Prescription for Corporate Income Tax Reform: A Corporate Consumption Tax

Noël B. Cunningham*
Mitchell L. Engler**

INTRODUCTION

Even in the polarized political times we live in, there seems to be an emerging consensus on two tax reform issues. First, there is a widely-shared bipartisan view that the corporate income tax is a "bad" tax that is desperately in need of reform or repeal. The corporate income tax is complicated, inefficient and is strewn with tax expenditures. And because it attempts to tax income on a world-wide basis at relatively high rates, many observers believe it is hurting our global competiveness. Corporate tax reform has been advocated by President Obama,[1] and was central to the recommendations of both a bipartisan task force[2] and a bipartisan commission[3] that were created to address our long-term deficit problems.

* Professor of Law, New York University.
** Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University.

[1] The President's Framework for Business Tax Reform, A Joint Report of the White House and The Department of the Treasury (Feb 2012), available at: http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf.

[2] Bipartisan Policy Center's Debt Reduction Task Force, "Restoring America's Future." (Nov 2010) available at: http://bipartisanpolicy.org/library/report/restoring-americas-future. This task force was co-chaired by former Republican Senator Pete V. Dominici and former White House Budget Director under Bill Clinton Alice M. Rivlin and its report is often referred to as the "Dominici-Rivlin Plan."

[3] The National Commission on Fiscal Responsibility and Reform, The Moment of Truth, The Report of The National Commission on Fiscal Responsibility and Reform (Dec 2010) available at: http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf. This Commission was chaired by Former Senator Simpson and former chief of Staff Erskine Bowles, and is often referred to as the Bowles-Simpson Plan.

Second, there is also a growing consensus that to solve our long-term deficit problems, we should seriously consider a national sales tax or a value-added tax. A value-added tax, or a VAT, has been adopted in over 140 countries, including all of our trading partners. Many economists believe adopting a VAT would be a more efficient way to raise revenue than raising the rates of our existing taxes. Indeed, the Bipartisan Debt Reduction Task force recommended a 6.5% conventional VAT.[4]

In fact, there is bipartisan support for accomplishing both of these goals simultaneously by converting the current corporate income tax into one based on consumption. Such a conversion has been proposed as part of a complete overhaul of our tax system as well as a revenue neutral reform of our corporate tax. These conversions have received support from conservative and liberal thinkers alike. On the conservative side, President Bush's President's Advisory Panel recommended changing the corporate tax to one based on consumption as part of its overall proposal entitled "Growth and Investment Tax Plan."[5] On the liberal side, Professor Alan Auerbach recently proposed a "Modern Corporate Tax" to replace the current corporate income tax.[6] His proposal was published under the auspices of the Center for American Progress and the Hamilton Project, both known as liberal think tanks.[7] The Modern Corporate Tax is also a tax based on

---

[4] The Bipartisan Policy Center's Debt Reduction Task Force, "Restoring America's Future," supra note 1.

[5]Report of the President's Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System, (Nov 2005) available at: http://www.treasury.gov/resource-center/tax-policy/Documents/Simple-Fair-and-Pro-Growth-Proposals-to-Fix-Americas-Tax-System-11-2005.pdf.

Conservative politicians have also been attracted to the idea of converting the corporate tax from an income tax into a consumption tax. The Republican Budget ("Ryan's Plan"), which passed the House of Representatives, would repeal our current corporate income tax, and replace it with a business consumption tax in the form of a subtraction value-added tax. Representative Paul D. Ryan, A Roadmap for America's Future (Jan 2010), available at: http://roadmap.republicans.budget.house.gov/uploadedfiles/roadmap2final2.pdf.

[6] Alan Auerbach, "A Modern Corporate Tax" (Dec 2010) available at: http://www.americanprogress.org/wp-ntent/uploads/issues/2010/12/pdf/auerbachpaper.pdf.

[7] In the interest of full disclosure, the authors have written an article for the Hamilton Project. *Facilitating Shared Appreciation Mortgages to Prevent Housing Crashes and Affordability Crises*, The Hamilton Project , Policy Brief 2008-10 (September 2008) (with A. Caplin, and F. Pollack).

consumption and is intended to replace the current corporate income tax in a revenue neutral manner. Although the Growth and Investment Tax Plan and the Modern Corporate Tax have much in common, they differ in several important ways. In this article we critically compare and contrast these two proposals, against each other as well as other consumption tax ideas.

