Center for Strategic Tax Reform
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Testimony Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means

Hearing on the Extraterritorial Income Regime

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Mr. Chairman and Members of the Committee. I am honored to appear before you today to talk about WTO-legal ways of making American companies and their employees more competitive in world trade.

Some people think that the answer may be provided by the so-called subtraction-method value added tax. In reality, however, the subtraction method VAT is largely a mirage that exists primarily in the imaginations of some academics. The tax they so describe is, in substance, identical to a slightly amended version of our present corporate income tax that takes into account the existence of the employer payroll tax (the FICA tax as it is often called).

Therefore, let us set aside the VAT syndrome and the political baggage that goes with it. We can then concentrate on the few changes in the current corporate income tax that are necessary for it to qualify as an "indirect tax" under WTO rules.

Once we have qualified our corporate tax as an "indirect tax", we can then exclude export income from U.S. tax. Once we have excluded export income from tax, we can then adopt a truly territorial tax system that will allow U.S. companies to invest and compete directly in foreign markets. Devices such as FSC and ETI are unnecessary.

There is no need to resort to some new and radical tax system. Indirect tax status is imminently obtainable within the framework of current law and within the framework of American tax traditions.

An "indirect tax" under WTO rules has a base equal to value added. To most people, the most familiar form is the European-style VAT structured to resemble a sales tax, but there are other forms of taxes on value added that bear no resemblance whatsoever to a sales tax and have nothing whatsoever to do with taxing consumers.

Value added is a concept similar to net income -- as explained in the Appendix to my testimony.

Only two amendments are necessary to convert our existing corporate tax on net income into a tax on value added. Each such amendment is meritorious on its own and neither is shocking.

The first amendment is to make the interest that a corporation pays to its debtholders nondeductible in the same way that the dividends it pays to its equity shareholders are presently nondeductible. As a result, all the income from both debt and equity capital would be included in the corporation's tax base.

After having included in the tax base the income from capital, the other step necessary to complete the value added base would be to include the income from labor. The measure of this income is the amount of wages paid to the corporation's employees -- just as the amount of income from capital is the amount of interest and dividends paid by the corporation.

Under the present corporate income tax, wages are, *in form,* deductible and, therefore, *in form,* are not included in the corporation's tax base, but, in reality, under current law, the corporation must pay a 7.65 percent FICA payroll tax on the first $84,900 of each employee's wages. Thus, under current law, wages up to $84,900 are already included in the corporate tax base -- except at a 7.65 percent tax rate instead of the 35 percent tax rate that applies to the rest of the corporate tax base.

The obvious solution is to broaden the corporate income tax base by allowing no deductions for interest, dividends or wages – and, with that broad tax base, lower the corporate tax rate to the range of 8 to 12 percent on a revenue-neutral basis. In order not to double tax the wage component of the new tax base, corporations would be allowed a credit for the employer payroll tax or corporations would be allowed to deduct wages up to $84,900 per employee with only the excess for highly paid employees being nondeductible.

There are various ways of "integrating" the existing corporate income and payroll taxes in order to have a base equal to value added and, therefore, to have the same base as an indirect tax under WTO rules. None of these increases the tax burden on the labor component of GDP except in the case of the highest paid employees and, even in their case, not by very much.

This is not pie-in-the-sky stuff. Its pedigree is impeccable. The starting point is the Comprehensive Business Income Tax (CBIT) proposal made in 1992 by the Treasury Department after years of study.1 The study was primarily authored by the Honorable R. Glenn Hubbard, presently Chairman of the President's Council of Economic Advisors, and Professor Michael J. Graetz of Yale University, both of whom were Deputy Assistant Secretaries of the Treasury at the time. The 1992 Treasury study suggested that (1) interest be made nondeductible like dividends and (2) that all businesses, whether or not incorporated, be subject to a uniform business tax which involved a half dozen or so amendments to the then current corporate income tax. The Treasury made this recommendation after concluding that allowing a deduction for interest, but not dividends, and taxing incorporated businesses differently from unincorporated businesses, had a significant negative effect on GDP growth.

Other amendments that would normally be included in converting the corporate income tax into a more comprehensive tax with a base equal to value added are (1) cash accounting for inventory and (2) full first-year expensing of capital equipment, but neither of these are necessary.2

Only the two simple amendments already described are necessary to achieve "indirect tax" status and the ability to solve the FSC/ETI problems and much more.

This Committee and this Congress have before them a huge bipartisan opportunity to serve the national interest. You can enact a few simple amendments that will then open the door to all kinds of opportunities for enhanced world trade, more and better paying manufacturing jobs in America, and overall higher standards of living for Americans.

Instead of penalizing exports and, therefore, driving offshore American companies that would rather stay home, we can exclude exports from tax and make the United States of America a prime location for manufacturing and selling to markets around the world. The U.S. would be an especially desirable location if we also amended the code to allow full first-year expensing such as proposed by Congressman Philip English and Congressman Richard Neal in their recent High Productivity Investment Act (H.R. 2485).

