THE NEED FOR SECOND-BEST TAX REFORM SOLUTIONS

COMMENTARY ON: *THE SAGA OF UNFULFILLED BUSINESS INCOME TAX REFORM* BY HARRY L. GUTMAN

Paul Oosterhuis[*]

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INTRODUCTION

Hank Gutman has provided a wide-ranging, insightful analysis of why business tax reform in the United States will not succeed without broadening our horizons to fundamental alternatives, including additional revenue sources. The fact that Republicans in the House of Representatives have proposed a variant of the cash flow tax that Gutman discusses heightens the current importance of his perspective.[1] Gutman's wealth of experience in tax policy makes him uniquely qualified to lead the effort toward reform. His service in the Treasury Department, at the congressional Joint Committee on Taxation, in academia, and in private practice affords him a unique perspective on the multitude of interwoven policy issues. Gutman addresses these issues in his usual blunt, no-nonsense fashion. He is refreshing, particularly when his views challenge conventional wisdom. There is much to be learned from his analysis.

It is clear that business tax reform requires fresh thinking, particularly on the subject of consumption taxes. Many policymakers share Gutman's vision that adopting a modest rate credit-invoice value-added tax (VAT) and using the proceeds to reform the current corporate and individual income tax is an ideal

* Paul Oosterhuis is a senior international tax practitioner at Skadden, Arps, Slate, Meagher & Flom.

1. *See* HOUSE REPUBLICAN TAX REFORM TASK FORCE, HOUSE REPUBLICANS, A BETTER WAY: TAX 24–25 (2016) [hereinafter A BETTER WAY], http://abetterway.speaker.gov/_assets/pdf/AbetterWay-Tax-PolicyPaper.pdf [http://perma.cc/996Y-D4HQ].

tax policy.[2] But enacting a VAT lies beyond the tax reform that will likely happen in 2017 or 2018. We are now at a time when Gutman and those who share his vision should seriously consider the consumption tax alternatives that they currently reject,[3] including variants of the House Republicans' *A Better Way* proposal,[4] that could be second-best solutions.

I. CONVENTIONAL BUSINESS TAX REFORM

Perhaps because the focus of my government and private practice experience has been on international tax matters, I see business tax reform largely through a cross-border lens. If we had a closed domestic economy, it is not clear whether our current 35% corporate tax rate would still seem too high. After all, one of the primary accomplishments of the Tax Reform Act of 1986 was to align corporate and individual income tax rates.[5] This encouraged the substantial growth of business activity in noncorporate form over the past thirty years, which has been efficient from an economic perspective. And by reducing or eliminating a host of excess retained earnings and reasonable compensation issues, this uniformity between corporate and individual tax rates also has been efficient from a tax administration perspective. As Gutman discusses, any conventional tax reform reduction in corporate tax rates would be principally funded by slowing the timing of depreciation and other deductions.[6] As a practical matter, this base broadening cannot be limited to C corporations,[7] given the extensive comingling of business income between C corporations and unincorporated business taxpayers.[8] Yet top individual rates, which are applicable to unincorporated business taxpayers, are unlikely to be reduced substantially below 35%.[9] Thus, base-broadening reform could mean substantial tax increases for unincorporated businesses. Representatives of unincorporated business taxpayers have made it clear that alternative measures, such as

2. *See, e.g.*, MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS 188–91 (2008).

3. Harry L. Gutman, *The Saga of Unfulfilled Business Income Tax Reform*, 89 TEMP. L. REV. 267, 288 (2017).

4. *See* A BETTER WAY, *supra* note 1.

5. The Tax Reform Act of 1986 reduced the top corporate tax rate to 34%. Pub. L. No. 99-514, § 601(a), 100 Stat. 2085, 2249. Then, the Omnibus Budget Reconciliation Act of 1993 raised it to 35%. Pub. L. No. 103-66, § 13221(a)(2)(D), 107 Stat. 312, 477. Top individual tax rates have fluctuated from a low of 28% after the 1986 Act, § 101(a), 100 Stat. at 2096, to the current rate of 39.6%.

6. Gutman, *supra* note 3, at 274, 274 n.27.

7. A C corporation is defined as "[a] corporation whose income is taxed through it rather than through its shareholders." *C corporation*, BLACK'S LAW DICTIONARY (10th ed. 2014).