This Article is divided into five Parts. Part I briefly describes why almost everyone agrees that our current corporate income tax is a "bad tax" and that it must be either reformed or replaced. Part II is designed as a primer for those readers who are not familiar with the valued-added tax and other related consumption taxes. It first describes and analyzes three basic consumption taxes, the retail sales tax, the credit-invoice VAT and the subtraction method VAT. It then describes and analyzes two variations on the subtraction method VAT, sometimes referred to as "two-tier VATs": the Flat Tax and the X-Tax. A two-tier VAT essentially combines (i) a subtraction value added tax with a deduction for wages at the business level with (ii) an individual tax on wages. Part III then more fully describes the Growth and Investment Tax Plan and the Modern Corporate Tax and critically compares and evaluates them. Part IV then develops more fully why one of these two latter taxes might appeal as a novel, compromise solution to the long-standing shared concerns most observers have with our current corporate income tax. Part V concludes.

Part I: Reforming (Replacing) the Corporate Income Tax

Professor Michael Graetz once observed: "Economists are unanimous … the corporate tax is a bad one.[8] The reasons are many. First of all, many observers who question the very existence of our "classical system" of corporate income taxation, which taxes corporate income twice, first at the corporate level when it is earned, and then again when it is distributed to shareholders.[9] This "double tax" system can create a bias against doing business in corporate form.[10] For this

[8] Ryan Roadmap, supra note [], at 38.

[9] There is an exception for qualified small businesses, which can elect "Subchapter S" status, which generally imposes only a single level of tax. See IRC §§ 1361-79.

[10] The extent of any excess tax under the double tax system turns on a number of factors, such as (i) the relative corporate and individual tax rates (including lower, preferential rates for the

reason, over the past 30 years tax scholars have been calling for the integration of the corporate and shareholder levels of tax.[11] As discussed in greater detail in Part IV.A, however, deferral concerns under our current income tax have hampered ready solutions to corporate integration.[12]

Our classical system also raises two other potential serious distortions. Consider first the disparate treatment of debt and equity. Since its inception in 1909, corporations have been allowed to deduct interest payments, but not dividends. This creates a serious bias in favor of debt financing and has resulted in many corporations having very high debt to equity ratios, which makes them more vulnerable to bankruptcy or insolvency difficulties. Also consider the disparate treatment of retained and distributed earnings under our realization-based income tax. The shareholder tax is deferred on retained earnings,[13] which is equivalent to imposing only a single level of tax at the corporate rate on retained earnings capital.[14]

---

second level of tax on the shareholders, and (ii) the ability to minimize the double tax through debt capitalization, as discussed below in the text. In addition, note that there are special rules subjecting certain publicly-traded entities to the classical double tax system regardless of whether they incorporate. See IRC § 7704. This provision can counteract the disincentive to incorporation (since covered entities will face the double tax regardless of the incorporation decision).

[11] See, e.g., U.S. Treasury Dept., Report on Integration of the Individual and Corporate Tax Systems -- Taxing Business Income Once (1992) and American Law Institute, Federal Income Tax Project, Integration of the Individual and Corporate Income Taxes, Reporter's Study of Corporate Tax Integration (1993).

[12] For instance, at first blush, there might seem to be a relatively simple solution to the double taxation problem: just exempt the shareholders from tax on corporate investments since the corporation is already subject to tax. As shown in example 10 in Part IV.A, however, this is problematic under an income tax when we consider shareholder sales of stock at a gain where such gain reflects unrealized, untaxed value inside the corporation.

[13] This assumes that the corporation avoids the accumulated earnings tax imposed on corporations which accumulate earnings and profits beyond the "reasonable needs of the business." See IRC §§ 531-37.

[14] This follows from the equivalency of deferral to yield exemption under certain assumptions, perhaps most notably constant tax rates. This relationship was first identified by E. Cary Brown in an essay entitled Business-Income Taxation and Investment Incentives, in Income, Employment and Public Policy: Essays in Honor of Alvin Hansen 300, 301. See also the

Putting aside these structural problems, there is one additional problem that has recently received a lot of attention: global competitiveness.[15] A criticism which has come to the fore over the past 10 years is that we are becoming less competitive in the emerging global economy.[16] Many observers believe our 35% corporate income tax rate is too high and should be lowered to attract more capital investment. There is little doubt that countries compete with one another for international investments with tax rates. Over the past 15 years, all members of the G-7, with exception of the United States, have reduced their corporate tax rates so that the United States currently has the highest one. Some insist that we must join this "race to the bottom" in order to stay competitive.