Instead of making it hard for American companies to directly compete in foreign markets that cannot be fully served by exports at the outset, we could adopt a territorial system that would give them an even chance. Moreover, when U.S. companies do succeed in a foreign market, we could stop penalizing them if they bring their money home for reinvestment in the American economy. (Present law gives them a tax break if they keep the money abroad invested in someone else's economy.) We could also stop favoring large companies (who can afford to keep the money abroad) over small companies who need to bring the cash home and, who, therefore, must pay the tax penalty imposed by current law.

The need to cure these and many other fundamental defects in America's international tax rules is a long-standing bipartisan point of view. Moreover, it is in the joint and mutual interest of all *companies* and all *employees* for America to be the location of choice for companies -- foreign and domestic – engaged in world trade.

In the past, the barrier to action was the mistaken belief that in order to do so, America would have to take some drastic step such as repealing the income tax and replacing it with some kind of sales tax.

Today, we know better. Only a few straightforward amendments to the income tax are necessary.

The time for bipartisan action is now. The need is great. The opportunity is here.

Appendix to Testimony

A Step-By-Step Guide: How To Convert The Corporate Income Tax Into An Indirect Tax under WTO and Thereby Solve the FSC/ETI Dilemma and Much More

Preamble: Why Do It

FSC/ETI and/or an outright exclusion of export income would be legal under WTO rules if the existing corporate income tax (or an amended version thereof) were classified as an "indirect" tax. So-called "inversions" and other devices by which U.S. companies flee to foreign locations would also be eliminated. Indeed, the United States of America would become the location of choice for both U.S.-owned and foreign-owned companies engaged in world trade.

What Is An Indirect Tax

A tax with a base equal to value added is classified as an indirect tax. The most familiar form is the European-style VAT which is structured to resemble a sales tax, but there are other forms of taxes on value added that bear no resemblance whatsoever to a sales tax. Indeed, as will be seen later, when the existing corporate income tax and the existing employer payroll tax are considered together, their consolidated tax base is almost exactly equal to value added.

Thus, it is not only the VAT-type sales tax that can have a value added base and, thereby, can gain the advantages that accrue under the WTO to taxes classified as "indirect".

A modified version of the existing corporate income tax can also gain those advantages for the United States.

The Concepts of Value Added and Income Are Similar

Like the corporate income tax, a tax on value added is imposed on businesses, not on individuals. Compared to the corporate income tax, the essential difference is in the tax base. In its most simple form (before adjustment for exports and imports), a business's value added tax base is equal to its gross income.

Example: During the year, Black Corp. has gross income of $100X from the production and sale of widgets. Its value added tax base is $100X.

This simple form of gross receipts tax would work just fine if all goods and services were produced and sold by one gigantic company, but, in reality, the total *value* of goods and services in the economy is *added* in bits and pieces by a large number of companies.

Note: The fundamental flaw with any gross receipts tax is the obvious pyramiding of tax that occurs when more than one company is involved in producing a particular product or service. For example, if, in order to produce and sell $100X of widgets, Black Corp. had bought widget parts and components from White Corp. for $30X, the combined tax base of

the two companies would be $130X even though only $100X of final product had been produced and sold.

Therefore, in order to void pyramiding, taxes on value added as well as taxes on net income typically allow a business to deduct from its tax base the cost of the inputs (such as parts and components) that it purchases from some other business.

Example: Black Corp. paid (1) $30X for widget components, (2) $10X for a widget assembly machine, (3) $1X for interest on debt to finance that machine and (4) $50X for employees to produce and sell the $100X of widgets it sold during the taxable year. Black Corp. also paid a $9X dividend to its shareholders.

(1) Value Added Calculation: Black Corp.'s value added tax base for the year is $60X, computed as follows:

Gross Income	$100X
Less: Deductible Costs Paid to Another Business for Components and Included in Payee's Tax Base under Value Added System.	$(30X)
Deductible Costs Paid to Another Business for a Machine and Included in Payee's Tax Base under Value Added System.	$(10X)
Value Added	$60X

Nondeductible Costs Not Included in Payee's Tax Base under a Value Added System:

$1X of Interest

$9X of Dividends

$50X Salaries to Employees

Note: In value-added parlance, Black Corp. has been allowed to deduct the amounts paid to other businesses because those amounts are included in the other business's value added tax base. Salaries paid to employees are not deducted because the employee's wages are not taxable under the value-added tax. Only businesses are subject to the tax on value added. In income tax parlance, it would be said that Black Corp. has been able to deduct inventory costs in the year paid (instead of using inventory accounting which over time tends to defer deductions beyond the year of payment). In income tax parlance, it would also be said that Black Corp. has been able to expense capital equipment (instead of depreciating its

cost over a period of years), but has not been able to deduct wages paid to employees or interest paid to debtholders or dividends paid to shareholders.