8. The tax bill proposed by Rep. Dave Camp largely funds its 25% corporate tax rate by slowing depreciation deductions, amortizing marketing and research and development expenditures, and repealing last in, first out (LIFO) accounting for inventories. *See* Tax Reform Act of 2014, H.R. 1, 113th Cong. §§ 3104, 3108, 3310 (2014).

9. Among realistic Republican tax reform proposals, for example, Ways and Means Committee Chairman Camp's bill included a 35% top individual tax rate. H.R. 1 § 1001(a). *A Better Way* proposes a 33% top rate. A BETTER WAY, *supra* note 1, at 16–17. Further top rate reductions for individuals cause substantial revenue losses that benefit the highest income taxpayers and thus are politically difficult to defend.

expensing for relatively small investments, do not solve this problem;[10] for example, annual expensing of $1 million, or even $10 million, of new depreciable property will not suffice because large and small businesses operate in unincorporated form.

Lowering the tax rate for the income of unincorporated businesses but not for the salary or other ordinary income of individuals reintroduces into the tax system many of the problems we have minimized over the past thirty years, including issues of excess retained earnings and reasonable compensation for business owners providing services. These issues create economic and tax administration inefficiencies.

Thus, in a hypothetical closed domestic economy, a 35% corporate tax rate may be appropriate, assuming a top tax rate on individuals that is close to 35%. But of course, we do not have such an economy. A large share of U.S. and non-U.S. corporate economic activity is attributable to global businesses, particularly in sectors that rely on technology, branding, or both to generate profits.[11] Such businesses require upfront investments in research and development (R&D) and marketing to facilitate a global reach for their products and services. They do not compete principally with local U.S. businesses; local businesses are their suppliers and their customers. Rather they compete with other U.S. and non-U.S. multinational corporations.[12] In that world, the fact that our 35% corporate tax rate is among the highest of all developed countries is indeed a serious issue.

Our 35% corporate tax rate discourages investment in the United States by foreign multinationals. As Gutman points out, however, for better or worse, our current tax rules allow foreign multinational investors to avoid the full impact of that rate through intercompany debt, supply chain, and other tax planning strategies.[13] This encourages investment, but it creates an unlevel playing field that favors non-U.S. multinationals over U.S. multinationals.[14] A lower U.S. corporate tax rate could facilitate legislation that would limit the tax planning opportunities of inbound multinationals without significantly discouraging their U.S. investments.

Equally important, as foreign income tax rates have decreased over the past

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10. *See, e.g.*, *Tax Reform*, NAT'L FED'N OF INDEP. BUS., http://www.nfib.com/content/issues/Taxes/Tax-Reform-58399/ (last edited Nov. 2, 2016) [http://perma.cc/9RZV-Y2W5] (stating principles for tax reform that NFIB supports, including the principle that "[t]ax rates on corporate and pass-through businesses should stay equal and low").

11. According to the annual survey of U.S. multinationals conducted by the International Tax Policy Forum (ITPF), in 2012, U.S.-based multinationals contributed 20.1% of U.S. gross domestic product (GDP), conducted 76.1% of U.S. industrial R&D, and paid 68.5% of the total compensation of U.S. manufacturing employees. INT'L TAX POLICY FORUM, ITPF COMPETITIVENESS INDEX 2015 (2015), http://www.ITPF.org/Library [http://perma.cc/JZ9M-FX9C].

12. A few examples of key competitors include the following: Apple and Samsung, H.P. Inc. and Lenovo, General Electric and Siemens, General Motors and Toyota, and Pfizer and Novartis.

13. *See* Gutman, *supra* note 3, at 285–87.

14. *See, e.g.*, J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Getting Serious About Cross-Border Earnings Stripping: Establishing an Analytical Framework*, 93 N.C. L. REV. 673, 687–88 (2015); Stephen E. Shay, *Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations,* 144 TAX NOTES 473, 473–74 (2014).

twenty years, our 35% rate has encouraged U.S. multinationals to increase their activities, and thus their income, outside the United States. Over that period, manufacturing and other activity have gradually shifted away from the United States and towards tax-favored foreign countries, particularly in businesses where intellectual property provides the core of potential profitability.[15] While it is difficult to separate tax considerations from the cost of wages and other nontax factors, based on my own experience, the impact of the relatively high U.S. corporate tax rate is significant.