In addition to tax rates, there is an additional issue that impacts our competitiveness: our current world-wide approach rather than the territorial approach utilized by some other countries. Under our world-wide approach, U.S. corporations are taxed on all their income, even amounts earned completely outside the U.S. by foreign subsidiaries. U.S. corporations generally can, however, defer the tax on some of such earnings until they are repatriated.[17] The combination of worldwide taxation with deferral on foreign subsidiary earnings creates several "competitive-related" concerns. First, the deferral possibility provides a "time value of money" incentive to keep earnings abroad in lieu of repatriating the earnings back to the U.S.[18] Somewhat related, there can be incentives to generate or allocate income to foreign subsidiaries in low-tax

---

discussion at note [] regarding how newly invested capital bears a double tax burden while retained earnings capital does not bear such a burden.

[15]Another current issue concerns so-called tax expenditures. The Internal Revenue Code is packed with special provisions known as tax expenditures. At least in the abstract, these seem to be universally condemned. Again the President and both bipartisan commissions have called for their repeal. It is our understanding that if these tax expenditures were eliminated the top corporate rate could be reduced to about 25% without a loss in revenue.

[16] For a recent academic's discussion regarding this hot topic of US tax rates and competitiveness, see Michael Knoll, The Corporate Income Tax and the Competitiveness of US Industries, 63 Tax L. Rev 771 (2010).

[17] There is an exception for certain passive foreign earnings under the so-called "Subpart F rules." See IRC §§ 951-65.

[18] See, e.g., Robert Peroni, Tax Reform Interrupted, The Chaotic State of Tax Policy in 2003, 35 McGeorge L. Rev. 277, 308-09 (2004)("this deferral privilege creates a bias in favor of locating business abroad in low-tax foreign countries and conducting such operations through a foreign subsidiary").

jurisdictions (in order to achieve the deferral benefits).[19] Finally, the current worldwide system can provide a disincentive to incorporating the parent company in the US since foreign parent corporations are subject to tax only on their US earnings.[20]

To compound all of these problems, it is also not clear who actually bears the corporate income tax burden. As a very basic first cut, it might seem that either the residual-owner shareholders or consumers via higher prices bear any such burden. Digging a little deeper, though, perhaps the extra burden impacts all capital investment as capital shifts from the heavily-taxed corporate sector to the lesser-taxed unincorporated sector.[21] Alternatively, due to increasing capital

[19] See, e.g., Craig Boise, Breaking Open Offshore Piggy Banks, Deferral and the Utility of Amnesty, 14 George Mason L. Rev. 667, 676-80 (2007) (discussing how pharmaceutical and technological companies "transfer" income abroad, and how the current "transfer pricing" rules of IRC § 482 generally are viewed as an inadequate solution to the problem).

Note how the transfer pricing issue flows from an "origin" sourcing approach within the "worldwide" system. Restated, a worldwide system might suggest that origin is irrelevant since all earnings are subject to tax. The deferral of foreign subsidiary earnings (with its lower effective tax rate), though, makes sourcing relevant. And under current law this is done on an "origin of the earnings" basis, which again, raises difficult transfer pricing issues. Compare the later discussion of the virtues of implementing a VAT on a destination basis (rather than an origin basis).

[20] See, e.g., the issues surrounding corporate "inversions" where US corporations reincorporated outside the US. For the connection of corporate inversions to worldwide taxation, see, eg, Robert Peroni, Tax Reform Interrupted, The Chaotic State of Tax Policy in 2003, 35 McGeorge L. Rev. 277, 310 (2004)("[Under] the inversion transaction, . . . a group of affiliated corporations that formerly had a US parent corporation at the top of the structure is changed so that the ultimate parent of the affiliated group is a publicly-traded foreign corporation located in a low-tax or no-tax jurisdiction. . . Proponents of gutting the U.S. worldwide system of international taxation are attempting to use this corporate inversion problem . . . as a vehicle for modifying the U.S. international rules. . .). Note that the US eventually adopted complicated rules to try to address the corporate inversion problem. See IRC § 7874. the incentive to incorporate the parent outside the US remains, though, to the extent one can structure around IRC § 7874 (eg, the formation of a new corporate enterprise).

[21] See, e.g., Arnold C Harberger, The Incidence of the Corporate Income Tax, Journal of Political Economy (1962). This might be most easily understood as the flip side to the notion that tax-exempt bond purchasers do not reap the full benefit of the IRS Section 103 tax exemption for covered interest income. In that case, the exemption pulls capital towards the tax-exempt bonds and away from taxable investments, thereby decreasing (increasing) the pretax return on tax-exempt (taxable) investments. In this reverse application here, the extra corporate tax

mobility, perhaps some or all of the US capital tax shifts to labor as the extra tax shifts capital investment abroad.[22]

Part II: Consumption Taxes.

