# US Comprehensive Tax Reform and the Destination-Based Cash Flow Tax

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Efforts to overhaul the US tax system have been the subject of many discussions and countless white papers over the years. From 1949 and to 1986, attempts by both sides of the aisle to simplify the tax code through bipartisan legislation fall short of expectation. The medley of amendments only add to the already complex and intricate web of existing tax provisions that fail to address the myriad of issues made worse by the explosion of digital commerce. Fundamentally, this is the natural consequence of patchwork legislation introduced outside the realm of comprehensive reform.

The GOP (the Grand Old Party – the Republicans) has been touting tax reform recently and has actually produced a 35-page blueprint as a starting point. While the blueprint carries with it some serious and radical ideas, the GOP never really thought that their plan would be seriously considered until the new incumbent President was elected to the White House. Piggy-backing on the GOP idea, the new administration is now looking to restart the discussion.

## The GOP Tax Reform and Destination Based Cash Flow Taxation

The GOP plans sweeping changes in the tax code specifically in the area of corporate income tax. Chief among its ideas is the introduction of the so-called “destination based cash flow taxation” (DBCFT). The key feature of this DBCFT concept as it applies to business tax is the application of the “border adjusted” tax that would significantly change the way the tax code works for corporate entities.

## What is DBCFT?

Currently, the US Tax Code taxes corporations on domestic income on a net basis under a source-based principle. This means that costs, to the extent allowed, are deductible from gross income and the net taxable income is subject to the 35% marginal tax rate. Capital expenditures are depreciated, amortized or written off over a number of years. US companies with operations outside the country are not taxed on their profits earned until repatriated to the US via dividend (unless exception applies).

The DBCFT has a different idea.

Key features of DBCFT are as follows:

- Corporate tax rate of 20%
- Profits earned outside the US are not subject to tax
- No depreciation for capital investment (but allows full expensing at year of purchase)
- No deduction on interest expense
- Corporate tax is "border adjusted"

## What is Border Adjustment?

DBCFT is achieved through border adjustment tax where exported goods and services are not taxed and imported goods are subject to tax. As implied by its name, DBCFT is anchored on the destination principle where taxation happens only in the place where goods are consumed. In other words, tax is levied based on where the goods and services end up and not where the goods are produced and services originated. This in fact is the very principle that governs the Value-Added Tax (VAT) system – a system of taxation that imposes tax on the consumer; hence, called a consumption tax. Under VAT, tax is imposed in the place of consumption of goods and services rather than the source of income or the residence of the taxpayer.

It is worth noting that the border adjustment tax is primarily the fundamental concept of the VAT system, which has been adopted by more than 150 countries in the world including most of the OECD member countries. This tax system is the main source of revenue for most countries alongside corporate income tax. While the US has hitherto been most adamant in adopting the VAT system, it is now considering applying this principle to business taxes in a modified form.

## The Border Adjusted Business Tax

The marriage between the principles of VAT and the border adjustment tax as it applies to corporate tax calls for the non-taxation of goods and services that cross the border and the taxation of goods and services that are imported into the US. Pure cash-flow taxes are commonly viewed as consumption rather than income taxes. Nevertheless, the GOP refuses to call DBCFT a VAT despite its clear semblance to the mechanism that makes up the VAT.
The question therefore arises as to whether DBCFT is a form of tariff as it taxes imports and not exports. In addition, there is also ambiguity as to whether the DBCFT is an instrument aimed at advancing protectionism that subsidizes exports (by exempting them from tax) and discourages imports since the latter is subject to tax.

## How DBCFT Will Be Implemented

It appears that the 35-page GOP blueprint is short on implementation details and will have to answer questions on how this radical shift in tax concepts will be implemented and administered, as well as the costs it entails to the IRS and its compliance burden on the taxpayers.

## The Economists' Arguments

While there seems to be an impression that exports are favored and imports are discouraged in the DBCFT model, some economists and academics believe that this notion will be quickly corrected as exchange rates and prices are adjusted. It is believed that the level of exports and imports should be at the level they were once before the DBCFT is implemented bringing market equilibrium.

Others argue that there may be an issue of perception to the common taxpayer as MNCs exporting goods and services may not have to pay any US tax despite billions of earnings each year, while small business owners who import goods and sell locally may be liable to US tax.

There is also a question as to whether DBCFT will preserve the principles of capital export neutrality in which business decisions are not supposed to be affected by tax rules. Consider the impact of a traditional IP planning, as an example. On the one hand, if a US MNC has IP sitting offshore, DBCFT may increase the US tax of the MNC if it will import the IP by way of rights to use and exploit the same from its offshore location. On the other hand, exporting IP offshore may result in non-taxable royalty income to the US MNC, which enables the foreign affiliate to deduct expenses related to the acquisition of the IP. Whether this is sound policy is yet to be tested.

## The WTO

Many tax experts have sounded the alarm that an income tax with the border adjustment feature will not pass the WTO's scrutiny. Recall that in the late 90's, the WTO struck down a US tax provision that purportedly subsidised exports in now defunct FSC rules.

## The Unknown

With this new-look corporate taxation, questions are beginning to surface. What will happen to the 68 bilateral income tax treaties the US signed with other countries? Will they be rewritten? What about the Section 482 rules? Since there will be no incentive to park profits abroad, will transfer pricing go away? What about Foreign Tax Credit? Will FTC still work? Are US corporations paying taxes abroad going to be able to continue to reduce US taxes through the credit mechanism? These are just a few of the questions surrounding the DBCFT.

With the many questions surrounding the concept coupled with the seemingly gargantuan task of rewriting existing tax principles, it appears that there is more harm than benefit with DBCFT. DBCFT carries with it a prima facie sense of welcome change, but it is presumable that the negative effects will immediately outweigh its suggested benefit.