The guidelines included in the final report of the Organisation for Economic Co-operation and Development's (OECD) OECD/G20 Base Erosion and Project Shifting (BEPS) Project[16] will likely encourage further shifting of activities and functions to tax-favored countries. By emphasizing that income should be attributed to the location of "people activities" and functions that relate to intellectual property development and management, the BEPS transfer pricing guidelines move away from the traditional arm's-length standard and provide substantial incentives for multinationals to move "value-creating" activities to tax-favored locations.[17] That, in turn, would encourage countries attempting to attract such activities to further reduce their corporate tax rates, either directly or indirectly; tax competition would continue to flourish.

Of course, U.S. multinationals that shift manufacturing and other value-creating activities to other countries can only reduce their U.S. taxes if profits are not distributed from their foreign affiliates back to the U.S. corporate group. Our 35% corporate tax rate thus provides a powerful incentive for U.S. multinationals to leave most of their foreign earnings in their foreign affiliates.[18]

This "lockout" effect is a particularly dysfunctional consequence of our current international tax regime. The dysfunction results not because the funds reflecting those earnings are abroad; they can be, and typically are, invested in U.S. dollar-denominated financial assets, so they are effectively part of the U.S. financial system. But the high tax rate distorts corporate decision making.[19]

15. Our Subpart F rules limit the benefits of shifting activities and income offshore in many circumstances, unless manufacturing activity is also performed offshore. IRS, DEP'T OF TREASURY, SUBPART F OVERVIEW 3–4 (2014), http://www.irs.gov/pub/int_practice_units/DPLCUV_2_01.PDF [http://perma.cc/BZC3-TQPE].

16. ORG. FOR ECON. CO-OPERATION & DEV. & G20, ALIGNING TRANSFER PRICING OUTCOMES WITH VALUE CREATION (2015), http://www.oecd-ilibrary.org/docserver/download/2315351e.pdf?expires=1486490478&id=id&accname=guest&checksum=258A20B7BCC5ADE98783450C3B2B7F94 [http://perma.cc/DMT7-LXCL].

17. *See, e.g.*, J. Gregory Ballentine, *Ownership, Control, and the Arm's-Length Standard*, 82 TAX NOTES INT'L 1177, 1177–78 (2016); Michael L. Schler, *The Arm's-Length Standard After Altera and BEPS*, 149 TAX NOTES 1149, 1150 (2015) (discussing Altera Corp. v. Commissioner, 145 T.C. No. 30 (July 27, 2015)).

18. *See, e.g.*, Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 132 (2011) [hereinafter Kleinbard, *Lessons*].

19. Some commentators argue that the fact that most multinationals can currently borrow inexpensively in the United States minimizes distortions caused by the lockout. *See, e.g.*, Edward D. Kleinbard, *"Competitiveness" Has Nothing to Do with It*, 144 TAX NOTES 1055, 1060–61 (2014) [hereinafter Kleinbard, *Competitiveness*]. But borrowing has its limits for most multinationals looking

Investments in foreign business assets are preferred over investments in U.S. business assets. Distributions of excess funds to shareholders are discouraged. And acquisitions of U.S. multinationals by foreign multinationals are encouraged as a way to unlock the non-U.S. affiliate earnings of U.S. multinationals. As with inbound investments by non-U.S. multinationals, our rules on outbound investments of U.S. multinationals create an unlevel playing field between U.S. multinationals and most foreign-based multinationals.

This incongruity has spurred "inversions," transactions in which U.S. corporations become subsidiaries of newly created foreign corporations with little, if any, change in their shareholders or management. The Obama Treasury Department diligently adopted regulatory changes that limited the ability of U.S. companies to undertake such transactions and limited the benefit of the transactions where undertaken.[20] The Obama administration and congressional Democrats also proposed legislation to further limit the ability of U.S. companies to invert into foreign companies.[21] These proposals constitute a clear admission that U.S. rules do not create a level playing field between U.S. and non-U.S. multinationals. The Obama administration attempted to deal with this essentially by building walls around existing U.S. multinationals to prevent them from leaving the United States. But the combination of continued U.S. tax advantages for non-U.S. multinationals and a relatively high corporate tax rate means that U.S. business assets will be more valuable to foreign owners than to U.S. owners. Over time, that simple fact has a substantial impact on U.S. multinationals.

