International Tax Reform and the Border Adjustment Tax

Panelists:

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House GOP Blueprint

Destination Based Cash Flow Tax ("DBCFT")

- US tax based on place of consumption irrespective of place of production
  - Neutralizes tax incentives for investment and employment decisions
  - Helps address uneven playing field
- Effectively repeals the current corporate income tax and replaces it with a new system
  - Other countries have a corporate income tax and a VAT

House GOP Blueprint

Exemption for foreign consumption

- Gross receipts received directly by US corporation
  - Related expenses still deductible against income from US consumption
  - NOL carries forward indefinitely with interest
- Income received through CFC’s
  - Exemption of dividends received from foreign corporations
  - Reform of Subpart F – generally , no need except for “truly passive” FPHCI
- Acts as a “natural” anti-base erosion tool

House GOP Blueprint

Comparison of US tax rates on different production decisions

	US Consumption	Foreign Consumption
US Production	20% on Net Income	-20% on US Deductions
Foreign Production	20% on Gross Receipts	0% on Net Income

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 all cash flows (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

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".

- 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.

Territorial system design issues

Some key issues for financial services companies

- 100% exemption or something less
  - Camp provided for a 95% exemption, with the 5% inclusion serving as a proxy for allocating US expenses to exempt income
- Transition to the new system
- Anti-base erosion rules
- Retention of some Subpart F rules, AFE rules
- Treatment of branches, and branch income

Alternatives to border adjustability

Minimum tax on foreign source earnings

- Design issues:
  - The minimum tax base:
    - All income?
    - Only intangibles related income?
    - Only income with "excess returns"?
  - The minimum tax trigger foreign tax rate threshold
  - The minimum tax rate itself
  - Foreign tax credit baskets for minimum tax income
  - Treatment of domestic expenses related to income subject to the minimum tax and to exempt income
- Adding a carrot to the stick:
  - Camp approach allowed a lower rate for export income of a type subject to the minimum tax if earned by a controlled foreign corporation (CFC)

Alternatives to the BAT: Anti-base-erosion focus -- IP and low-taxed income

Camp Proposal Option A: Excess Income from Intangible Asset Transfers (from Obama budget)	Camp Proposal Option B: Current Tax on Low-Taxed Cross-Border Foreign Income	Camp Proposal Option C: Reduced Tax Rate on Intangible Income and Current Taxation

► New category of Subpart F income for Foreign Base Company Excess Intangible Income (FBCEII): excess returns from “covered intangibles” transferred from US if subject to low foreign ETR
► Broad definition of covered intangible
► Broad determination of income attributable to covered intangible
► Excess return if gross income > 150% of costs
► Home country exception
► Full or partial exclusion from FBCEII based on foreign ETR:
  ► If foreign ETR ≤ 10% – full inclusion
  ► If foreign ETR is between 10% and 15% – proportionate inclusion
  ► If foreign ETR ≥15% – no inclusion
	► New category of Subpart F income
	► Includes CFC’s gross income, with exception for income that is either:
	  ► Derived in the CFC’s home country
	  or
	  ► Subject to an ETR in excess of [10%]
	► Home country requirement that income be derived in connection with property sold for use, consumption or disposition in such country or services provided with respect to persons or property located in such country
	► ETR determined separately on a country-by-country basis
		► New category of Subpart F income for “Foreign Base Company Intangible Income “(FBCII)
		► Also new concept of foreign intangible income of a US corp
		► US corp allowed a deduction for 40% of its foreign intangible income and its pro rata share of the FBCII of its CFCs, resulting in current taxation of intangible income at a 15% tax rate
		  ► FBCII with respect to property sold into US or services provided in US would not be eligible for the 40% deduction
		  ► Taxed at 25%
		► Broad definition of intangible property
		► Broad determination of income attributable to covered intangible

Anti-base-erosion focus: IP and low-taxed income

Senator Enzi's Bill	President's Obama's FY 16 budget
▸ New category of Subpart F income for income that is subject to a foreign effective tax rate of not more than 50% of the top US corporate tax rate (i.e., 17.5%) ▸ Exception for qualified business income ▸ But exception would not apply to intangible income ▸ US corp allowed a deduction of 50% of its qualified foreign intangible income ▸ Qualified foreign intangible income would be foreign intangible income derived from the active conduct of a business in the US, provided the US corp developed the intangible property or added substantial value to it. ▸ Broad definition of intangible property	▸ Includes proposal for a Minimum Tax on income of CFCs, under which a CFC would be subject to immediate US tax at a specified tax rate with an FTC for foreign taxes paid ▸ Income subject to the minimum tax is active income exceeding a risk-free rate of return on equity investment ▸ Minimum tax threshold: 22.3%, measured per country (including branches in the country) ▸ Minimum tax rate: 19% ▸ Minimum tax income subject to country-by-country FTC limitation ▸ U.S. interest expense allocable to foreign earnings would be disallowed or proportionately reduced if earnings subject to minimum tax

An alternative to the Blueprint: Summary of H.R. 1 (Camp) international tax reform (2014)

- 25% corporate tax rate
- Repeal, limitation of many business tax preferences
- 95% exemption for non-subpart F dividends from CFCs
  - 5% inclusion of foreign earnings, pro-rated FTC
- One-time transition tax on tax-deferred foreign earnings
  - 8.75% on cash and cash equivalents
  - 3.5% on earnings invested in property, plant, and equipment
- Anti-base erosion/innovation box
  - Stick: 15% minimum tax on low-taxed active CFC earnings from foreign markets in excess of 10% of investment in tangible depreciable assets; 25% rate applies if sales into the US market
  - Carrot: 15% US tax on the same form of earnings if earned directly by the US corporation from sales into foreign markets
- Interest expense:
  - net interest >40% of EBITDA not deductible if US group's debt-equity ratio >110% of global group's debt-equity ratio
  - Tightening Sec. 163(j) earnings stripping rules for inbound companies
- No change in foreign branch income taxation