Washington Center for Equitable Growth

Can the Ryan tax blueprint work?

Problems with the House Speaker's destination-based corporate tax plan

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A new analysis by Reuven Avi-Yonah and Kimberly Clausing describes how Speaker of the House Paul Ryan's "A Better Way" blueprint model for a **destination-based cash flow type business tax** falls short. Specifically, the proposal would:[1]

- **Be incompatible** with World Trade Organization rules and risk undermining the world trading system
- **Be incompatible** with our current tax treaties, requiring massive treaty overrides
- **Still enable** U.S. corporations to earn substantial income in tax havens overseas
- **Introduce many other technical challenges** that are not easily resolved
- **Decrease tax revenues** in a regressive manner

In short, the Ryan blueprint would make major changes to the corporate tax code that would shift the United States toward a destination-based cash flow business tax. Here are the broad differences between the current tax code and the Ryan corporate tax plan:

Our current corporate tax code versus House Speaker Ryan's proposed corporate tax blueprint

The current corporate income tax code…

- Taxes corporate profits at a marginal rate of **35%**
- Requires businesses to write off capital expenditures, depreciating their costs over time
- Permits businesses to deduct interest payments against any income

Ryan's House corporate income tax plan would…

- Tax corporate profits at a marginal rate of **20%**
- Permit businesses to immediately write off capital expenditures, leading to a zero marginal return rate on investments
- Prohibit businesses from deducting net interest expenses
- Impose a tax on imports and exempt export income
- Eliminate the requirement for foreign subsidiaries of U.S.-based multinationals to pay tax on the profits earned abroad

These reforms would make the corporate tax border adjusted

Border adjustments enable products' sales revenues to be taxed in the country where they are consumed. This kind of tax is traditionally a feature of value-added taxes, which are employed by our major trading partners. The Ryan proposal is not a VAT but rather a modified consumption-based tax. Unlike in VATs, the Ryan plan would permit businesses to take an immediate deduction for their domestic labor costs. This feature is what prevents the tax from being a straightforward tax on consumption.

There are five major problems with Ryan's proposed destination-based cash flow business tax

I. It is incompatible with World Trade Organization rules and risks undermining the world trading system.

- The tax is a direct tax and would violate the WTO Subsidies and Countervailing Measures Agreement. Under this agreement, a tax may be border adjustable only if it is an indirect tax. Indirect taxes are defined as consumption-based taxes such as sales, excise, or value-added taxes. Direct taxes, in contrast, are income-based, including taxes on wages, profits, or rents. Because the Ryan blueprint allows businesses a deduction for wages, it is a tax imposed on an income base.

- The House proposal would damage U.S. international and trade relations. The proposal argues that the deduction for wages effectively subsidizes exports and taxes imports and increases the incentive for businesses to be based in the United States. The proposal also would reduce our trading partners' tax revenues because foreign companies' profit shifting to the United States will not affect U.S. tax liabilities but will reduce foreign liabilities. Trading partners are likely to legally challenge these measures, increasing the likelihood of retaliatory tariffs and causing an uncertain investment environment in the United States.

- Many economists argue that the trade effects of the plan will be blunted if not eliminated by subsequent appreciation of the U.S. dollar. Yet lags in the exchange rate change or incomplete exchange rate adjustment could cause substantial disruption to importing industries. And, even if the exchange rate adjusts fully eventually, dollar appreciation will have large effects on U.S. holders of foreign assets, and dollar appreciation would expose the world economy to additional risk. Further, retaliation by trading partners could have effects that outlast these disruptions.

- If the U.S. government in the end were to comply with WTO rules by turning this plan into a "normal" value added tax, or VAT, then it would turn the corporate tax into a regressive consumption tax. If the United States eventually complies with WTO rules by dropping the border adjustment, then the tax plan will lose even more revenue, and there will be massive opportunities for tax avoidance.

2. It is incompatible with our current tax treaties, requiring unlikely, massive treaty overrides.

- The Permanent Establishment limitation in income tax treaties, which requires importers to have a physical presence in the United States, would not work with a destination-based tax on imported products. Eliminating this restriction would fundamentally change the underlying treaty bargain, as recently affirmed by the 35-member nation Organisation for Economic Cooperation and Development.

- In order for it to be imposed on a destination-basis, the tax must apply to all imports. Under the Ryan tax plan, royalties from licensing intangibles to consumers must be subjected to a 20 percent withholding tax. This would require overriding all of our tax treaties, which have always provided zero withholding on royalties.