In this Part we describe and discuss several different taxes based on consumption. We begin by describing three of the most broadly based consumption taxes, the retail sales tax, the credit-invoice value-added tax ("VAT") and the subtraction method VAT. We demonstrate how closely related these taxes are to one another and try to identify criteria with which to choose among them. We then look at two variations of the subtraction method VAT: the Flat Tax and the X-Tax. These so-called "two-tier VATs" have been used as part of several different tax reform proposals, including the Growth and Investment Tax Plan and the Modern Corporate Tax, which are discussed in Part III, below.

A. The Retail Sales Tax, the Credit- Invoice VAT and Subtraction VAT: A Comparison

In the United States the consumption tax that we are most familiar with is the retail sales tax, or "RST." This type of tax has been adopted in 45 states as well as the District of Columbia. Under a retail sales tax, the tax is imposed and collected by retailers when they sell their products to consumers.

Many other countries, including all of our trading partners, have adopted a different type of consumption tax, a value-added tax or VAT. This tax differs from a retail sales tax in that it is collected at each stage of production and is levied on the value added at that stage. As described below, the two principal ways that a VAT can be implemented are the credit-invoice method and the subtraction method. Under the credit invoice VAT, at each stage of production, the seller is required to charge a tax on its sales, but is given credit for any taxes it has paid for

---

might pull capital towards the unincorporated sector and away from the corporate sector, thereby decreasing (increasing) the pretax return on unincorporated (corporate) investments.

[22] See, e.g., Arnold C Harberger, The State of the Corporate Tax: Who Pays It? Should It Be Replaced? In New Directions in Federal Tax Policy for the 1980s (1983).

its inputs, including capital investments, but not labor costs. Under the subtraction VAT, each business pays a tax on the difference between its gross receipts less its purchases of materials, including capital investments. As discussed in greater detail below, borrowing taxations and labor costs typically are ignored under either VAT form.

As demonstrated in the example below, the RST and both VATs are economic equivalents as the total tax base equals consumption in each case despite the above differences in collection. The subtraction VAT does differ from the RST and the credit-invoice VAT in one technical way. Both the RST and the credit-invoice VAT are imposed on the price of the product; the tax base does not include the tax itself and is therefore "tax exclusive." The way the subtraction VAT is determined, the tax is not separately stated; it is embedded in the price of the item. For this reason, the subtraction VAT is imposed on the actual price of the item plus the tax; its base is therefore "tax inclusive."[23] For this reason, the nominal tax rate of the subtraction VAT will always be less than the equivalent rate under either the RST or the credit-invoice VAT. To illustrate, as in the example below, if a tax rate of 10% is imposed under a RST or a credit-invoice VAT, the equivalent rate under the subtraction VAT would only be 9.09%.[24]

Let's take a look at a more concrete example demonstrating the theoretic equivalence of the different versions:

> Farmer (F) sells cotton to Manufacturer (M) for $100. M uses the cotton to make a dress which it sells to Wholesaler (W) for $300. W, in turn, sells the dress to Retailer (R) for $350. R sells the dress to the ultimate consumer for $500. Assume there is a 10% tax imposed under the RST or a credit-invoice VAT, and a 9.09% tax imposed under a subtraction VAT. Finally, assume that the entire tax is passed on and is borne by the consumer (C).

Under an RST, R would simply charge the consumer $550, the price of the dress plus the tax. Under the credit-invoice VAT, each business would pay a tax of

[23] In this sense, it is like an income tax under which taxable income equals gross income less allowable deductions.

[24] This is easy to prove. The tax exclusive rate = the tax inclusive rate (TIR)/(1- TIR). A tax exclusive rate of 10% is equivalent to a tax inclusive rate of 9.09%: .1 = .0909/.9090

10% on its sales, but would be given a credit for all of the taxes it paid on its inputs. The tax is separately stated.

Transaction	**Price**	**10% Tax**	**Credit**	**Tax Remitted**
F to M	$100	$10	0	$10
M to W	$300	$30	$10	$20
W to R	$350	$35	$30	$5
R to C	$500	$50	$35	$15
				$50

Note that although the tax is collected at the various stages of production, the ultimate amount of the tax is precisely the same as under the RST, $50.

The subtraction VAT is a bit different in how it is computed. It is imposed on the difference between Sales and Purchases or Inputs. Rather than explicitly stating the tax on a transaction, the tax is implicitly embedded in the price of the product. For that reason, the tax base of the subtraction VAT is tax inclusive. Therefore, the equivalent rate for the subtraction VAT would be 9.09%.

Transaction	**Sales**	**Inputs**	**Base**	**9.09% Tax**
F to M	$110	$0	$110	$10
M to W	$330	$110	$220	$20
W to R	$385	$330	$55	$5
R to C	$550	$385	$165	$15
				$50

Being economically equivalent, these three taxes share much in common. As long as imposed broadly, the taxes are neutral with respect to the choice of whether to consume or save and will have the same "incidence," i.e., no matter which tax is imposed, it will result in the same distribution of the tax burden.