One proposal to deal with the adverse impact of our high corporate tax rate focuses directly on the foreign income of U.S. multinationals; it is a current tax (sometimes called a "minimum tax") on the earnings of foreign affiliates of U.S. multinationals at a rate substantially lower than 35%.[22] We do not know at what tax rate such a current tax would be revenue neutral compared to the present law tax burden on U.S. multinationals. We do know that the proposal by the Obama administration for a tax at a 19% rate, with 85% of foreign income taxes allowed as a credit and the foreign tax credits calculated on a per country basis, increases taxes on U.S. multinationals by almost $300 billion over ten years.[23] Perhaps, then, such a tax at a 15% rate, or even slightly lower, could avoid such a tax increase. A 15% current tax would end the lockout effect, which would definitely be a good thing. But, given the continued 35% rate on domestic

to the future, and of course, cash sitting idly offshore remains a corporate inefficiency.

20. *See* Temp. Treas. Reg. § 1.7874-8T (2016); Prop. Treas. Reg. § 1.385-1–4, 81 Fed. Reg. 40226 (Jun. 21, 2016); I.R.S. Notice 2015-79, 2015-49 I.R.B. 775; I.R.S. Notice 2014-52, 2014-42 I.R.B. 712.

21. *See* Stop Corporate Inversions Act of 2014, H.R. 4679, 113th Cong. (2014) (sponsored by Reps. Sander Levin, Charles Rangel, James McDermott, Richard Neal, Lloyd Doggett, and others); U.S. DEP'T OF TREASURY, GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2016 REVENUE PROPOSALS 37–38 (2015) [hereinafter TREASURY, GENERAL EXPLANATION].

22. Tax Reform Act of 2014, H.R. 1, 113th Cong. § 3001(b) (2014); TREASURY, GENERAL EXPLANATION, *supra* note 21, at 19–22.

23. JOINT COMM. ON TAXATION, JCX-15-16, ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2017 BUDGET PROPOSAL 1 (2016).

income, it would not eliminate, and indeed could enhance, the incentives for U.S. multinationals to move functions and activities, and thus income, to tax-favored jurisdictions. And the advantages for non-U.S. multinationals making inbound investments would likely continue. These issues can only be mitigated by reducing the basic 35% corporate tax rate.

For these reasons, our 35% corporate tax rate should be reduced (in addition to revising our international rules to end the lockout effect). If funded through base broadening that affects all business income, any such reduction must extend to noncorporate businesses. But as Gutman persuasively describes, it is difficult, if not impossible, to reduce our business income tax rate significantly below 28% through base-broadening provisions alone.[24] That means we must either find an alternative source of revenue or fundamentally alter our approach to taxing business income.

Another basic rationale for considering more fundamental alternatives (less familiar to lawyers like Gutman and myself but even more important from a policy and political perspective) is the impact of tax reform on incentives for businesses generally to invest in the United States and thus promote economic growth. Gutman understandably expresses some skepticism about "dynamic scoring" of revenue estimates for tax legislation.[25] But the analysis necessary for such scoring is revealing.[26] Slowing down depreciation deductions to fund lower corporate tax rates does not necessarily encourage new investment in plants and equipment.[27] Amortizing rather than deducting R&D expenditures will not necessarily encourage growth in new technology investments even with a reduction in corporate tax rates. At a time when measures that encourage productivity and economic growth in the United States are a high and largely bipartisan priority, tax reform to reduce corporate tax rates funded by slowing these deductions seems counterproductive. Therefore, reform leaders should consider another source of funding or a more fundamental restructuring of our corporate tax—one that encourages economic activity in the United States.

II. IS CORPORATE INTEGRATION THE ANSWER?

Gutman aptly describes the corporate integration proposal under consideration by Senate Finance Committee Chairman Orrin Hatch as an alternative to a corporate rate reduction.[28] The proposal is expected to provide a dividends-paid deduction with an offsetting shareholder tax that is withheld from

24. *See* Gutman, *supra* note 3, at 274.

25. *See id.* at 272–73 n.18.

