 19 (“Corporate profits as a share of U.S. gross domestic product during 2012–2014 period were as high as any point since the 1960s. The United States is home to a disproportionate share of the Forbes Global 2000 list of the world’s most important corporations.” (footnote omitted)).

tax rate, the U.S. tax system is uncompetitive and inefficient. The system distorts choices such as where to produce, what to invest in, how to finance a business, and what business form to use. And it does too little to encourage job creation and investment in the United States while allowing firms to benefit from incentives to locate production and shift profits overseas. The system is also too complicated—especially for America’s small businesses.¹⁰⁰

B. Alternatives

We have seen many reform proposals over the last five years. The Obama administration proposed a vague Framework for Business Tax Reform in 2012 and reformulated it in 2016.¹⁰¹ Dave Camp, former Chairman of the House Ways and Means Committee, introduced a comprehensive detailed tax reform proposal in 2014.¹⁰² The Simpson-Bowles Commission¹⁰³ and the Domenici-Rivlin Task Force¹⁰⁴ produced reports and proposed tax reform plans in 2010. Reform proposals agree that the corporate rate should be reduced and business tax expenditures scaled back or eliminated.¹⁰⁵ Unlike the other proposals, the Domenici-Rivlin report proposed a VAT.¹⁰⁶ The proposals differed as to whether and the extent to which foreign income should be taxed on either a worldwide or territorial basis.¹⁰⁷

As noted earlier, House Republicans have recently proposed a reduced corporate income tax rate of 20%, a border-adjustable business tax structure that allows expensing of capital investments other than real estate, a territorial system for taxation of offshore income, and a reduced tax rate for the repatriation of offshore earnings.¹⁰⁸ During his campaign, President Trump proposed a reduced corporate tax rate of 15%, elective expensing, and current taxation of worldwide income at a 15% rate.¹⁰⁹

100. See PRESIDENT’S FRAMEWORK, *supra* note 4, at 1–2.

101. PRESIDENT’S FRAMEWORK: AN UPDATE, *supra* note 4, at 2–3.

102. Tax Reform Act of 2014, H.R. 1, 113th Cong. (2014) (detailing proposed tax reforms for individuals, businesses, foreign income, and excise taxes).

103. NAT’L COMM’N ON FISCAL RESPONSIBILITY & REFORM, *supra* note 7.

104. DOMENICI & RIVLIN, *supra* note 7.

105. See BIPARTISAN POLICY CTR., RESTORING AMERICA’S FUTURE 17, 30 (2010) (recommending a cut to the corporate tax rate and to eliminate most tax expenditures); NAT’L COMM’N ON FISCAL RESPONSIBILITY & REFORM, *supra* note 7, at 32–33 (recommending the establishment of a corporate tax rate capped below the current maximum rate and the elimination of all tax expenditures for businesses).

106. BIPARTISAN POLICY CTR., *supra* note 105, at 38–43.

107. Compare *id.* at 128 n.90 (“The Task Force plan leaves in place the provision that allows U.S. multinationals to defer taxation of the profits of their foreign subsidiaries until those profits are repatriated to the U.S. parent.”), with NAT’L COMM’N ON FISCAL RESPONSIBILITY & REFORM, *supra* note 7, at 29–30 (“A territorial tax system should be adopted to help put the U.S. system in line with other countries, leveling the playing field.”). See also BIPARTISAN POLICY CTR., *supra* note 105, at 28.

108. See A BETTER WAY, *supra* note 9, at 23–29. The Republican plan is similar to the proposals made in PRESIDENT’S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA’S TAX SYSTEM (2005).

109. See *supra* note 19, and accompanying text.

C. *Why They Have Failed*

None of the pre-2016 proposals gained traction. *The fundamental problem with all of them is that they are half measures.* For example, reducing the corporate rate to 25%, even if that were politically possible, is not sufficient to address the foreign tax rate differential. If the average effective tax rate on foreign income is roughly 16%,¹¹⁰ there will continue to be a rate and transfer pricing incentive to move profits abroad. As discussed below, a switch to a territorial system does not eliminate those problems.¹¹¹ Moreover, a worldwide system with current taxation of 25% applied to all corporate earnings would not be acceptable to a large share of the corporate community. Additionally, solutions focused on the taxation of foreign income fail to address the tax expenditure issues that were identified earlier and that produce disparate effective corporate tax rates.¹¹²

V. PROPOSAL

A. *A More Comprehensive Goal*

A more comprehensive goal is to devise a system that directly addresses the rate, base, and foreign income issues. Assuming that integration is not feasible,¹¹³ a reduction of the corporate rate to 15% (without even addressing base issues) would be salutary. First, it would promote direct foreign investment. Second, assuming a 16% average effective tax rate on foreign income, there will, on average, be no tax incentive to shift income overseas. Admittedly, there will be foreign jurisdictions in which the business tax rate is less than 15%, and depending upon how the United States taxed the income earned in those jurisdictions, there could be a residual advantage to moving income to those jurisdictions. That advantage could be eliminated straightforwardly in one of two ways: either by adopting a worldwide system pursuant to which all worldwide earnings are subject to current U.S. tax at 15% with a tax credit of up to 15% for foreign taxed earnings, or by establishing a territorial system with a 15% minimum tax on foreign income. Either should be acceptable. Both systems result in an important derivative benefit: because there would be no U.S. tax benefit to income shifting, troublesome transfer pricing issues would be eliminated from a U.S. perspective.¹¹⁴ However, in the absence of a minimum

110. See Harry Grubert, *Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized*, 65 NAT'L TAX J. 247, 281 tbl.B1 (2012) (finding that the average effective tax rate on foreign income is 15.86%).

111. See *infra* note 115 and accompanying text for a discussion of a territorial system.

112. See *supra* notes 53–85 and accompanying text for a discussion of horizontal equity.

113. See McNulty, *supra* note 74, at 329–30 (“Integration in the United States would be desirable. Research and studies have shown that the theoretically optimal method of taxing corporate-sector earnings would be to tax them on a pass-through, partnership or Subchapter S approach. . . . However, there are important practical and administrative problems with this approach when applied to widely-held corporations, and those problems have not yet fully been solved.” (footnote omitted)).

114. Foreign jurisdictions will still be concerned about the allocation of income. Thus,

tax, a pure territorial system—in which the active income is taxed at the source—would require robust anti-avoidance rules, the absence of which would retain incentives to shift income to low-tax jurisdictions through aggressive transfer pricing.¹¹⁵

At a 15% rate, the distortions introduced by business tax expenditures and double taxation would not be as severe. This is not to say that base distortions should not be addressed. They should. But, if a rate reduction to 15% could be financed and implemented, the tensions surrounding the elimination of tax expenditures would be mitigated.

B. *Financing the Structure*

The obvious way to finance business tax reform is to adopt the revenue source that the rest of the world has used to finance the very tax structure that the corporate world says it wants.¹¹⁶ More than 160 countries, including thirty-three of the thirty-four OECD members, have adopted a credit-invoice VAT.¹¹⁷ In those countries, consumption taxes—including the VAT—generally account for one-fifth of tax revenue.¹¹⁸ However, it is not enough to propose a VAT just because the rest of the world has done it. A major shift in traditional revenue sources requires rigorous substantive vetting, not to mention a massive educational campaign. So, let us start by asking why we should tax consumption.

companies would continue to expect transfer-pricing challenges.

115. See Kleinbard, *Throw*, *supra* note 47, at 547 (“[T]erritorial income tax proposals are a terrible idea. Once the actual implementing rules of a realistic territorial tax system are understood, territoriality cannot be recommended, even on the grounds advanced by that idea’s proponents.”); see also Mihir A. Desai, *The Trump-Obama Corporate Tax Reform Fail*, WALL ST. J. (Mar. 6, 2016, 6:32 PM), <http://www.wsj.com/articles/the-trump-obama-corporate-tax-reform-fail-1457307126> [<http://perma.cc/8HEA-SRS5>] (“Unfortunately, recent reform proposals have a serious flaw: a ‘minimum tax’ on foreign business income.”); Samuels, *supra* note 13 (“[U]nder some tax reform proposals that have been put forward U.S. companies would be required to pay an immediate ‘minimum tax’ on the active business income they earn outside the United States—a tax that would clearly be out-of-line with international tax norms.”). However, just because other countries do not have a minimum tax or strong base erosion principles does not mean we should abstain. There is no need to contribute to the race to the bottom. Adopting a “toothless” territorial regime will promote base erosion. CLAUSING, *supra* note 30, at 8 (“But reforms that address competitiveness worries—such as the ‘toothless territorial’ system that many in the multinational business community favor—would make the tax base erosion problem far worse.”); see also Michael J. Graetz & Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 NAT’L TAX J. 771, 771–73 (2001) (“Foreign tax credit systems are frequently said to implement ‘worldwide’ taxation or a ‘universality’ principle, while exemption systems are described as ‘territorial’ taxation. . . . Our analysis illustrates that shifting to an exemption system might well afford an opportunity to simplify U.S. international income tax law, but only if simplification is made a priority in enacting such a change. Our discussion here also points to potential simplification of the rules governing international taxation of business, whether or not exemption is enacted.” (citation omitted)).