(2) Net Income Calculation: Black Corp.'s net income tax base for the year is approximately $24X, computed as follows:

Gross Income $100X

Less: Approximate Amount of Deductions Allowed under Inventory Accounting Rules for the $30X Paid for Components that was included in the Payee's Tax Base a/ . . . . . $(20X)

First-Year Depreciation Deduction Allowed for the $10X Paid for the Machine that was included in the Payee's Gross Income b/. . . . . ($4.4X)

Cost of Salaries Paid to Employees . . . . . ($50X)

Interest Cost . . . . . ($1X)

Net Income.....$24.6X

a/ Although in our overly simplified example where all purchases and sales are made in the same year, the full $30X would be deductible, in the typical real-life case, the business would have some costs that would be perpetually deferred under inventory accounting rules.

b/ The depreciation calculation assumes 30% bonus depreciation and MACRS depreciation on 5-year property.

Comparison of Value Added and Net Income Calculations

The differences between the two systems are easily discernible (and, as shown later, easily reconcilable).

a. Cash vs. Inventory Accounting. In the example, the value added system uses cash accounting whereas the net income calculation uses inventory accounting, but this is not an inherent difference: an amended corporate income tax whose base was equal to value added could continue to use inventory accounting. A cash system is simpler and generally better, but that reform is not necessary in order to convert the corporate income tax into an "indirect tax".

b. Expensing vs. Depreciation. In the example, the value added system expenses capital equipment purchases, whereas the net income calculation uses depreciation, but, again, this difference is not immutable. Expensing is a superior rule, but the corporate income tax can be converted into an "indirect tax" without making that change. The corporate tax could qualify even though it continued to use the depreciation rules of current law.

The two remaining differences relate to the deductions allowed under the current corporate income tax for interest paid to debtholders and compensation paid to employees. Because a value added base (the key to "indirect tax" status) includes the output of *all* capital (as well as the output of labor), no deductions for interest or compensation are allowed. Therefore, in this case, the familiar income tax deductions must give way to the value added rule but, as shown below, the deduction for interest is not an inherent characteristic of a corporate income tax and, insofar as concerns wages, the absence of any income tax deduction for compensation paid employees is not the radical change that might be thought. In fact, when the existing payroll tax is taken into account, a large portion of wages paid are, in effect, already nondeductible under present law.

c. No Deduction for Interest Paid. A deduction for interest paid is not an inherent or necessary characteristic of a corporate income tax. Indeed, allowing a deduction for interest (the cost of debt capital) but not for dividends (the cost of equity capital) is a major distortion under present law that impedes GDP growth according to a Treasury study a few years ago.3 That study recommended replacing the current corporate income tax with a Comprehensive Business Income Tax (CBIT) that allowed no deduction for interest. (Dividends are not deductible under present law.) (As will be seen later, had the CBIT proposal raised its horizons only slightly higher and taken into account the payroll tax that existed then (and now) in another portion of the Internal Revenue Code, the Comprehensive Business Income Tax would have had a base equal to value added.

d. No Deduction for Wages. The idea that wages paid *are* fully deductible under present law is largely a mirage arising from the fact that the corporate income tax (where wages are deductible and are not part of the tax base) is in one part of the tax code and the employer payroll tax (where wages are not deductible and are in the tax base) is in another part of the tax code. When, however, these two taxes are viewed together, it is easily seen that *in substance* most wages are already nondeductible. In form, under present law when a business pays wages it is entitled to deduct them from its corporate base, but when the business turns to another page of its tax return, it must add back those wages to the base of its employer payroll tax and pay tax on them. The difference is, of course, that the corporate rate is presently 35 percent whereas the payroll tax rate is presently 7.65 percent, but under the reformed corporate tax, the tax rate would be much lower -- about the same as the 7.65 percent employer payroll. In that case, the amended "indirect" corporate income tax could continue to allow a deduction for wages up the the $84,900 cutoff point of the payroll tax or could disallow a deduction for all wages, but allow a credit for the payroll tax. In either case, the total tax attributable to wages -- whether called a corporate tax or payroll tax would not be greatly different from present law.

Thus, like so much else about the comparison between a value added base and a net income tax, the differences are much less than thought.

Obvious Conclusion: The Existing Corporate Income Tax Can Readily Be Converted into an Indirect Tax

The bottom line point is glaringly simple: Forget about VATs (subtraction-method or otherwise) and all other exotic tax reforms. Instead, convert the existing corporate income tax into an indirect tax by the simple expedient of disallowing the deduction for interest (treat same as dividends) and integrating the corporate income tax with the existing payroll tax by various cross credits or offset formulas that results in a combined labor and capital base equal to value added.

Once indirect status is achieved, export income can be excluded from tax. Once export income is excluded, a correct and fair territorial system could be adopted. With indirect status, imports could also be brought into the U.S. tax base. That is, however, an option, not a requirement.

Notes

1 Department of the Treasury, *Integration of the Individual and Corporate Tax Systems – Tax Business Income Once* (Washington, DC: GPO, 1992). Because the CBIT proposal would have maintained a higher rate of tax -- about 31 percent on corporations -- it recommended that the nondeductibility of interest be phased in over a period of time. CBIT would also have excluded interest and dividends at the personal level.

2 Some kind of border tax adjustment for imports could also be added -- such as if a company sought to move a plant abroad and sell back into the United States -- but that is not a necessary component and is outside the scope of the present inquiry.

3 *Supra* at n. 1