Historically, RSTs and VATs have ignored financial transactions. Although ideally the fees charged by financial institutions should be includable in the tax base, this has been difficult to accomplish. The general rule under both taxes is simply to ignore them. The general rule under the subtraction VAT is also to ignore financial transactions: loans are not included and repayments are not deducted. However, in an effort to include financial fees, some subtraction VATs

have special rules for financial institutions. Financial transactions and the problems they present are discussed more fully in Part III.

From an international perspective, consumption taxes are of two types. The most common type is one that follows the "destination principle," i.e., the tax is imposed where the goods are consumed, no matter where they are produced. The other type is one that follows the "origin principle," i.e., the tax is imposed where the goods are produced, no matter where they are consumed. As a practical matter most consumption taxes are designed to follow the destination principle. Under this principle, exports are not subject to the tax, but imports are. This allows domestically produced goods to be competitive abroad, and puts foreign produced goods on an even footing with those produced domestically. In order to accomplish this there must be border adjustments under both VATs. Consider first exports. Under both taxes a business enterprise does not include the sales proceeds of its exports but is allowed to recoup any tax paid on its domestic inputs through the allowance of the credit or a deduction. This combination allows the product to leave our shores without any tax.[25] In contrast, imports are subject to full tax since an importer is not allowed any deduction or credit for foreign goods purchased.

Since these three taxes have so much in common, if the U.S. were to adopt a national tax based on consumption which one should it choose and why? Although we are most familiar with the retail sales tax, it seems unlikely that the U.S. would adopt this tax one for a variety of reasons. First, since most states already have one in place, some folks might feel as if the federal government were encroaching on the states' turf. More importantly, the RST is probably the least efficient of the three. As Cnossen points out, "the retail level tends to be the weakest link in the production-distribution chain."[26] If it is not collected at the retail level, the entire tax is lost. Under both VATs, however, even if the tax is not collected at the retail level, most of the tax on the item will have already been collected at an earlier stage of production.

As between the two VATs it is a closer call. Many observers prefer the credit-invoice VAT and believe that it has a several advantages over the subtraction VAT. There is no doubt world-wide that the credit-invoice VAT is the

[25] Technically, exports are "zero rated."
[26] Cnossen at 31

consumption tax of choice.[27] For this reason, there is a tremendous amount of experience that the U.S. could draw upon to avoid the mistakes made by others. It is also generally believed that tax evasion is more difficult under a credit-invoice VAT because of the credit-invoice's paper trail. Somewhat related, destination-basis border tax adjustments are easier to determine under a credit-invoice VAT.[28] Finally, some believe that the credit-invoice VAT may be more insulated from political tinkering because lower rates or exemptions do not benefit pre-retail firms, in favorable contrast to the subtraction VAT.[29]

The case for the credit-invoice VAT might be somewhat overstated for at least two reasons, though. First, there are also many economists who believe it is the credit-invoice VAT that is more susceptible to political tinkering rather than the subtraction VAT.[30] For instance, it is easier to impose different rates for various products under the credit-invoice VAT.[31] Second, a subtraction VAT

[27] Indeed, almost all countries with a national tax on consumption have adopted it. Add cites.

[28] As noted above, border tax adjustments on exports essentially allow the exporter to recoup the prior VAT even though the exported good is excluded from sales receipts. This is easier to accomplish under the credit-invoice VAT where there is a paper trail reporting the exact amount of the prior tax. As a somewhat related point, some commentators have expressed concern that the subtraction VAT would not be eligible for border tax adjustments under WTO rules. See Cnossen p.30 fn 5; Shay and Summers, Selected International Aspects of Fundamental Tax Reform Proposals, *51 U. Miami L. Rev. 1029*.

[29] An exemption at the middle level(s) of production could actually increase taxes since the exempt mid-level purchaser presumably would lose the credit on its purchases, yet the final product would still bear the full tax. as Cnossen observes, "[u]nder the [subtraction VAT] it would be tempting [for politicians] to exempt some 'worthy' product, sector, or activity." Cnossen at 31.

[30] Martin Sullivan, Introduction: Getting Acquainted with the VAT, at 13.