116. See *infra* notes 183–206 for a discussion of political aspects of the tax reform debate.

117. ORG. FOR ECON. COOPERATION & DEV., *supra* note 34, at 16, 18.

118. *Revenue Statistics—Tax Structures*, ORG. FOR ECON. COOPERATION & DEV., <http://www.oecd.org/tax/tax-policy/revenue-statistics-tax-structures.htm> [<http://perma.cc/E79X-QU9M>] (“General consumption taxes presently produce 20% of total tax revenue . . .”).

C. *Why Tax Consumption?*¹¹⁹

Consumption equals income minus savings ($C=I-S$).¹²⁰ Thus, in a consumption tax, savings—or in the case of business, capital investments—are currently deducted. The result of this deduction, commonly called “expensing,” is to exempt the new investment’s normal rate of return from taxation.¹²¹ It is this feature that makes a consumption tax more economically efficient than an income tax. The removal of the tax wedge on new investment increases the after-tax rate of return relative to an income tax and should therefore induce more investment than a comparable income tax.¹²² Additionally, a consumption tax weighs neutrally on the choice between whether to save or consume, as compared to an income tax, which penalizes saving.¹²³ Further, a broad-based consumption tax should not distort relative prices among consumer goods.¹²⁴ Economists also assert that a consumption tax has a neutral effect on trade so long as the tax is destination-based—that is, not imposed on exports and is imposed on imports.¹²⁵ Finally, there is no persuasive evidence that the

119. See, e.g., STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., BACKGROUND ON CASH-FLOW AND CONSUMPTION-BASED APPROACHES TO TAXATION 2–4, 57–61 (Comm. Print 2016) [hereinafter STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., BACKGROUND ON CASH-FLOW] (“One common concern about the current income tax system is its complexity. The complexity leads to the use of resources in order to learn the rules of the tax and to prepare returns for the Federal government’s collection of the tax. A purported benefit of replacing the current income tax with a consumption tax is that the latter is simpler and requires fewer resources to collect the same amount of revenue.”); Alan D. Viard, *The VAT: Coming Soon to a Campaign Stop near You*, 150 TAX NOTES 719, 719 (2016) [hereinafter Viard, *The VAT*] (“Although VATs and other consumption taxes have the same work disincentives as income taxes, they avoid the saving and investment disincentives that are built into income taxes.”).

120. ALAN D. VIARD, FUNDAMENTAL TAX REFORM: A COMPARISON OF THREE OPTIONS 2 (2015) [hereinafter VIARD, FUNDAMENTAL TAX REFORM].

121. See Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1601–09 (1979); see also Alvin C. Warren, Jr., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax* 88 HARV. L. REV. 931, 931 (1975); David A. Weisbach, *The (Non) Taxation of Risk*, 58 TAX L. REV. 1, 29–30 (2005); David A. Weisbach & Joseph Bankman, *The Superiority of an Ideal Consumption Tax*, 58 STAN. L. REV. 1413, 1455 (2006).

122. See Lawrence H. Summers, *The After-Tax Rate of Return Affects Private Savings*, 74 AM. ECON. REV. 249, 249 (1984) (“Both the theoretical analysis and the empirical work demonstrate the strong likelihood that increases in the real after-tax rate of return received by savers would lead to substantial increases in long-run capital accumulation.”). *But see* Irwin Friend & Joel Hasbrouck, *Saving and After-Tax Rates of Return*, 65 REV. OF ECON. & STAT. 537, 537 (1983) (“[W]e have no sound basis for alleging either a strong positive or negative after-tax rate of return effect on saving.”); Lily L. Batchelder, *Accounting for Behavioral Considerations in Business Tax Reform: The Case of Expensing* (January 24, 2017) (unpublished working paper), <http://ssrn.com/abstract=2904885> [<http://perma.cc/9QZW-H4Q4>].

123. DEP’T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 19 (1984) [hereinafter DEP’T OF THE TREASURY, TAX REFORM FOR FAIRNESS].

124. Gale & Harris, *supra* note 35, at 76.

125. See generally Alan Auerbach et al., *Destination-Based Cash Flow Taxation* (Saïd Bus. Sch. & Univ. of Oxford, Working Paper No. 17/01, 2017). This conclusion is counterintuitive to tax professionals not familiar with the economic literature. See ALAN J. AUERBACH & DOUGLAS HOLTZ-EAKIN, AM. ACTION FORUM, THE ROLE OF BORDER ADJUSTMENTS IN INTERNATIONAL TAXATION (2016), <http://www.amerianactionforum.org/wp-content/uploads/2016/11/The-Role-of-Border->

introduction of a consumption tax results in long-term inflation, a well-documented concern.¹²⁶

From a different perspective, a consumption tax is the equivalent of a tax on the normal rate of return on existing capital (exempting income from new investment because it is treated as an expense) plus a tax on wages and super returns from new investment.¹²⁷ To the extent that the consumption tax burden falls on wages, the tax “reduces the amount of current or future consumption that an individual can obtain by giving up leisure”—thus influencing work-leisure choices.¹²⁸ In this regard, it does not differ significantly from an income tax.

The introduction of a consumption tax has distributional consequences that are difficult to quantify precisely.¹²⁹ While the conventional wisdom has been that the economic burden of consumption falls on consumers, more recent analysis suggests a more complicated picture.¹³⁰ The imposition of a

Adjustments-in-International-Taxation.pdf [http://perma.cc/W5J2-4KT2]; STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., BACKGROUND ON CASH-FLOW, *supra* note 119, at 51–53. Moreover, neutrality may depend upon the form of the consumption tax. Border adjustments as part of a business cash flow tax with a wage deduction (one form of consumption taxation) such as that proposed in the Republican *A Better Way* proposal, could subsidize exports and penalize imports. Martin A. Sullivan, *Economic Analysis: Unlike VAT, Cash Flow Tax Helps Exports, Hit Imports*, 154 TAX NOTES 187, 188–89 (2017). However, the trade effects are likely to be small. Martin A. Sullivan, *Economic Analysis: Cash Flow Tax and Trade: Small Effects Likely*, 125 TAX NOTES 297, 298 (2017). Moreover, the more significant question may be whether a destination-based cash flow is compliant with WTO rules prohibiting trade subsidies and penalties.

126. Alan A. Tait, *VAT Policy Issues: Structure, Regressivity, Inflation, and Exports*, in VALUE-ADDED TAX: ADMINISTRATIVE AND POLICY ISSUES 1, 7–9 (Alan A. Tait ed., 1991); *see also* Alexander M. G. Gelardi, *Value Added Tax and Inflation: A Graphical and Statistical Analysis*, 6 ASIAN J. FIN. & ACCT. 138, 140 (2014) (“Few studies have examined the impact on inflation due to the introduction of a national retail consumption tax. . . . Esenwein and Gravelle (2004) in a Congressional Research Service paper stated that the introduction of a consumption tax would likely give a one-time price inflation to avoid an economic contraction. However, this is not certain.”); Alina Carare & Stephan Danniger, *Inflation Smoothing and the Modest Effect of VAT in Germany* 17 (Int’l Monetary Fund Working Paper, Paper No. WP/08/175, 2008), <http://www.imf.org/external/pubs/ft/wp/2008/wp08175.pdf> [http://perma.cc/2DHJ-4BGA] (“[T]he inflationary profile of a large tax hike is likely affected by the length of the announcement period. Price adjustment in advance of the VAT hike help smooth the inflation profile and thereby can avoid large spikes which create risks of triggering second round effects. The incentives for inflation smoothing also appear to be linked to the degree of intertemporal consumption shifting with items experiencing larger demand increases being affected more.”); Rob Pike et al., *Impact of VAT Reduction on the Consumer Price Indices*, 3 ECON. & LAB. MKT. REV. 17, 18 (2009) (“The article concludes that despite the difficulty in collecting price information the reduction in the quality of the inflation indicators is likely to be negligible.”).

