Financial Transactions Committee
Through the Looking Glass: Financial Transactions under a Destination-Based Cash Flow Tax.
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Intellectual History

- Meade Committee Report
- Hall-Rabushka Flat Tax
- David Bradford's X-Tax
- 2005 President's Advisory Panel on Federal Tax Reform – Growth and Investment Tax
- Recent Work by Auerbach and Devereaux

House Republican Blueprint: the Destination-Based Cash Flow Tax (DBCFT)

Key features:

- Immediate expensing (no depreciation) ➠ "cash flow tax"
- No deduction for net interest
- Border "adjustments":
  - ➠ Exports exempt
  - ➠ Imports taxed (no deduction for imports + tax consumer imports) = " destination-basis" tax

Result:

- Economically equivalent to a VAT with a business-level wage subsidy

Cash Flow Tax

- Businesses taxed at a single rate on (domestic) business cash flows
- Wages & compensation above a zero-bracket amount taxed at one rate (Flat Tax) or multiple graduated rates (House Blueprint / 2005 GIT)
- In academic theory, this introduces progressivity to a consumption tax

Border Adjustments / Destination Basis

- Tax base = domestic consumption
- Typically recommended for administration and enforcement reasons
  - Limits tax avoidance opportunities – prevents profit shifting and base erosion – prevents structuring to avoid U.S. taxes
  - "Transfer pricing" considerations (no incentive to over- or under-charge for sales with related parties)
- Economists generally believe border adjustments do not affect the balance of trade (does not imply that moving from an income tax structure to a consumption tax structure would not affect trade)
- Political rhetoric about trade complicates the current debate

2005 President's Advisory Panel on Federal Tax Reform – Growth and Investment Tax Option

- Proposed a destination-base cash flow tax as part of a progressive consumption taxation approach
- Incorporated VAT principles for administering the tax
- Suggested studying an "R+F" base for taxing financial institutions
  - For financial institutions, all inflows would be taxable and all outflows would be deductible
  - To prevent over-taxation of business purchases of financial services, financial institutions would apply a formula (based around an established interest rate, e.g. LIBOR), to determine the portion of a payment that was to be attributable to deductible financial intermediation services (as opposed to "financial" payments)
  - Developing such a system would require significant study

The House Republican Blueprint

"Products, services, and intangibles that are exported outside the United States will not be subject to US tax… products, services, and intangibles imported into the United States will be subject to US tax regardless of where they are produced."

"The Committee on Ways and Means will work to develop special rules with respect to interest expense for financial services companies, such as banks, insurance, and leasing, that will take into account the role of interest income and interest expense in their business models."

Five Potential Approaches

1. "R+F" base (tax financial and insurance services)
2. Pure "R" base (exempt financial and insurance services)
3. "R" base (exempt financial and insurance services) + a separate income tax regime for financial services businesses + deny deductions for "financial" payments made by "R" businesses
4. "R" base (exempt financial and insurance services) + a separate income tax regime for financial services businesses + allow deductions for "financial" payments made by "R" businesses + border-adjust cross-border financial services payments by "R" businesses
5. "R" base (exempt financial and insurance services) + a separate income tax regime for financial services businesses + allow deductions for "financial" payments made by "R" businesses for both domestic and cross-border financial services

VAT treatment of financial services

- VAT = a tax on final private domestic consumption, structured as a transaction tax
- Financial and insurance services problematic because:
  - Measurement and allocation problems
  - Separating the tax base (consumption = income - Δ savings)
- Exemption ('input taxation') is the norm:
  - Contravenes internal & external neutrality
  - Incentives to insource/import
  - Complex input tax apportionment required

VAT: Alternatives to exemption?

(1) Zero-rating (no tax on outputs, full deduction for taxed inputs)

- NZ – B2B zero-rating

(2) Addition method: VAT = profits + wages

(3) Global subtraction method (without allocation to customers):

(4) Cash-flow taxation:

- Poddar & English – Cash-flow model; TCA; truncated TCA
- Cash-flow taxation of insurance in NZ, Australia, etc

(5) Other

Poddar & English Cash Flow Model

Simple bank deposit & loan for one year

- Interest paid to depositor 3%
- Interest charged to borrower 9%
- Spread 6%
  (reflects Bank's value added)

Assumptions:

- Pure interest rate 5%
- Thus:
  - implicit fee to depositor = 5 – 3 = 2%
  - implicit fee to borrower = 9 – 5 = 4%

VAT rate = 10%; VAT is included in cash flows

Deposit (3%) & lend (9%) $1,100 for 1 year; 10% tax (tax included in cash flows)

Day	Transaction	Bank	Tax	RA
0	Consumer Deposit	1,100	100	0
	Consumer Loan	-1,100	-100	
365	Interest paid (3%)	-33	-3	6
	Interest rec'd (9%)	99	9	
	Loan repaid	1,100	100	
	Deposit withdrawn	-1,100	-100	
	Net	66	6	6

Variation (depositor is a non-resident)

Day	Transaction	Bank	Tax	RA
0	Non-resident Consumer Deposit	1,100	0	-100
	Consumer Loan	-1,100	-100	
365	Interest paid (3.18%)	-35	0	109
	Interest rec'd (9%)	99	9	
	Loan repaid	1,100	100	
	Deposit withdrawn	-1,100	0	
	Net (60 + tax on implicit fee to res.)	64	9	9
	'Pure' interest (5%) on input credit from Day 0			-5
	Net = tax on implicit fee to resident consumer			4

Variation: customers are businesses

Day	Transaction	Bank	Tax (Bank)	Tax (Bus)	RA
0	Business Deposit	1,100	100	-100	0
	Business Loan	-1,100	-100	100	
365	Interest paid (3%)	-33	-3	3	0
	Interest rec'd (9%)	99	9	-9	
	Loan repaid	1,100	100	-100	
	Deposit withdrawn	-1,100	-100	100	
	Net	66	6	-6	0

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Some Key Issues (not comprehensive)

- Effect on Prices of Goods and Services
  - Exchange rate adjustments
  - Potential nominal price effects
  - Potential effects on wages
  - Asset valuation issues
  - WTO Compatibility
- Tax Treaty Issues
- Foreign Government Reactions
- State and Local Government Reactions
- Treatment of Losses (structural NOLs)
- Difference in Taxation of Corporations and Flow-Through Entities
- And, of course, taxation of financial institutions and financial transactions

What about taxation of derivatives?

- Derivatives are used in many different contexts.
  - Hedging (potentially including both taxable and tax-exempt cash flows)
  - Speculation (Trading)
  - Dealing
- Would a different regime be required for each one?