[31] Under the credit-invoice VAT, the entire amount of the tax rests upon the rate imposed on the final sale (since there is a dollar for dollar credit on the earlier stages of production). As such, the desired aggregate tax under the credit-invoice VAT can be achieved by tinkering with just the final sale. In contrast, adjusting the final rate alone does not accomplish the objection under the subtraction VAT since only the final stage of production would bear the changed rate. To illustrate, let's return to the above example, but now assume we want to tax the final product at a 20% tax-exclusive rate (equal to a 16.67% tax-inclusive rate). To accomplish this under the credit-invoice VAT, we merely need to apply the 2-% rate at the point of final sale. If so, R will remit $65 on sale [($500 x .2) -$35], which results in $100 total tax when combined with prior $35 collections. In contrast, merely providing a 16.67% rate on R under the subtraction VAT would increase the collections from R to only $30 [($565 -$385) x .1667].

could be restructured to make it more like the credit-invoice VAT in certain regards if thought desirable: e.g., to provide a similar paper trail.[32]

B. The Two-tier VAT: The Flat Tax and the X-Tax

The Flat tax: One of the principal criticisms of the VAT has always been distributional: it is regressive (with respect to income). Although there as several ways one might inject a degree of progressivity into a conventional VAT, these tend to be inefficient.[33] In response to this criticism, scholars developed a new way to implement a VAT: a subtraction value added tax, which permits a deduction for wages. This type of tax is sometimes referred to as a "two-tier VAT" and was first suggested by Professors Hall and Rabushka as part of their now famous Flat Tax.[34] Under the Flat Tax, wages are deducted at the business level, but are subject to tax at the individual level; both businesses and individuals would be taxed at the same flat rate, initially set at 19%. By designing the tax this way, the Flat Tax was able to inject a degree of progressivity into the tax by providing a limited wage exemption at the individual level based on family size. For example, a family of four under the Flat Tax would be entitled to an exemption of $41,000. If this family earned $82,000 in wages during the year, it would only pay an effective rate of tax of 9.5% on its wages.

[32] See David A. Weisbach, Does the X-tax Mark the Spot, 56 SMU L. Rev. 201 (2003). Among other things, this might facilitate border tax adjustments under a destination approach. In similar fashion, this might address another potential perceived advantage of the credit-invoice tax: its "salience" since the typical convention is to state separately the amount of the credit-invoice tax. See Graetz. While the amount of the subtraction VAT typically is not separately stated, it might be possible to reverse such convention under the subtraction VAT if salience rose to a prominent level. On both these points, though, the immediately preceding footnote might issue a cautionary word about the feasibility of this where rates change across products or time. See e.g., Shay and Summers, supra note [] at 1053 (discussing border adjustability difficulties under the subtraction method where tax rates vary).

[33] For example, a higher rate of tax might be imposed on "luxury" goods. Differential tax rates, though, can distort taxpayers' consumption choices.

[34] This Flat Tax was first introduced by Hall and Rabushka in an OP-ED piece in the WSJ in the fall of 1981. It was initially more fully developed in an 1983 article and then finally published as a book in 1985.

As originally designed, the Flat Tax adopted the "origin principle," i.e., it taxed goods and services where they are produced or performed, not where they are actually consumed. For this reason, there are no border adjustments: exports bear the tax and imports arrive here tax free.

It might appear at first that the origin principle would be very bad idea in terms of international trade: by exporting goods bearing a tax and importing goods tax free, wouldn't the U.S. be put at a severe disadvantage, both home and abroad? Actually in the long run it would not. In fact through expected changes in the exchange rates, U.S. goods would remain competitive in both markets in the long run. This can be easily demonstrated. For purposes of the following illustration, assume the following:

1. The price for identical US and French goods is initially the same in both the US and France: each unit costs $100 or 200 Francs (F);
2. The initial exchange rate is $1 for 2 F;
3. Ignore transportation costs; and
4. There is a 10% credit-invoice VAT imposed on all goods produced in the U.S. There are no border adjustments, i.e., there are no exclusions for exports and no inclusions for imports.
5. Finally, the entire 10% tax is borne by consumers and is reflected in an increase in U.S. prices.

Under this regime, exports leave our shores with the VAT and imports would not be subject to the tax. Initially this would seem to put US goods at a competitive disadvantage: On our facts, the US product would initially sell in the US for $110, while the French product would still sell for $100. In France, the US product would initially sell for 220 F and the French product for 200 F. This would not be a stable situation in either country, however, because the US products would not be competitive, either domestically or abroad. Indeed, the US dollar would have to decline in value by approximately 9% (i.e., 1 – 1/1.1) to restore the pre-tax equilibrium.[35] If it did,[36] then the new exchange rate would be: $1: 1.82F.

[35] For a comparable example, see Gillis, Mieszkowski & Zodrow, Indirect Consumption Taxes: Common Issues and Differences Among the Alternative Approaches, 51 Tax L. Rev. 725.