127. VIARD, FUNDAMENTAL TAX REFORM, *supra* note 120, at 2. A super return is the excess of the return on investment over the normal return.

128. Viard, *The VAT*, *supra* note 119, at 722.

129. *See* ERIC TODER ET AL., USING A VAT TO REFORM THE INCOME TAX 21 (2012) (describing the Tax Policy Center’s model for measuring the VAT’s distributional effects, which is adapted from the model that measures the individual and corporate income tax).

130. STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., BACKGROUND ON CASH-FLOW, *supra* note 119, at 53, 57, 62–64; *see also* Robert Carroll & Alan D. Viard, *Value Added Tax: Basic Concepts and Unresolved Issues*, 126 TAX NOTES 1117, 1122 (2010) [hereinafter Carroll & Viard, *Value*

consumption tax will result in a one-time increase in the overall price level.¹³¹ The consequences of that price increase depend heavily on the response of the Federal Reserve (Fed). The economic burden of the tax will fall on equity holders to the extent of the business cash flow component of the tax and on wage earners to the extent it is the equivalent of a payroll tax. The one-time price increase will also reduce the real value of business debt, shifting part of the economic burden to debt holders.¹³² Fed intervention in the form of altering monetary policy to produce an increase in price level can mitigate these distributional consequences. If there is no response by the Fed, the consumption tax could be expected to result in economic contraction and the burden of the tax will fall on workers, on those who receive super returns on invested capital, and on those who owned capital when the tax was imposed. One thing is clear: it is incorrect to treat the burden of the consumption tax as falling solely on consumers.¹³³

The perceived economic benefits of a consumption tax must be viewed through an equity lens as well. As William G. Gale and Benjamin H. Harris have observed:

A substantial body of literature based on economic theory and simulation models documents the potential efficiency gains from substituting a broad-based consumption tax for an income tax. These gains arise from a combination of broadening the tax base, eliminating distortions in saving behavior, and imposing a one-time tax on existing wealth.¹³⁴

However, it is precisely these efficiency gains that give rise to equity concerns. The explicit exclusion of capital income from the consumption tax base means that the tax is imposed on wage earners and those who are dissaving—for example, retirees and borrowers. That is a political nonstarter. It would be difficult to explain to retirees why their savings—which have already been taxed through the income tax—would now be subject to tax when they consume.¹³⁵ To be viewed as fair, a consumption tax must be accompanied by a levy on income from capital investments in some form, either an income tax, a wealth tax, or both. No tax system in the world relies exclusively on consumption taxes.¹³⁶

Added Tax] (“Conventional analysis criticizes broad-based consumption taxes, such as a VAT, for being regressive, on the ground that low- and moderate-income households consume a larger share of their income and therefore bear a greater share of the tax burden than under an income tax. The conventional analysis overstates the difference between the two tax systems, however, because it assumes that owners of capital bear the full burden of the current corporate income tax.”).

131. See Alan D. Viard, *Tax Increases and the Price Level*, 142 TAX NOTES 115, 115 (2014) [hereinafter Viard, *Tax Increases*].

132. *Id.* at 125; Viard, *The VAT*, *supra* note 119, at 722.

133. See Viard, *The VAT*, *supra* note 119, at 722 (“Although some analyses treat the VAT burden as falling on consumers, that approach is unsound.”).

134. Gale & Harris, *supra* note 35, at 68 (citation omitted).

135. Transition relief for pre-enactment savings may be required.

136. See KYLE POMERLEAU, TAX FOUND., SOURCES OF GOVERNMENT REVENUE IN THE OECD, 2014, at 2 (2014), <http://taxfoundation.org/sites/default/files/docs/FF443.pdf> [<http://perma.cc/ZMZ5-DXTM>]; ORG. FOR ECON. COOPERATION & DEV., *supra* note 34, at 15 (“On

D. *How Are Consumption Taxes Structured?*

Consumption taxes come in many forms, but their common thread is that normal returns on capital investment are excluded from the base.¹³⁷ Either explicit exclusion of capital income or a deduction for investment can accomplish that result. So long as the tax rate remains constant, these two methods are equivalent. For example, a Roth Individual Retirement Account (IRA) and a Traditional IRA—which are consumption tax elements in our current income tax structure—are economically equivalent so long as tax rates do not change.¹³⁸

The most common form of consumption tax is a VAT, which is “a tax imposed and collected on the ‘value added’ at every stage in the production and distribution process of a good or service.”¹³⁹ Outside the United States, most countries rely on a credit-invoice VAT, with tax imposed on all sales and a credit for previously paid VAT provided to all purchasers in a supply chain other than final consumers.¹⁴⁰ Another form of VAT is a subtraction-method VAT, which is imposed on businesses, not transactions, and is determined on an accounts basis, based on the annual value of all sales less the annual value of all purchases.¹⁴¹ In the United States, the most familiar consumption tax is a retail sales tax, with tax only imposed upon retail purchases. Other variants include the Hall-Rabushka flat tax and the Bradford X tax, which combine a subtraction-method VAT with a deduction for wages, which are then taxed at the individual level.¹⁴² To constitute consumption taxes, these systems exclude capital gains, interest, dividends, rents, and royalties from the individual tax base. The Republican *A Better Way* proposal is a variant of the Bradford X tax.

There are significant noneconomic differences among the various ways a consumption tax is imposed, including administrability, enforcement,

average, consumption taxes produce 31% of the total tax revenue in the OECD member countries. In 2012, approximately two thirds of revenue from consumption taxes was attributable to taxes on general consumption and one third to taxes on specific goods and services.” (citations omitted)).

137. STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., BACKGROUND ON CASH-FLOW, *supra* note 119, at 36–39.

138. This is the “immediate deduction-yield exemption equivalence.” See Graetz, *supra* note 121, at 1598. It is demonstrated by the following example. Assume an income rate of 20%, an investment of \$100, and a yield of 10%. If the investment is not deductible, the after-tax cost is \$100, the pre-tax yield is \$10, and the after-tax yield is \$8. If the investment is deductible, the after-tax cost is \$80, and the after-tax yield is \$8. *Cf. id.* at 1603 (“Consider, for example, two 60% taxpayers, A and B, each with funds available for consumption of \$40, who desire to purchase an investment for \$100. A, choosing Immediate-Deduction, will receive tax savings of \$60 from the \$100 deduction. On sale for \$110, tax of \$66 will be due, leaving him with \$44, a 100 return. B chooses Yield-Exemption and borrows \$60, as he receives no financing from a tax deduction. Assuming a cost of borrowing of 10%, B keeps \$44 after receiving \$110 and paying the debt of \$66. But if B can borrow at 5%, he can keep \$47, thereby obtaining a greater return than A.”).

139. See STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., BACKGROUND ON CASH-FLOW, *supra* note 119, at 2.

140. Carroll & Viard, *Value Added Tax*, *supra* note 130, at 1117–18.

141. *Id.* at 1118–19.

142. VIARD, FUNDAMENTAL TAX REFORM, *supra* note 120, at 3–4.

transparency, and WTO compatibility.¹⁴³ For example, the business cash flow tax (which is a subtraction-method VAT) is calculated from corporate accounts. A credit-invoice VAT is calculated on individual transactions and is usually shown on sales invoices. As described below, the credit-invoice VAT is an easier system to police than a subtraction-method VAT. Moreover, the subtraction-method VAT lacks transparency. Its common description as a business tax confuses its economic substance—in other words, it can lead to the incorrect inference that its burden is borne entirely by business, when, as discussed above, workers bear the share of the consumption tax reflected by the nondeductibility of wages, and the balance is borne by capital and debt holders.¹⁴⁴ Unlike a credit-invoice VAT, a subtraction-method VAT would likely be administered in a way that would conceal it from the public.¹⁴⁵ Thus, because the tax is collected from businesses rather than shown to consumers, it is a “hidden tax” that would have the potential to hide the “true cost of government,”¹⁴⁶ an irony for proponents who denounce a credit-invoice VAT because it is a “cash cow.”¹⁴⁷

Another issue is whether a credit-invoice VAT is expressed as “tax-inclusive” or “tax-exclusive.”¹⁴⁸ This is a matter of transparency. While a tax-inclusive VAT quotes a total price to the purchaser that includes the VAT, the tax-exclusive VAT states the VAT separately.¹⁴⁹ Either is conceptually

143. See, e.g., STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., BACKGROUND ON CASH-FLOW, *supra* note 119, at 2, 34–35 (“This being the case, it is instructive to examine how a retail sales tax compares to a VAT in terms of administrability, compliance burden, and ease of implementation.”); Sullivan, *Border Adjustments*, *supra* note 17, at 306 (“But a business cash flow tax looks like and is collected like a direct tax on modified business income. Most scholars who have examined this issue believe that taxes similar to the cash flow tax in the blueprint are not likely to be compatible with WTO rules unless those rules are changed.”); Viard, *The VAT*, *supra* note 119, at 719 (“The biggest problem with the Cruz and Paul plans is their pronounced lack of tax transparency. The senators have consistently described their proposed levies as business taxes rather than VATs and have underplayed or denied the burden that the VATs would place on workers. Moreover, their proposed VATs would be largely invisible to the public because they would not be listed on customer receipts or pay stubs.”).