26. Martin A. Sullivan, *Economic Analysis: Dynamic Scoring Update for Non-Economists*, 148 TAX NOTES 1288, 1288–89 (2015); Martin A. Sullivan, *Economic Analysis: Time to Shop for a Different Approach to Tax Reform?*, 146 TAX NOTES 948, 949–50 (2015).

27. Admittedly, there is evidence that those publicly owned companies whose stocks trade based on earnings rather than cash flows are insensitive to the timing of depreciation and other deductions because they do not provide a financial statement benefit. *See, e.g.*, John R. Graham et al., *Tax Rates and Corporate Decision Making*, REV. FIN. STUD. 22–24 (forthcoming), http://ssrn.com/abstract=2548641 [http://perma.cc/YK5R-SJ74].

28. *See* Gutman, *supra* note 3, at 281–82.

the payment of dividends. The proposal's goal is to show the benefit of the corporate tax reduction at the corporate level offset by an increased tax at the shareholder level to the extent of dividend payments.[29] As Gutman describes it, this proposal would require imposing the withholding tax on tax-exempt and foreign shareholders, as well as taxable U.S. shareholders.[30] Gutman is correct that imposing such a tax on all tax-exempt organizations, including qualified retirement plans, would be difficult politically. Apparently the corporate integration proposal also envisions that interest expenses would be treated like dividends, thus deductible at the corporate level and subject to a similar withholding tax on payment to lenders. A withholding tax on interest would be even more difficult to make politically or practically workable because most interest income comes from financial intermediaries that typically earn a modest spread; the withholding tax would likely be disproportionate to that spread, hurting the bottom line of those entities.

Even if these obstacles could be overcome, the proposed treatment of foreign income of U.S. corporate groups under the potential dividends-paid deduction integration proposal seems fundamentally inconsistent with a major goal of existing international income tax policy: that foreign earnings should not be subject to higher levels of taxation than domestic earnings unless a foreign income tax rate exceeds the U.S. income tax rate. Under the corporate integration proposal, distributions out of domestic earnings would bear no corporate-level tax, and an offsetting withholding tax would be applied at the shareholder level. But distributions out of foreign earnings would nonetheless bear any foreign tax imposed on those earnings at the corporate level, plus a full withholding tax at the shareholder level. In effect, the foreign tax imposed on distributed foreign earnings would be treated as a deduction for U.S. tax purposes.[31] International double taxation of corporate income would result. For these reasons, corporate integration is not likely the solution to business tax reform. Either a fundamental change to our corporate income tax or a new source of revenue is necessary to fund a reduction in the current corporate tax.

III. FUNDAMENTAL CHANGE TO THE CORPORATE INCOME TAX

Gutman argues that our current objectives in business income tax reform can best be met if reform is funded by a consumption tax.[32] He concludes that a credit-invoice VAT is preferable on enforceability and transparency grounds to

29. Edward Kleinbard offers a rather cynical perspective on this proposal in *The Trojan Horse of Corporate Integration*, 152 TAX NOTES 957 (2016) [hereinafter Kleinbard, *The Trojan Horse*], characterizing it as a technique to satisfy major corporations' interests through a reduction in their effective tax rates for financial statement purposes. But it is not clear to this author that many U.S. corporations desire a proposal that would cause a public perception that corporate taxes were eliminated, particularly where their shareholders do not receive the benefit of a tax reduction.

30. *See* Gutman, *supra* note 3, at 280–81.

31. Kleinbard, *The Trojan Horse*, *supra* note 29, at 958 (explaining that the corporate community "would enthusiastically support corporate tax integration that takes the form of a dividends paid deduction").

32. *See generally* Gutman, *supra* note 3.

other consumption taxes, such as a subtraction-method VAT or a cash flow tax.[33] That view reflects the conventional wisdom of academic commentators.[34] However, if one dives into the details, it is unclear whether an accounts-based tax, like a subtraction-method VAT or a cash flow tax, would be any less administrable than a credit-invoice VAT. We live in a world where physical invoices are rapidly becoming obsolete and where manually reviewing such invoices is not an efficient use of tax authority resources. Moreover, while including the tax as a separate item on invoices is politically useful for those who want citizens to "feel the pain" of taxes, the reality is that the percentage of the tax borne by purchasers (versus wage earners and capital providers) is, as Gutman admits,[35] a much more complicated question, the answer to which varies from product to product and industry to industry.[36] It is true that other countries' experiences with credit-invoice VATs provide us with a wealth of guidance in designing and administering a consumption tax. But that experience, while helpful, cannot outweigh the current American political reality that a consumption tax that looks, smells, and feels very much like a business tax (i.e., subtraction-method VAT or destination-based cash flow tax) is likely to be much more acceptable than a consumption tax that looks, smells, and feels very much like a sales tax (i.e., credit-invoice VAT).