[36] If such exchange rate adjustment was incomplete, other pricing changes would establish the new equilibrium. See Graetz, Miami ("economists have generally agreed . . . that a destination-

This would have the effect of raising the price of the French product in the US to $110[37] and lowering the price of the US product in France to 200F[38] in France. In other words, through changes in the exchange rates, the relative prices of the products would be the same as they were before the imposition of the tax.

The X-Tax: In the late 1980's, many observers believed that the Flat Tax might not be progressive enough to meet our social goals. In 1986, Professor David Bradford proposed a modification of the Flat Tax to address this issue.[39] His proposal, known as the "X-Tax," is essentially the same as the Flat Tax, except that it provides for graduated tax rates for wages. Although this modification necessarily would be more complex than the Flat Tax, it would allow policy makers to implement whatever degree of progressivity they consider appropriate.

In the next Part, we will introduce two relatively new consumption-type taxes that are similar in many ways to the two-tier VATs just discussed. These are the Growth and Investment Tax Plan, proposed by President's Bush's Advisory Panel and the Modern Corporate Tax proposed by Professor Alan Auerbach.[40]

III. The Growth and Investment Tax Plan and the Modern Corporate Tax

The Growth and Investment Tax Plan or "GIT" and the Modern Corporate Tax, or "MCT" are relatively new variations of the two-tier VAT and have much in common with the X-Tax. In this Part we will first briefly describe these two taxes and then more fully discuss how they differ from the X-Tax and from one another.

GIT: In 2005, President George W. Bush created the Advisory Panel on Tax Reform. The Panel's mandate was to suggest ways to simplify the tax laws and make them "more conducive to economic growth." In the end, the Panel recommended an overall tax reform proposal which they entitled "The Growth and

---

based consumption tax does not offer any economic advantages over an origin-based consumption tax after taking into account adjustments in exchange rates, prices, and wages").

[37] $110 converts to 200 Francs at the new exchange rate: 110 x 1.82 = 200.2 (rounding).

[38] 200 Francs converts to $110 at the new exchange rate: 200/ 1.82 = 110 (rounding).

[39] David Bradford Untangling the Income Tax (1986).

[40] [See also, USA Tax (Nunn- Domenici).]

Investment Tax Plan" or GIT.[41] GIT is comprised of two parts: a business tax and an individual or household tax. In many ways, the GIT resembles the X-Tax. At the business level it would replace the current corporate income tax with a subtraction value added tax that would permit a deduction for wages and would operate under the destination principle. At this level it differs from the X-Tax in that, rather than ignoring financial transactions, it adopts special rules for financial institutions. Under the GIT, all businesses would pay a flat 30% rate on their cash-flows. Although the GIT has a progressive rate schedule at the individual level, it differs from the X-Tax by retaining a tax on capital income of 15%.

MCT: Although Professor Auerbach presented his Modern Corporate Tax as a revenue neutral reform of the corporate income tax, it is best understood as a replacement of the current corporate income tax with a consumption tax similar in many ways to the GIT. Essentially, it is a subtraction VAT that permits a deduction for wages and is based on the destination principle. It also adopts special rules for financial institutions – although different from those of the GIT. The MCT also differs from the GIT in one very significant way: its coverage. The entity-level GIT is applied to all businesses, except sole proprietors. The MCT, on the other hand, initially would be applied to corporations and those entities that are similar to corporations, such as LLCs. It would not apply, at least initially, to businesses generally. Although it certainly could become part of a larger reform effort, overall reform is not necessary. In addition, the MCT would retain the current corporate tax rate of 35%, which is somewhat higher than the GIT.

In this section we will first explore the special rules the GIT and the MCT prescribe for financial institutions. Then we will examine whether these taxes are designed in ways that would be considered acceptable to the World Trade Organization (WTO) and therefore entitled to border tax adjustments. Finally we consider whether the narrow coverage of the MCT might raise additional issues under the WTO and also create the opportunity for tax abuse.

[41] GIT, supra note [].

A. Special Rules for Financial Institutions

The taxation of financial services is very difficult to accomplish because the fees for these services are often embedded in the interest rate that is charged. Indeed it is so difficult that most countries that have adopted a VAT have special rules for financial services and usually exempt them from the tax.[42] However financial services are becoming a larger and larger part of our overall economy and most observers believe that, if possible, their value should be taxed. This is precisely what both the GIT and the MCT set out to do, but in different ways. The GIT provides that financial institutions would be required to use cash-flow accounting: they would include all loan proceeds in the tax base and, on repayment, deduct all principal and interest payments made. As discussed in greater detail below, the MCT adopted a different approach: it requires all businesses – not just financial institutions -- to use cash-flow accounting on loans.