144. See Viard, *The VAT*, *supra* note 119, at 721–22 (“If the Federal Reserve does not increase the price level, the burden of a VAT should be viewed as falling on workers, recipients of above-normal returns on new investment, and holders of equity claims on the business capital in existence when the VAT is introduced. If the Fed increases the consumer price level, that description of the burden should be modified to reflect the losses to lenders and debt holders and the gains to borrowers and equity holders.”).

145. See *id.* at 724 (“The use of a hidden VAT could conceal the true cost of government and distort the public debate on the proper size of government.”).

146. *Id.*

147. See, e.g., Scott A. Hodge, *VATs—Even Cash Cows Have Their Limits*, TAX FOUND.: THE TAX POL’Y BLOG (July 25, 2011), <http://taxfoundation.org/blog/vats-even-cash-cows-have-their-limits> [<http://perma.cc/6CHL-VSU5>] (“To many Americans, VATs are ‘cash cows’ that generate huge amounts of tax revenues to fund Europe’s generous social welfare programs.”). The business cash flow tax is the economic equivalent of a VAT, but that equivalence is hidden because it is imposed on business. Thus, it could be politically easier to increase the business cash flow tax rate (by claiming it is a tax on business) than the rate on a comparable VAT.

148. See Viard, *Tax Increases*, *supra* note 131, at 123–25.

149. Viard, *The VAT*, *supra* note 119, at 720–21.

acceptable, but the latter is obviously more transparent.

Finally, there is the issue of WTO compatibility. Most credit-invoice VATs are “destination-based.” In other words, they are implemented through “border-tax adjustment mechanisms.”¹⁵⁰ VAT is charged on imports but not exports. Border adjustments are recognized as an important factor in reducing base erosion incentives.¹⁵¹ However, while there is no question that a border adjustable credit-invoice VAT is compatible with WTO rules regarding export subsidies and import penalties, the situation with regard to border adjustable business cash flow taxes, such as that proposed in the Republican *A Better Way* proposal, is much less clear.¹⁵²

*E. How Does a Credit-Invoice VAT Work?*¹⁵³

This Part provides context as to how a credit-invoice VAT operates. It is reprinted with minor changes from the author’s previous article, *Cardin’s Key to the Tax Kingdom*.¹⁵⁴

The following are key features of a modern VAT:

- It is a tax on final consumption. In this respect, it is similar to a retail sales tax.
- It is a multistage transaction tax that is levied at each stage of the supply chain.
- It is not a tax on business. Businesses act as collection agents.
- It is broad based and applies to virtually all goods and services.
- It adopts the “destination principle,” under which exports are not subject to VAT and imports are.¹⁵⁵

Here is how it works. Each seller in the supply chain charges VAT on a sale and gives the purchaser (other than a final consumer) an invoice that shows how much tax has been charged. Except for a sale to a final consumer, a credit may subsequently be claimed for the amount of tax shown on the invoice when the purchaser sells the product.

To illustrate, assuming a VAT rate of 10%, manufacturer A sells a widget to wholesaler B for \$100. Manufacturer A collects \$110, remits \$10 to the tax

150. See Harley Duncan & Jon Sedon, *Coordinating a Federal VAT with State and Local Taxes*, 127 TAX NOTES 1029, 1031–32 (2010).

151. Alan J. Auerbach & Michael P. Devereux, *Cash Flow Taxes in an International Setting* (Saïd Business School, Research Paper No. RP 2015-3, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2556892 [<http://perma.cc/PK67-N67S>].

152. See Sullivan, *Border Adjustments*, *supra* note 17, at 306.

153. See generally KPMG, COMMONWEALTH OF PUERTO RICO TAX REFORM ASSESSMENT PROJECT, UNIFIED TAX CODE OF PUERTO RICO: TAX POLICY IMPLEMENTATION OPTIONS GENERAL EXPLANATION OF PRINCIPAL OPTIONS 1–13 (2014) (proposing a credit-invoice VAT for Puerto Rico, and explaining the benefits and how it would function); DEPARTAMENTO DE HACIENDA DE PUERTO RICO, <http://www.hacienda.gobierno.pr/> (last visited Feb. 15, 2017) [<http://perma.cc/7Z4Z-VU2D>]. The author was the KPMG Engagement Partner with respect to this project.

154. Gutman, *Cardin’s Key*, *supra* note 12 (copyright 2015 Tax Analysts, reprinted with permission).

155. *Id.* at 344.

authority and gives wholesaler B an invoice that reflects the \$10 tax. Wholesaler B sells the widget to retailer C for \$150. Wholesaler B remits \$5 to the tax authority, calculated as the \$15 VAT on the sale to retailer C minus the \$10 paid by manufacturer A. Wholesaler B gives retailer C an invoice that shows \$15 in previously collected tax. Retailer C sells the widget to customer D for \$200, and remits \$5 to the tax authority—the \$20 VAT on the sale to D minus previously paid VAT of \$15. The VAT-inclusive price to customer D is \$220, which is exactly the same as a 10% retail sales tax, though it has been collected in three stages through the supply chain.

It is precisely the method of collection that makes the credit-invoice VAT the preferred method of imposing a consumption tax. The use of an invoice to establish a right to a tax credit is a critical element in VAT design and creates an audit trail that is unavailable in either a retail sales or business cash flow tax.

Some goods and services pose special problems in a VAT.¹⁵⁶ The most common are financial services, residential housing, goods and services provided by government entities and nonprofit organizations, and the application of the tax to small business.¹⁵⁷ Problematic goods and services are generally dealt with by removing them from VAT.¹⁵⁸ There are two ways that this can be done. One is to exempt the transaction from VAT. The alternative is to zero-rate the transaction.¹⁵⁹ These methods have very different consequences, and it is important to understand the difference.

1. Exemption¹⁶⁰

In VAT parlance, when an item is exempt from VAT, the purchaser pays no VAT on the purchase, but the seller is not entitled to a credit for the input tax paid by previous sellers in the chain. In other words, the only element of the chain not subject to tax is the value added at the exempt stage of the supply chain. VAT exemption is the one situation in which the VAT becomes a cost to the business.

Moreover, exemption has other consequences. If exemption occurs above the final transaction in the supply chain, a cascading of the tax occurs. The total tax on the supply chain exceeds the tax that would be collected if the entire supply chain were subject to VAT.¹⁶¹

156. *Id.* at 345.

157. *Id.*; *see, e.g.*, DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, *supra* note 123, at 39–42 (discussing structural issues, including “the distinction between zero rating and exemption; the alternatives for reducing the absolute burden on the poor and regressivity; the choice between single or multiple rates of tax; and the tax treatment of exports and imports”).

158. Gutman, *Cardin's Key*, *supra* note 12, at 345; *see also* Charles E. McClure, Jr., *State and Local Implications of a Federal Value-Added Tax*, 38 TAX NOTES 1517, 1531 (1988).

159. Gutman, *Cardin's Key*, *supra* note 12, at 345; *see also* McClure, *supra* note 158, at 1531–32 (comparing the impact of exemption and zero-rating under credit-invoice VAT).

160. Gutman, *Cardin's Key*, *supra* note 12, at 345.

161. *See* Carroll & Viard, *Value Added Tax*, *supra* note 130, at 1119–20 (comparing the effects of exemptions under subtraction-method and credit-invoice VAT). Assume a 10% VAT rate. A sells X to B for \$100. The VAT is 10% and is paid to the government. B makes a final sale to C, an exempt

2. Zero-Rating¹⁶²

The other method of removing a transaction from VAT is to zero-rate it. Quite simply, this means that the transaction is subject to VAT at a zero rate, which still affords the seller a credit for the previously paid VAT.¹⁶³ This treatment effectively removes the entire supply chain from the VAT.¹⁶⁴ Consequently, it is more expensive to the government than an exemption. While this treatment is applied to exports to ensure that they bear no VAT, it is a problematic way to deal with other difficult items not only because of its cost, but also because it amounts to a subsidy for the zero-rated sale.¹⁶⁵ While tax expenditures can be used to provide a subsidy,¹⁶⁶ it would be better to identify the need and provide a targeted direct subsidy.¹⁶⁷

The following discusses the issues raised by problematic goods and services.