Consequently, Gutman and those who share his vision should think about second-best solutions. In particular, they should consider variants on the destination-based cash flow tax proposals, including those proposed by the President's Advisory Panel on Federal Tax Reform in 2005,[37] discussed in detail in proposals by Alan Auerbach and Michael Devereux,[38] and by House Republicans in their *A Better Way* proposal.[39] Each of these proposals, if applicable to nonfinancial transactions,[40] is essentially a subtraction-method VAT with a deduction for wages paid to U.S.-based employees. Each provides for the expensing of capital assets, which can encourage investment. Each is or

33. *Id.* at 293.

34. For an excellent compilation of articles on the relative merits of alternative forms of VATs, see generally Itai Grinberg, *Where Credit Is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT*, 63 TAX L. REV. 309 (2010).

35. *See* Gutman, *supra* note 3, at 295.

36. *See, e.g.*, ERIC TODER, JIM NUNNS & JOSEPH ROSENBERG, TAX POLICY CTR, USING A VAT TO REFORM THE INCOME TAX 7–12 (2012).

37. PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 191–206 (2005).

38. *See, e.g.*, ALAN J. AUERBACH, CTR. FOR AM. PROGRESS, A MODERN CORPORATE TAX 10–15 (2010); 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].

39. *See* A BETTER WAY, *supra* note 1, at 15, 27–29.

40. Financial transactions (e.g., equity debt and currency transactions) involving financial institutions cause unique issues that may best be dealt with by exempting business-level transactions and imputing taxable services revenues to such institutions. *See* Grinberg, *supra* note 34, at 339–42; Peter R. Merrill, *VAT Treatment of the Financial Sector*, *in* THE VAT READER 163, 165–66 (Tax Analysts ed., 2011).

can be destination based, which would level the playing field between U.S. and non-U.S. multinationals and eliminate transfer pricing issues.[41] Most importantly, each proposal reduces or eliminates the disincentives for domestic investment in people and property that our current corporate tax creates.

The design of a destination-based cash flow tax requires resolving many issues, including how to tax the financial sector, how to verify goods and services that are imported and exported, and how to tax remote sales and services provided to U.S. consumers. With sufficient effort by bright and experienced professionals like Gutman, these issues may be resolvable. Two issues, however, are more fundamental: (1) whether a destination-based cash flow tax can be compatible with the requirements of the General Agreement on Tariffs and Trade (GATT),[42] and (2) whether from a tax policy perspective, any cash flow tax should completely replace all federal business taxes or should somehow be combined with such taxes. Each of these issues requires serious discussion.

From an economic perspective, a destination-based cash flow tax is trade neutral, meaning it does not discriminate against imports in favor of exports when flexible exchange rates are taken into account.[43] Nonetheless, most legal observers believe a destination-based cash flow tax likely violates GATT requirements as a legal matter if wages of U.S. employees are deductible.[44] This would appear to violate the GATT requirement that imports be treated the same as domestic production (because the wages incurred outside the United States on imported goods and services would not be deductible).[45] Similarly, the fact that wages incurred in the United States to produce exempt exports of goods and services would be deductible could be viewed as an improper subsidy for those exports.[46]

The legal argument that the deduction of U.S.-incurred wages should not be viewed as violating GATT could be based on the same premise as that for deducting purchases of goods—the amounts paid to both sellers of goods and wage earners are subject to U.S. tax in the hands of the recipients, and thus the deduction merely avoids a cascading of the cash flow tax. Without any change in our taxation of wages, however, the parallel between the taxation of wages and purchases is tenuous. The individual income tax is arguably separate from any business cash flow tax, and the correlation between the income tax paid by any wage earner and the deduction of those wages under the cash flow tax is, at best,

41. *See* Gutman, *supra* note 3, at 288.

42. General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194; Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Apr. 15, 1994, 1867 U.N.T.S. 14 [hereinafter ASCM].

