Financial Sector

Moderator: David S Miller, Proskauer Rose LLP

Speakers: Steven Bunson, Head, Global Tax, Goldman Sachs & Co.
Viva Hammer, Legislative Counsel at Joint Committee on Taxation

Presentation authored by David S. Miller

A “Pure” DBCFT v. the Republicans’ DBCFT

- A pure DBCFT is a subtraction-method VAT, with a deduction for wages.
  - A pure DBCFT is a consumption tax.
- The House Republicans’ DBCFT is <u>not</u> a “pure” DBCFT; it is a hybrid system.
  - Businesses apply the DBCFT to physical assets, services and intangibles, but financial assets (whether held by businesses or individuals) are subject to an <u>income</u> <u>tax</u>.
  - A pure DBCFT would exempt all foreign-source income; the House Republicans’ DBCFT taxes foreign personal holding company income (FPHCI).

VAT v. a "Pure" DBCFT v. the Republicans' DBCFT

Credit-method VAT	"Pure" DBCFT (X-tax)	The House Republicans' DBCFT
• Collected at each stage of production with a credit for taxes paid earlier.	• Collected from businesses.	• Collected from businesses.
• Imposed on goods, services, and intangibles consumed by individuals.	• Imposed on goods, services, and intangibles consumed by individuals.	• Imposed on goods, services, and intangibles consumed by individuals.
• No tax on investments.	• No tax on investments.	• Tax on investments and FPHCI.
• No deduction for interest.	• No deduction for interest.	• No deduction for net interest.
• Wages not deducted.	• Wages deducted.	• Wages deducted.
• Border adjusted.	• Border adjusted.	• Border adjusted.

First Principles Under a Pure DBCFT

- Consumption tax “first principles”:
  - A consumption tax should tax only individual consumption of goods, services and intangibles.
  - A consumption tax should tax economic rents (but only economic rents).
  - A consumption tax should not change the price between current and future consumption (so as to be neutral with respect to savings), or the relative prices of final consumption goods.
- These principles do not necessarily apply to the House Republicans’ DBCFT.

Pure DBCFT: Taxation of Businesses

- No tax is imposed on the interest income (or other fees for financial services) paid by a business.
  - Interest and other fees for financial services paid by a business are just another input in production. No different than buying office supplies, machinery or raw materials.
- Different ways to achieve this result:

Pure DBCFT: Taxation of Businesses

- Option #1: Could require both a business borrower and lender to report financial cash flows in the base (R+F).
  - The business borrower would include borrowings in income and deduct interest and principal; the lender would deduct the loan but include payments of interest and principal in income.
  - Counterintuitive for borrowers. A borrower would be taxed when it borrows funds.

Pure DBCFT: Taxation of Businesses

- Option #2: Could allow businesses to deduct interest and financial service fees and tax the financial institutions on interest and financial services fees.
  - But then businesses would not be allowed to expense purchases of equipment.
  - This would be inconsistent with the House Republicans' objectives of encouraging investment and eliminating the bias for debt.

Pure DBCFT: Taxation of Businesses

- Option #3: Could simply exclude interest and fees for financial services from the tax base. This is a “real” or “R” base because it includes only “real” and not “financial” or “F” transactions in the tax base.
  - Business borrowers could not deduct interest expense and other financial services fees.
  - Financial institutions would not include interest income and financial service fees received from businesses in income, but could still deduct wages.
  - Symmetry helps to avoid gaming.

Pure DBCFT: Taxation of Businesses

- Because interest and financial services income received by a financial institution from a domestic business would be exempt from tax, it may look at first as though economic rents would escape tax altogether. But this is only a shift in the identity of the payor. Because the borrower is denied a net interest deduction, the borrower is taxed on the economic rent.
- But problem of perception.

Application of the Three Principles to a Pure DBCFT: Individuals

- Economists generally agree that, under a pure DBCFT, financial institutions should not be subject to tax on the interest paid to them by individuals on loans (and individuals would not receive a deduction).

Application of the Three Principles to a Pure DBCFT: Individuals

- There is a dispute among economists as to whether financial services provided to individuals should be taxed.
  - Some economists argue that financial service fees charged as part of a spread along with interest should not be taxed because a tax would effectively penalize borrowing and distort the price between current and future consumption.