3. Financial Services¹⁶⁸

Financial services are a problem because it is difficult to identify the base upon which the tax should be levied. The value of financial intermediation is usually included in the interest rate and is difficult to determine on a transaction-by-transaction basis. Extracting the value of the service element is problematic.

Setting valuation aside, a VAT is a tax on goods and services, whereas returns on savings compensate for the time value of money and should not be included in a consumption tax base until those returns are applied to the purchase of goods or services.

entity for \$200. There is no VAT on the sale, but C does not get a credit for the VAT paid by B. The government collects 10% in total tax as compared to 20% if there were no exemption. Assume further that C sells to D for \$300. The VAT of 30% is due on the sale, but D gets no credit for paying the prior VAT. The total tax paid is 40% compared to 30% if there were no exempt entity in the chain. The latter example illustrates “cascading.” See *id.* at 1118 (defining cascading as “multiple taxation of the same final consumption item”).

162. Gutman, *Cardin's Key*, *supra* note 12, at 346.

163. Walter Hellerstein & Harley Duncan, *VAT Exemptions: Principles and Practice*, 128 TAX NOTES 989, 991 (2010).

164. Assume a 10% VAT. A sells X to B for \$200. The VAT of 20% is collected. B sells X to C for \$250, but the sale is “zero-rated.” See McClure, *supra* note 158, at 1531. There is no VAT on the sale, and C gets a credit of \$20, which could be refunded from the government. As a result, the net government revenue is \$0 as compared to \$25 if there were no zero-rating in the transactions.

165. See Graetz, *supra* note 121, at 1659–60; Hellerstein & Duncan, *supra* note 163, at 998–99.

166. See *Policy Basics: Federal Tax Expenditures*, CTR. ON BUDGET AND POL'Y PRIORITIES, <http://www.cbpp.org/research/federal-tax/policy-basics-federal-tax-expenditures> (updated Feb. 23, 2016) [<http://perma.cc/DTS9-77T9>] (“Tax expenditures’ are subsidies delivered through the tax code as deductions, exclusions, and other tax preferences. Tax expenditures reduce the amount of tax that households or corporations owe.”); Sullivan, *New Corporate Coalition*, *supra* note 31, at 1463 (demonstrating that tax expenditures impact the effective tax rates of companies).

167. See Hellerstein & Duncan, *supra* note 163, at 999.

168. Gutman, *Cardin's Key*, *supra* note 12, at 346.

4. Residential Housing¹⁶⁹

The taxation of residential housing is also problematic. One difficulty is determining the imputed rental value of owner-occupied housing—an amount that, if determinable, should be subject to tax. The second problem is the compliance and administrative burden associated with requiring all owner-occupants to register and account for the VAT. While rental and leasing contracts are easier to tax because an arms-length transaction establishes a value, a difference in treatment between buying and renting would distort consumers' decision to do one or the other.¹⁷⁰ As a result, most jurisdictions exempt the value associated with occupying residential real estate. Thus, the cost of a landlord's inputs cannot be recovered and may well be passed to tenants in the form of higher rents. Jurisdictions vary in their treatment of the purchase of residential housing.

5. Government and Nonprofit Activities¹⁷¹

The VAT treatment of government activities presents a particular challenge because of the diverse nature of goods and services supplied by those entities. These activities vary from collecting income for redistribution purposes to supplying goods and services that are in competition with the private sector. However, unlike the private sector, government bodies generally perform these activities not for their own profit, but for the common good, and the income derived is usually used to finance those activities or other government functions. Therefore, subjecting activities performed by government bodies to VAT seems, in principle, unfair because it would increase the cost of the goods and services provided by government entities.

A common approach globally is to treat goods and services provided by public bodies that are in competition with private businesses as subject to VAT in order to ensure a level playing field with the private sector. Goods and services provided by public bodies in a noncommercial context are generally considered outside the scope of VAT.

However, there are several difficulties with this approach. First, when countries decide to tax only those activities that are in competition with the private sector, issues arise in determining which activities and under which circumstances those activities should be considered “in competition” and thus taxable.

Second, when public bodies provide both taxable and nontaxable services, tax credit apportionment issues can arise. VAT should be recovered only to the

169. *Id.* at 347.

170. See Graetz, *supra* note 121, at 1622–23 (“The ultimate outcome might well be to exclude from the expenditure tax base most taxpayers’ housing costs. Such a scheme would have two undesirable consequences. It would misallocate resources by encouraging taxpayers to overconsume housing relative to other taxable forms of consumption; and it would create inequities since the deductions and exclusions that would likely be enacted would tend to be of greater value to persons in higher tax brackets.”).

171. Gutman, *Cardin’s Key*, *supra* note 12, at 348.

extent it has been incurred for the purpose of making taxable supplies (supplies subject to VAT). Businesses making both taxable and exempt supplies need to allocate VAT into one of the following three categories:

1. VAT incurred on expenses used for making taxable supplies (recoverable)
2. VAT incurred on expenses used for making exempt supplies (not recoverable)
3. VAT incurred on expenses used for making both taxable and exempt supplies (specified percentage recoverable)

The allocation of VAT into these categories can increase compliance costs significantly and give rise to complex disputes, particularly regarding the formulas used for calculating VAT recoverable under category three. Subjecting public bodies to full taxation promotes neutrality and simplicity.¹⁷² This means that VAT would be imposed on supplies both made by and for the government. In addition to the economic advantages, the full taxation model results in a simplification of the VAT and thus a reduction of administrative costs.¹⁷³

The inclusion of government bodies within the VAT regime will not result in those bodies bearing a tax burden. However, the inclusion of government bodies greatly simplifies the operation of the tax. Nonprofit organizations should also be subject to full taxation to avoid any distortion of competition with the for-profit sector.

6. Small Business¹⁷⁴

The issues posed by application of the VAT to small business revolve principally around administration and compliance. A properly designed VAT requires businesses to register with the tax administration to pay VAT on outputs and to claim refunds on inputs. Some assert that the compliance burden placed on small businesses, when coupled with the administrative cost of handling the return, tax payment, and refund requirements of the VAT system, exceed the revenue the VAT would generate. This problem can be addressed by exempting small businesses with, for example, gross receipts below a specified level. The exemption mechanism in this case would permit those companies to not register for VAT.

However, exempting small businesses from the system would create economic distortions. Businesses that sell to final consumers have to absorb the input VAT as a cost of goods sold and will likely pass that cost on to consumers. Therefore, if the exempt business were in the middle of the supply chain, tax cascading would occur.

The decision whether to exempt small business is not clear-cut. Most VATs

172. See, e.g., Pierre-Pascal Gendron, *How Should the United States Treat Government Entities, Nonprofit Organizations, and Other Tax-Exempt Bodies Under a VAT?*, 63 TAX L. REV. 447, 483–85 (2010).

173. *Id.* at 488–89.

174. Gutman, *Cardin's Key*, *supra* note 12, at 348.

do. However, in the United States, the case for exemption is not as strong as in other countries. Most state sales taxes require the registration of businesses regularly making sales as commercial establishments.¹⁷⁵ Thus, these businesses have already learned to keep adequate records. In any event, if an exemption regime is adopted, in order to eliminate cascading problems, small businesses should be given the option to register and become a part of the system.

7. Regressivity¹⁷⁶

The practical and political key to acceptance of a broad-based VAT is the provision of adequate relief from the regressive nature of the tax.¹⁷⁷ “Adequate” is not a self-defining term. The appropriate level of relief is a policy decision that is informed by a desired distribution of the tax burden. But no matter the ultimate outcome, it is generally agreed that some levels of household income (a policy decision determined by elected officials) should not bear tax on their purchase of necessities (also a policy decision determined by elected officials).¹⁷⁸

a. Relief Through Exemptions or Special Rates¹⁷⁹

Early VATs provided regressivity relief by exempting or applying a special rate to defined “necessities.”

Exemptions increase the cost of collection (administration costs for the government and compliance costs for businesses). There are frequent disputes over which goods and services are included in the tax base. Exemptions also create political pressure for other businesses/industries requesting exemption.