43. ALAN S. AUERBACH & DOUGLAS HOLTZ-EATON, THE ROLE OF BORDER ADJUSTMENTS IN INTERNATIONAL TAXATION 4–5 (2016), http://www.americanactionforum.org/print/?url=https://www.americanactionforum.org/research/14344/ [http://perma.cc/9ML2-3JFP].

44. *See* Wolfgang Schön, *Destination-Based Income Taxation and WTO Law: A Note* 13 (Max Planck Inst. for Tax Law & Pub. Fin., Working Paper No. 2016-3, 2016).

45. ASCM, *supra* note 42, art. 3.1, 1867 U.N.T.S. at 16.

46. *Id.* Annex I(g), 1867 U.N.T.S. at 48.

imprecise.

Because the business cash flow tax is a flat rate tax, converting the deduction for wages to a tax credit against federal Social Security and Medicare payroll taxes and the individual income tax would be more defensible, depending on the rate of each tax.[47] For example, if the cash flow tax were imposed at a 20% rate and wages were not deductible, but instead a credit equal to 20% of wages were provided as an offset first to the Social Security and Medicare taxes and then to any individual income tax, strong arguments could be made that the cash flow tax would be a GATT-legal subtraction-method VAT. The credit against payroll and individual taxes could be viewed as a method of mitigating the impact of the tax on wage earners. The fact that such a wage credit is likely legal under GATT while a wage deduction likely violates GATT, even though the two should be economically equivalent over time, illustrates the formalism of the GATT requirements.

One thing is clear: if the United States were to replace its current corporate tax, which is origin- or activity-based, with a destination-based cash flow tax—like the 2005 President's Advisory Panel and the 2016 Republican *A Better Way* proposals—the GATT challenges by other nations would come swiftly. Our trading partners would be understandably concerned about the movement of functions and activities to the United States if the United States fully taxed imported goods and services and exempted all exported goods and services. We should take that concern seriously; completely eliminating any origin-based business tax[48] would be provocative to the rest of the world and arguably unnecessary to solve our current problems.

But the answer to these concerns need not be limited to a credit-invoice VAT and a reduced corporate income tax, as Gutman recommends. Rather, Gutman and those who share his vision should think creatively about second-best solutions by exploring in greater depth variants of the cash flow tax along the lines of the 2005 President's Advisory Panel and the Republican *A Better Way* proposals. Those proposals could be quite similar to Gutman's vision if they were modified to combine a destination-based and an origin-based tax. Both taxes would have a cash flow base, but only a portion of the tax would be destination-based.[49] As an example, perhaps an origin-based cash flow tax could

47. The Social Security tax is imposed at a flat rate of 6.2% separately on employers and employees for a combined rate of 12.4%. I.R.C. §§ 3101(a), 3111(a) (2012). The Medicare tax is a separate 1.45% tax, yielding a combined rate of 2.9%. §§ 3101(b), 3111(b).

48. As opposed to a destination-based cash flow tax, an origin-based cash flow tax treats cash flow as taxable in the jurisdiction of the relevant activity. Thus, a U.S. manufacturer would deduct all costs, including those for imported supplies and goods, and the manufacturer would be taxable on all revenues, including exports. *See, e.g.*, Grinberg, *supra* note 34, at 37–38. For this reason, an origin-based cash flow tax is viewed as a tax on production (not on consumption), similar to today's income tax.

49. Given the GATT's rule regarding destination-based cash flow taxes, the 2005 President's Advisory Panel proposed an origin-based cash flow tax. Other proposals for such a tax date back to David Bradford's X tax. *See* DAVID F. BRADFORD, FUNDAMENTAL ISSUES IN CONSUMPTION TAXATION 8 (1996).

be adopted as a minimum tax floor under a destination-based cash flow tax. Alternatively, a cash flow tax could be implemented that excludes a fixed percentage of export revenues and denies a deduction for the same percentage of import costs.[50]

The point here is not to say that either of the above suggestions provides a solution that should completely satisfy Gutman and those who share his vision. Rather they are examples of creative second-best proposals that thoughtful tax policy professionals like Gutman should now seriously consider—even though these proposals differ from the taxes found around the world today—given our 2017 political and legislative environment.

50. I credit Peter Marrs of General Electric for first developing the idea for such a proposal.