- Such massive treaty overrides would be regarded by our treaty partners as violations of international law and would likely lead to retaliation against U.S.-based companies.

3. It wouldn't stop U.S. corporations from earning substantial income in tax havens overseas.

- By moving to a destination-based cash flow business tax with a reduced corporate tax rate, the Ryan plan claims that corporate income shifting and inversions abroad would stop.[2] Yet there would still be many ways to game a destination-based cash flow business tax to take advantage of lower corporate tax rates overseas. Rents from intangibles (such as intellectual property) can be located in jurisdictions with a zero tax and then repatriated tax-free, providing incentives for U.S. corporations to alter their decisions for tax purposes.

- Under current law, for example, a U.S. parent company can develop intellectual property in the United States, shift it to a low-tax jurisdiction, and accumulate profits from exploiting it overseas in that jurisdiction without paying current U.S. tax. These sorts of strategies have caused U.S.-based multinationals to accumulate $2.5 trillion in low-taxed profits offshore, which they cannot repatriate without incurring U.S. tax. Under the Ryan proposal, U.S. parent companies can develop intellectual property in the United States, deduct research and development and wages, and sell the intellectual property to its foreign affiliate in a low-tax jurisdiction. The sale proceeds will be exempt as an export, so the U.S. parent will show a loss. The foreign affiliate can exploit the intellectual property offshore in the same ways it does now. Under the Ryan proposal, however, the profits can be repatriated to the United States tax-free.

4. It would introduce many other technical challenges that are not easily resolved.

- The complexity and confusion surrounding the plan make it easier for savvy corporate tax planners and lobbyists to design loopholes, risking erosion of the U.S. corporate tax base.

- Many exporting companies in the United States will be likely to show losses, necessitating large refunds from the U.S. Treasury to make the tax system work as designed. This could lead to "optics" problems where the federal government is subsidizing highly successful companies. Yet if the refunds are not allowed then that could lead to inefficient, tax-driven mergers in order for companies to utilize losses.

- The plan ignores important technical elements, such as the taxation of financial institutions and financial flows as well as transition problems.

- There could be significant impacts to state and local corporate tax systems that have not been addressed by the plan.

5. It would decrease tax revenues in a regressive manner.

- Recent analyses of the blueprint show that its proposed changes would decrease federal revenues by $3.0 trillion over the first ten years, largely due to the changes in business taxation.[3]

- Differences in the plan between the top marginal individual income tax rate and lower business tax rates could encourage the wealthy to take advantage of pass-through business income tax rates.[4]

- Under the plan, well-off individuals in the top one percent of the distribution would see an average individual tax cut of $213,000, while those in the bottom 80 percent would only see a tax cut of $210.[5]

- Under the plan, hedge fund managers earning income as carried interest can avoid tax by "exporting" their services to an offshore tax haven fund, removing any tax burden on this income. This provides far more favorable tax treatment than current law, where carried interested is taxed at a rate of 23.8 percent.

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Endnotes

1 Reuven Avi-Yonah and Kimberly Clausing, "Problems with Destination-Based Corporate Taxes and the Ryan Blueprint," Law and Economics Research Paper 16-029 (University of Michigan Law School, 2017), Forthcoming, *Columbia Journal of Tax Law*. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2884903; Office of the Speaker of the House of Representatives, "A Better Way: Our Vision for a Confident America – Tax," July 2016. https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.

2 For more on corporate profit shifting and inversions, please see Kimberly Clausing, *Profit Shifting and U.S. Corporate Tax Policy Reform*, (Washington, DC: Washington Center for Equitable Growth, 2016). http://equitablegrowth.org/report/profit-shifting-and-u-s-corporate-tax-policy-reform/.

3 James R. Nunns and others, "An Analysis of the House GOP Tax Plan," (Washington, DC: Urban-Brookings Tax Policy Center, 2016). http://www.taxpolicycenter.org/publications/analysis-house-gop-tax-plan.

4 There are four major types of firms—S Corporations, Limited Liability Companies, Sole Proprietierships, and Partnerships—that are considered to be pass-through businesses because the profits from these firms can be "passed-through" to the business owner and taxed on their individual income tax returns.

5 James R. Nunns and others, "An Analysis of the House GOP Tax Plan."

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