Exemptions may also affect business decisions. Under a [VAT], suppliers making exempt supplies cannot claim credits or refunds for [VAT] paid on their purchases. This creates an incentive to self-supply or vertically integrate rather than incur [VAT] charged by third-party suppliers. . . .

Exemptions relieve all purchasers [not just low-income taxpayers] from the burden of the tax and therefore can be costly from a revenue perspective. . . .

Finally, a business that makes both exempt and taxable supplies may need to make complex calculations to determine how much [VAT] it has paid on its purchases related to taxable supplies and can therefore be claimed as a credit or refund. . . .

175. See DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, *supra* note 123, at 61.

176. Gutman, *Cardin's Key*, *supra* note 12, at 348.

177. A VAT is regressive because the proportion of income taken by the tax decreases as income rises, so it more severely impacts individuals with lower incomes.

178. KPMG, *supra* note 153, at 7.

179. Gutman, *Cardin's Key*, *supra* note 12, at 349. See generally ORG. FOR ECON. COOPERATION & DEV., *supra* note 34, at 44–48 (2014) (“While standard rates of VAT have risen, the base to which these rates are applied has often remained unchanged and many OECD countries continue to apply a wide variety of VAT exemptions and reduced rates” (citations omitted)); Hellerstein & Duncan, *supra* note 163 (discussing the problems with VAT exemptions).

Rather than providing exemptions [for necessities], regressivity issues . . . should be addressed by cash transfer payments to a defined class of taxpayers to eliminate the tax burden associated with the purchase of those necessities. . . . Indeed, uniform application of the tax across all income levels should provide sufficient revenue to finance regressivity relief to the lowest income levels. . . .

New Zealand is a good example. The evidence available at the time of [VAT] introduction suggested that while the bottom 20% of households allocated between 23% and 29% of their budgets to food, the top two deciles spent between 7% and 10% of their budgets on food. However, overall, upper income households spent twice as much as low-income households. Of every NZ\$100 spent on food in New Zealand, the least well off spent NZ\$6.50, whereas the most wealthy spent NZ\$12. Thus, taxing all food made revenue available to redistribute and supplement the income of the poor.¹⁸⁰

b. Alternative Methods of Regressivity Relief

As an empirical matter, to the extent data exist by household income levels on consumption of specific items (such as food, housing, medicine, education), it is possible to mitigate the consumption tax burden rather precisely by a cash payment to the taxpayer. However, using a precise calculation requires an extensive monitoring system. The cash payment can either be a payment based on taxes paid on actual amounts spent by the taxpayer or calculated in bands using average consumption by income level. The distribution goals can be attained by adjusting the payment to those households. . . .

The question then arises as to how the relief is to be delivered and what systems exist to ensure that it is being delivered only to those entitled to receive it. The delivery system can be accomplished using one or some combination of the following:

- Direct disbursement to households;
- Tax credits; and
- Electronic Benefit Transfer System. . . .

Historically, payments have been in the form of checks or warrants. This system is more expensive than other options. The distribution of checks requires a mailing address which is problematic for some people in the lower socioeconomic strata. If a mailing address is not practical, it requires the taxpayer to physically go to a government location to obtain the check. Furthermore, the lower socioeconomic strata tend to be disproportionately underserved by the banking system, which results in high fees paid to check cashing establishments. Thus, this disbursement option tends to be costly to administer and inconvenient to the taxpayer, and may provide a lower net benefit to the taxpayer. . . .

180. KPMG, *supra* note 153, at 6; Ian Dickson & David White, Tax Design Insights from the New Zealand Goods and Services Tax (GST) Model 6 (Victoria University of Wellington, Working Paper No. 60, 2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2046352 [<http://perma.cc/2GBU-9D6U>].

A second option . . . is to provide a tax credit. This can be done either by using the income tax system or at point of sale for consumption taxes. Using the income tax as a basis for the payments is generally done on an annual basis. The delay in relief for most recipients would require them to pay the tax and wait for up to a year for reimbursement. The same delay would occur if the credit were refundable. Thus, this method would not provide timely relief.¹⁸¹

Moreover, there are serious compliance problems associated with using the current U.S. income tax system as a delivery mechanism. A more promising option is the use of electronic funds transfers. Benefit payments are increasingly done using an electronic benefit transfer (EBT) system or card.

The EBT cards are less costly to administer (prepare, distribute, and account for), provide timely benefits through online management and provide increased ability to track, control and potentially monitor usage. An [EBT] system can also increase and standardize customer service by reducing the taxpayers need to interact within the limited operating hours . . . and finite number of locations. The EBT cards and potential increased customer service hours assist taxpayers by limiting the interference with their workplace requirements.¹⁸²

In all cases, however, a compliance system to monitor income and eligibility requirements is necessary.

F. VAT Implementation and Administration¹⁸³

The introduction of a VAT requires entirely new systems of recordkeeping, administration, and enforcement. However, in part because of the VAT's self-enforcing structure, evidence from other countries has shown that once start-up costs are absorbed, it is less expensive to administer than an income tax.

Based on experience in other countries, the important points regarding VAT implementation are to provide a strong early education effort¹⁸⁴ and to allow enough time to put in place the necessary administrative apparatus and taxpayer guidance—the latter usually taking approximately eighteen to twenty-four months.¹⁸⁵

181. KPMG, *supra* note 153, at 7.

182. *Id.* at 8.

183. Gutman, *Cardin's Key*, *supra* note 12, at 350; DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, *supra* note 123; STAFF OF JOINT COMM. ON TAXATION, 102D CONG., FACTORS, *supra* note 91, at 334–42.

184. The educational efforts undertaken in New Zealand, Malaysia, and Australia provide useful examples. See, e.g., Roger S. Muir, *The Goods and Services Tax: Reflections on the New Zealand Experience, Six Years On*, 3 REVENUE L.J. 100, 101–02 (1993) (describing the public education campaign in New Zealand); Diane Kraal & Jeyapalan Kasipillai, *Finally, a Goods and Services Tax for Malaysia: A Comparison to Australia's GST Experience*, 31 AUSTL. TAX F. 257, 284 (2016) (describing the public education campaign in Malaysia); COMMONWEALTH TREASURY OF AUSTL., ECONOMIC ROUNDUP: AUTUMN 2003, at 27–29 (2003) (describing the public education campaign in Australia).

185. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, *supra* note 123, at 122. For example, Australia budgeted two years for public education and transition issues during the implementation of its Goods and Services Tax (VAT). Kraal & Kasipilli, *supra* note 184, at 278.

1. Interaction with States¹⁸⁶

Retail sales taxes represent a significant portion of state and local tax revenues.¹⁸⁷ Thus, as an initial proposition, one would anticipate resistance from those jurisdictions based principally on federalism and revenue concerns. With respect to federalism, states could be concerned that as a practical matter they would be forced to alter their existing consumption tax structures to adapt to a federal structure that may not recognize particular state interests.¹⁸⁸ With respect to the revenue, “the concern is that if federal reform causes the national government to dominate a base that has traditionally been used primarily by states, it could reduce the fiscal flexibility of states and disrupt the current balance in the intergovernmental system.”¹⁸⁹

Both concerns will affect the political acceptability of a VAT. However, at the end of the day, “[w]hile the Federal government should be sensitive to the impact a national sales or value-added tax would have on state and local governments, it is not clear that this should preclude Federal adoption of such a tax.”¹⁹⁰

2. The Path Forward

The substance of the domestic tax debate has changed significantly in the last year. In particular, the Republican *A Better Way* proposal seeks to replace the corporate tax with a business cash-flow tax similar to a subtraction-method VAT.¹⁹¹ A prominent Republican member of the House Ways and Means Committee has proposed replacing the corporate income tax with a credit-invoice VAT.¹⁹² A Democrat on the Senate Finance Committee has proposed a credit-invoice VAT to finance a lower corporate rate.¹⁹³ Thus, consumption taxes are plainly in play in the political arena. However, the path from the

186. See generally DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, *supra* note 123, at 26–27; STAFF OF JOINT COMM. ON TAXATION, 104TH CONG., DESCRIPTION AND ANALYSIS OF PROPOSALS TO REPLACE THE FEDERAL INCOME TAX 29 (1995); Duncan & Sedon, *supra* note 150, at 1029–30; McClure, *supra* note 158, at 1517. See *supra* notes 156–59 and accompanying text for a discussion of the treatment of government goods and services.