Application of the Three Principles to a Pure DBCFT: Individuals

- Some economists argue that financial services affect the buying of an "investment good" and not a "consumption good". Because, under a pure DBCFT, investment goods should not be taxed, then financial services should not be taxed.
  - This rationale would not apply under the House Republicans' DBCFT because it does impose income tax on investments.

Application of the Three Principles to a Pure DBCFT: Individuals

- Some economists argue that financial services are a consumption good like any other consumption good.
  - Just as consumer purchases of consumer goods are not exempt, neither should consumer purchases of financial services be exempt.
  - Also, if financial services are not taxed, then financial institutions would earn economic rents that would not be taxed.

Application of the Three Principles to a Pure DBCFT: Individuals

- The economists who believe that financial services income should be taxed argue that financial institutions should be taxed on an R+F basis with respect to transactions with individuals.

Taxing Financial Institutions on an R+F Basis

- Taxing on an R+F basis means that <u>all cash flows</u> (other than equity capital) give rise to taxable revenues or deductions.

		Pre-Tax	R+F tax basis
Year 1	Bank receives a deposit	$100	$20
	Bank lends to the borrower	-$100	-$20
Total		**0**	**0**
Year 2	Borrower repays loan with interest	$110	$22
	Repayment of deposit with interest	-$105	-$21
Total		**5**	**1**

- Bank is subject to tax on the $5 of "spread", regardless of whether the spread arises from a credit premium or from services.
- Contributions of equity are not taxable under R+F, so that a financial institution that raises equity capital and lends it avoids tax on its economic return.

Taxing Financial Institutions on an R+F Basis

- Financial institutions would be subject to tax on an R+F basis only on transactions with domestic individuals and tax-exempts.
- Financial institutions would not be subject to tax on transactions with businesses and foreigners.
- Financial institutions could deduct all salaries (including those allocable to transactions with businesses and foreigners).
- Auerbach, et. al. acknowledge that financial institutions would earn profits but would be subject to little or no tax. They say that this is merely a "problem of perception".

Treatment of Financial Institutions Under the House Republicans' DBCFT

- In contrast to a pure DBCFT, the House Republicans' DBCFT does tax individuals and businesses on investments and FPHCI.
  - Businesses are taxable on investment income and FPHCI and cannot deduct net interest expense.
  - It would be inconsistent with the House Republicans' DBCFT if financial businesses could avoid tax on investment income from contributed capital and FPHCI, or could receive interest deductions attributable to equity capital.

How Should Financial Institutions Be Taxed Under the Blueprint?

- Option #1: Treat financial institutions the same as non-financial institutions (i.e., no net interest expense deduction).
  - If a financial institution borrowed to buy securities and loan them to U.S. customers, the financial institution would be taxed on a gross income basis (no deduction for interest on borrowing and no deduction for interest paid on cash collateral).
  - This would increase the cost of securities borrowing.
  - This could affect competitiveness with non-U.S. institutions.
  - Could be gamed:
    - A financial institution could create transactions that generate the economic equivalent of interest but wouldn't be treated as interest for tax purposes.
    - To prevent this, rules would need to combine financial instruments to create deemed debt instruments in order to disallow interest expense equivalents.

How Should Financial Institutions Be Taxed Under the Blueprint?

- Option 2: Tax financial institutions under a modified income tax.
  - The financial institution would be taxable under the income tax rules (without border adjustments) except:
    - Depreciation would be on an economic income basis, rather than being expensed.
    - Interest deductions attributable to contributed equity and not attributable to depreciable property would be denied.
    - Financial institutions would be able to exclude fees for exported services, other than fees on services bundled with financial instruments provided to foreigners, and
    - Businesses would not be able to deduct financial service fees bundled with borrowings.

How Should Financial Institutions Be Taxed Under the Blueprint?

- Option 3: Tax financial institutions on an R+F basis.
  - Financial institutions would include borrowings in income and deduct loans; they would include domestic-source interest income and deduct interest expense paid to U.S. lenders; they would exclude interest income received from foreigners and not deduct interest expense paid to foreigners.
    - However, this would exempt their normal return on equity, which would be contrary to the House Republicans' proposal to impose tax on the investment income and FPHCI of non-financial institutions.