187. In 2014, sales taxes accounted for 47.5% of state tax revenue. CHERYL LEE ET AL., U.S. CENSUS BUREAU, STATE GOVERNMENT TAX COLLECTIONS SUMMARY REPORT: 2014, at 1 fig.1 (2015), <http://www.census.gov/content/dam/Census/library/publications/2015/econ/g14-stc.pdf> [<http://perma.cc/7VXD-GT2Z>]. General sales taxes accounted for 31.3% of state revenue, while selective sales taxes, such as alcohol, fuel, and tobacco sales taxes, accounted for another 16.2% of state revenue. *Id.* at 1 fig.1, 2.

188. See William F. Fox & LeAnna Luna, *Subnational Taxing Options: Which Is Preferred, a Retail Sales Tax or VAT?*, 21 J. ST. TAX'N 1, 8 (2003).

189. Harley T. Duncan, *Federal Tax Reform and State Taxes: A Framework for Analysis*, 38 ST. TAX NOTES (SPECIAL SUPPLEMENT) 5, 8 (2005).

190. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, *supra* note 123, at 26.

191. A BETTER WAY, *supra* note 9, at 18, 25.

192. RENACCI, *supra* note 9, at 1–2.

193. Progressive Consumption Tax Act of 2014, S. 3005, 113th Cong. (2014), *reintroduced as* Progressive Consumption Tax of 2016, S.3529, 114th Cong. (2016) (both introduced by Sen. Ben Cardin).

introduction of a sensible idea to its enactment is difficult. These are the issues discussed in this final section.

The domestic resistance to a credit-invoice VAT is somewhat baffling, particularly because there does not appear to be similar resistance to a business cash flow tax, which is the economic equivalent. For reasons discussed above, the credit-invoice VAT is preferable to a subtraction-method VAT. Perhaps the Summers quotation at the beginning of this article captures the essence of the problem.¹⁹⁴ But regressivity concerns can be successfully addressed, as can the “money machine” issue.¹⁹⁵ More importantly, the VAT is not being introduced as a stand-alone tax. Rather it is part of a comprehensive plan to provide the financing to achieve business taxation reform that is fair and encourages economic growth.¹⁹⁶

Stakeholders push for a tax system that will encourage savings and investment. They want an international tax regime that looks like “the rest of the world.”¹⁹⁷ They want the corporate rate lowered. Each is a laudable objective, but revenue constraints preclude traditional solutions. Moreover, the concerns of stakeholders do not appear to be shared by the general public. Thus, solutions that are common in the rest of the world appear bold and risky to U.S. politicians.

An initial step to practical business tax reform is to explicitly introduce the general notion of consumption taxation, and a VAT in particular, to the political discourse. The educational effort described earlier will be a crucial element in securing public acceptance.¹⁹⁸ Until recently, consumption taxation has been addressed obliquely by politicians who seem to understand and desire the benefits of consumption taxation but disavow support when the tax is described as a VAT.¹⁹⁹ The Republican *A Better Way* proposal and proposals by Representative James Renacci and Senator Ben Cardin have cleared the way for a robust discussion about the best way to impose a consumption tax.

Still, politicians will be loath to take on an issue that will be presented by opponents as a tax increase on consumers for a simultaneous tax reduction for business. But as a distributional matter, that is not true. In fact, financing a corporate rate reduction by a VAT combined with an income tax increase on

194. Rosen, *supra* note 2.

195. BIPARTISAN POLICY CTR., *supra* note 105, at 41. Transparency in the imposition of the tax can quantify the effect on the size of government and allow voters to react. This argues for expressing the VAT on a tax-exclusive basis. For instance, Senator Cardin’s proposed Progressive Consumption Tax Act of 2014 included a refund of consumption tax revenue that exceeded 10% of gross domestic product for a given year. S. 3005 § 301. The Renacci plan contemplates a similar circuit breaker. RENACCI, *supra* note 8, at 9.

196. See, e.g., RENACCI, *supra* note 8, at 1–2 (stating that the proposal “delivers . . . big change” and “ensures a level playing field”).

197. Samuels, *supra* note 13.

198. See *supra* notes 183–85 and accompanying text for a discussion of what would be required for implementing a VAT.

199. See e.g., A BETTER WAY, *supra* note 9, at 28, 33.

capital income is, according to a number of recent economic studies,²⁰⁰ largely imposing an explicit tax on those who currently bear the implicit economic burden of the corporate tax. That is, the economic burden of the corporate tax and the VAT are distributed similarly.²⁰¹ As noted earlier, the economic burden of a VAT is borne by equity and debt owners and wage earners. So is the burden of the corporate tax. The empirical question is how evenly the consumption tax burden matches up with the corporate tax burden. If, as suggested above, the burdens are roughly equivalent,²⁰² a user-friendly way to describe the relationship must be devised.

One could also point out that the tax structure advocated here (lower corporate tax rates combined with a VAT)²⁰³ has been largely adopted by more

200. See *supra* note 130 and accompanying text.

201. While there is no consensus on the distribution of the burden of the corporate tax, both the CBO and the Joint Committee on Taxation assume that the long-run burden of the tax is borne 75% by capital and 25% by labor. Others believe the share borne by labor is even higher. See, e.g., William C. Randolph, *International Burdens of the Corporate Income Tax*, (Working Paper Series, Cong. Budget Office 2006-09, 2006), <http://cbo.gov/sites/default/files/cbofiles/ftpdocs/75xx/doc7503/2006-09.pdf> [<http://perma.cc/DUV9-AAJW>].

202. See *supra* notes 129–36 and accompanying text for a discussion of the distributional consequences of the consumption tax.

203. Value-added taxes and taxes on capital have been instrumental in other countries' corporate tax rate reductions. In 1981, Ireland reduced its corporate tax rate to 10% on qualifying manufacturing income and paid for it by increasing the rate of VAT on motor vehicles by 5% to 25%. Finance Act 1980 §§ 41(2), 80 (14/1980) (Ir.) <http://www.irishstatutebook.ie/eli/1980/act/14/enacted/en/print> [<http://perma.cc/UM6Z-B6ML>]. In 1987, the corporate tax rate on qualifying financial services income was reduced to 10%. Finance Act 1987 (10/1987) (Ir.) <http://www.irishstatutebook.ie/eli/1987/act/10/enacted/en/print#sec40> [<http://perma.cc/VF7R-8PN2>]. In 1996, after the EU revoked its state aid approval for Ireland's incentive tax rates, Ireland began reducing its general corporate income tax, with the first reduction from 50% to 30%. IRELAND DEP'T OF FIN., IRELAND'S INTERNATIONAL TAX STRATEGY 5 (2013), <http://www.budget.gov.ie/Budgets/2014/Documents/Department%20of%20Finance%20International%20Tax%20Strategy%20Statement.pdf> [<http://perma.cc/GJH8-STR6>]; Finance Bill 1996 (9/1996) (Ir.), <http://www.irishstatutebook.ie/eli/1996/act/9/enacted/en/html> [<http://perma.cc/432G-5362>]. By 2003, the corporate rate was reduced to 12.5%, with the exception of capital income and certain other excepted trades, which are taxed at 25%. Taxes Consolidation Act 1997 (2/1999) (Ir.), <http://www.irishstatutebook.ie/eli/1997/act/39/enacted/en/html> [<http://perma.cc/T5UJ-GC28>]. While this is a steep reduction for some corporate taxpayers, it is actually a 2.5% increase for those that previously paid the low, 10% rate.

In 1991, Sweden enacted major tax reform, reducing the corporate tax rate from 57% to 30%. Jonas Agell et al., *The Tax Reform of the Century—The Swedish Experiment*, 49 NAT'L TAX J. 643, 646 (1996). This reduction was paid for in two ways: (1) by broadening the base of the VAT to include certain real estate transactions, among others; and (2) by imposing a 30% flat tax on all capital income. *Id.* In 2009, Sweden further reduced its corporate tax rate from 28% to 26.3%, and in 2013, to 22%. David Kleist, *NSFR Seminar 2014—National Report for Sweden*, 2014, NORDIC TAX J. 215, 216. These reductions were paid for by limiting the extent to which interest payments to associated entities were deductible, imposing a minimum tax of 10%. *Id.* at 222–23.

Germany substantially reduced its corporate tax rate in 2008 from 38.9% to 30.2%. JOINT COMM. ON TAXATION, BACKGROUND ON BUSINESS TAX REFORM, *supra* note 25, at 32 tbl.10. It financed its reduction by capping the deductibility of interest payments at 30% of income (aimed at preventing earnings stripping), by imposing a flat withholding tax of 25% on capital income, and by eliminating accelerated depreciation. See Wolfgang Kessler & Rolf Eicke, *Germany's Corporate Tax Reform—The*

Road Not Taken, 46 TAX NOTES INT'L 1135, 1135–37 (2007).

The Netherlands reduced its corporate tax rate in 2007 from 29.6% to 25.5%. *Corporate Tax Rates Table*, KPMG, <http://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html> [<http://perma.cc/3J3W-JBE2>] (last visited Feb. 15, 2017) [<http://perma.cc/Z6PS-Z7CQ>]; *Werken aan winst*, Stb. 2006, 1 (Neth.). It paid for this reduction by increasing taxes on capital. The ability to carry capital losses forward and back was reduced from indefinite to nine years and from three years to one, respectively. *Id.* Depreciation has also been slowed: depreciation of real estate is limited to the assessed value determined by local authorities, intangible assets are amortized over a minimum of ten years (an increase of five years), and capital assets must be depreciated over a minimum of five years. *Id.*

New Zealand increased the rate of its VAT by 2.5% in 2010 from 12.5% to 15% in order to pay for a decrease in its corporate tax rate from 30% to 28%. *Corporate Tax Rates Table, supra*; Taxation (Budget Measures) Act 2010, ss 30, 45 (N.Z.).

From 2010 to 2015, the United Kingdom lowered its corporate tax rate from 28% to 20%. *Corporate Tax Rates Table, supra*; HOUSE OF COMMONS LIBRARY, CORP. TAX REFORM (2010–15), 2015–6, HC 05945, at 3 (UK). The initial reduction from 28% to 26% for fiscal year 2011 was financed by an increase in the rate of VAT from 17.5% to 20% and by slowing the rate of depreciation by limiting the amount of capital expenditures that could be expensed from 20% to 18%. FINANCE (NO. 2) ACT 2010, cl. 3.1 (UK) (increase the rate of VAT); FINANCE ACT 2011, cl. 10–11 (UK). For fiscal year 2012, the reduction from 26% to 24% was paid for by limiting the annual and lifetime allowances for pension income from £225,000 to £50,000 and from £1.8 million to £1.5 million, respectively. *Id.* at 17–18. The reduction to 23% for fiscal year 2013 was funded by two changes: (1) limiting the value of individual income tax expenditures to £50,000 or 25% of adjusted gross income; and (2) instituting an annual tax on residential property owned by corporations, ranging from a £15,000 tax on properties valued at anywhere from £2–5 million to a £140,000 tax on properties valued at over £20 million. FINANCE BILL 2013, cl. 94–99, sch. 3 (UK). The reduction to 21% for fiscal year 2014 was paid for by (1) the imposition of a 28% capital gains tax levied on companies on the disposition of residential property valued at over £2 million, (2) an expansion of the annual tax on corporate-owned property by imposing a £3,500 tax on properties value at between £500,000 and £1 million, and (3) an expansion of the annual tax on corporate-owned property by imposing a £7,000 tax on properties valued at between £1 million and £2 million. *See* FINANCE BILL 2014, cl. 109–10 (UK); *Capital Gains Tax*, GOV.UK, <http://www.gov.uk/capital-gains-tax/work-out-your-capital-gains-tax-rate> (last visited Feb. 15, 2017) [<http://perma.cc/2ZFU-EJ8A>]. The reduction to 20% for fiscal year 2015 was paid for by limiting relief on payments made to related parties as part of the acquisition of intangible fixed assets and a 25% tax on diverted profits. FINANCE ACT 2015, cl. 26, 79 (UK).

In 2015, Japan reduced its statutory corporate tax rate from 37% to 32.1% as part of a major tax reform initiative aimed at spurring economic activity. MINISTRY OF FIN. JAPAN, FY2015 TAX REFORM (MAIN POINTS) 2; *see also* STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., BACKGROUND ON BUSINESS TAX REFORM, *supra* note 25, at 32 tbl.10. It paid for this reduction by limiting the extent to which operating losses can be carried forward to offset gains from 80% for 2014 to 65% for 2015 and then to 50% for 2016, and by limiting the portion of dividends that corporations can exclude from gross income, which is an explicit tax increase on capital income. MINISTRY OF FIN. JAPAN, FY2015 TAX REFORM (MAIN POINTS) 2. The exclusion limits were reduced from 50% when the shareholding ratio is less than 25% and 100% when the shareholding ratio is 25% or above for 2014—to a 20% exclusion when the shareholding ratio is 5% or lower, 50% when the shareholding ratio is a third or lower, and 100% when the shareholding ratio is more than one third. *Id.*

On May 1, 2016, China completed a business tax reform initiative by replacing the business tax with a VAT for four sectors of the economy: construction, real estate, financial services and insurance, and consumer services. DANIEL CHAN ET AL., DLA PIPER, TAX UPDATE (2016). An 11% VAT will replace a 3% business tax on the construction sector, an 11% VAT will replace a 5% business tax on the real estate sector, a 6% VAT will replace a 5% business tax on the financial and insurance sector, and a 6% VAT will replace a 5% business tax on the consumer services sector. *Id.*

In several countries, increased taxes on capital income have been accompanied by reducing the

than 160 countries worldwide.²⁰⁴ While this may be validating for some, for others, it will be the very reason to oppose the change—not because of the salutary effect on business taxation but because the VAT also finances the robust social welfare networks of many of those countries.

A broad-based 10% VAT will raise \$5 trillion over ten years,²⁰⁵ which is more than enough revenue to reduce the corporate rate to 15% and also finance significant income tax simplification and individual rate reductions. Indeed, that is what legislation introduced by Senator Cardin would do.²⁰⁶ Sadly, but somewhat predictably, the bold Cardin initiative has not attracted much attention. But one hopes that the Republican *A Better Way* and the Renacci proposals can create the impetus for further discussion.

A substantive change of this magnitude in our revenue structure cannot occur without strong executive branch leadership and congressional support. But that will not happen unless the executive branch and members of Congress have political cover. Educated members of the business community know that their ultimate reform goals cannot be achieved without a new revenue source. They could provide the cover necessary to break the political logjam. Their mantra has been that the U.S. tax system should look like the rest of the world. Enactment of a VAT to finance a lower corporate rate looks like the rest of the world. It is time for the business community and politicians to speak up.

CONCLUSION

With the Republican sweep of Congress and the presidency, there is renewed hope that the legislative logjam can be broken because Republicans have consistently made tax reform a high rhetorical priority, and there is agreement among the Trump administration and House Republicans as to the need for—if not the substance of—business tax reform. At the end of the day, their goals may not be attainable without more revenue than either of their current plans generate. At that point, the proposals in this Article, which should

rate of capital recovery, which is counter-productive to encouraging investment. Australia, for example, has twice financed reductions in its corporate rate by reducing the rate of capital recovery: a 10% reduction to 39% in 1989 and a further reduction to the current 30% rate in 2000. See *OECD Corporate Income Tax Rates, 1981–2013*, TAX FOUND. (Dec. 18, 2013), <http://taxfoundation.org/article/oecd-corporate-income-tax-rates-1981-2013> [<http://perma.cc/5GEEK-4YLT>]; *Income Tax Rates Amendment Act 1988* s 3(a) (Austl.) (enacting the 1989 reforms); see also DEP'T OF THE TREASURY, BUS. TAX WORKING GRP., CONSULTATION GUIDE 5 (2012) (Austl.); *Taxation Laws Amendment Act (No. 2) 1999* sch 3 (Austl.) (enacting the 2000 reforms). As discussed above, the United Kingdom, the Netherlands, and Germany have also slowed or eliminated capital recovery to finance a reduction in the corporate rate. FINANCE ACT 2011, cl. 10–11 (UK); *Werken aan winst*, Stb. 2006, 1 (Neth.); Wolfgang Kessler & Rolf Eicke, *Germany's Corporate Tax Reform—The Road Not Taken*, 46 TAX NOTES INT'L 1135, 1135–37 (2007).

204. ORG. FOR ECON. COOPERATION & DEV., *supra* note 34, at 14.

205. See Gutman, *Cardin's Key*, *supra* note 12, at 343.

206. See Progressive Consumption Tax Act of 2016, S. 3529, 114th Cong. (2016) (proposing a 10% VAT, which would finance a reduction of the top individual marginal tax rate to 28% with exemptions of \$50,000 for single filers, \$75,000 for heads of household, and \$100,000 for families; and a reduction of the statutory corporate rate to 17%).

be the preferred reform method in any case, should be enacted.