To fully appreciate these proposals and their differences, we must first examine more fully the two alternative ways to treat borrowing transactions under a consumption tax. The first way is the "cash-flow" method described above, which again includes all borrowed funds in the tax base, but allows deductions for all repayments of principal and interest. In present value terms, the amount borrowed and the repayments will precisely equal one another if the loan is bearing a market rate of interest. This observation is the basis for the second alternative method, which is simply to ignore borrowing transactions entirely. Since their present values are identical, under this method all borrowed funds are excluded on receipt while repayments of principal and interest are not deducted. We will call this second method the "exemption" method. To illustrate how these two methods work and to demonstrate their equivalence, consider the following example. In all the examples in this section, assume that the risk-free rate of return or "pure interest rate"[43] is 5% compounded annually.

---

[42] It should be noted that this problem is also present under an income tax.

[43] See Satya Poddar and Morley English, Taxation of Financial Services under a value-added tax: applying the cash flow approach, National Tax Journal (1997) for the notion of a pure rate of interest and a similar example.

Transition issues also need to be taken into account. See Poddar and English supra.

> ***Example #1:*** Bank makes a $1,000,000 loan to an individual customer on December 31, 2012 bearing 5% interest compounded annually. The customer pays back principal and interest of $1,050,000 on December 31, 2013.

Under the cash flow method, the Bank would have a deduction of $1 million in 2012 and an inclusion of $1,050,000 in 2013. In present value terms, these two amounts are equal and exactly offset one another.[44] For this reason, these results could have been achieved under the exemption method by simply ignoring the transaction entirely.[45]

Since these two methods are equivalent, the exemption method has had more appeal for at least two reasons. First, as discussed in greater detail below, ignoring borrowing transactions would equate the treatment of debt and equity contributions to a business' capital. When a corporation raises equity, the funds raised are not included in the tax base, and when the corporation pays dividends, it is not given a deduction. Second, this method would seem to be easier from an administrative point of view. Why have businesses report financial transactions using the cash flow method if the same results can be achieved by simply ignoring them?

Once we recognize that the Bank charges fees for its services, the analysis becomes more complicated and the choice between methods becomes more difficult. Sometimes these fees are separately stated, but more often they are embedded in the interest charge. This fact creates both conceptual and practical problems. To illustrate, consider the following:

> ***Example #2:*** Depositor, an individual, deposits $1,000,000 in Bank on December 31, 2012. Depositor will earn 3% interest and receive various Bank services worth 2%. On the same day,

[44] 1,050,000/1.05 = 1,000,000.

[45] Where the Customer is another covered business, the inclusions and deductions perfectly offset for a second reason since any inclusion by one is matched by a deduction by the other. This does not apply, however, in the case of an individual customer as they are outside the business consumption tax system. In this regard, see Part IV.C for a discussion of how individuals remain taxable on their interest income under the GIT and MCT.

> Bank loans the $1,000,000 to Customer, also an individual, at a rate of interest of 8%. The extra 3% above the pure interest rate is for services the Bank provides to Customer. All the transactions are closed out on December 31, 2013 (i.e., the Bank receives $1,080,000 from Customer and repays Depositor $1,030,000).

In this example, it is clear that the Bank is providing financial services to Depositor and Customer, both individuals, for which it is charging $50,000 in the aggregate.[46] These fees are not explicit but are embedded in the interest rates: Depositor is receiving 2% less than the pure interest rate and Customer is paying 3% more than that rate. The exemption method, though, would allow an escape from tax for the embedded services element. Cash flow reporting neatly picks it up automatically and without having to determine the pure rate: (i) Bank has offsetting inclusions and deductions of $1,000,000 in 2012, but (ii) has a net excess of $50,000 in 2013 ($1,080,000 - $1,030,000).[47] For this reason, both the GIT and the MCT require financial institutions to use the cash-flow method.

The MCT differs from the GIT in one regard: the GIT only requires financial institutions to use the cash-flow method; other businesses use the exemption method. The MCT, on the other hand, requires all covered business

[46] This can be seen most easily by focusing on the $50,000 of *net* taxable receipts taken into account under cash flow reporting, as shown at the end of this paragraph.

[47] To see this at a deeper level, we can return to present value analysis. Consider first the deposit. With loans taken into account, Bank reports $1,000,000 of receipts in 2012 and receives a $1,030,000 deduction in 2013. The shortfall under the loan exemption approach is evidenced by the lack of present value equivalency between the two where the 3% stated interest is below the 5% pure interest rate. With a 5% discount rate, the 2013 deductions have a lower present value than the 2012 inclusion. 1,030,000/1.05 = 980,952. In essence, there is a hidden service element on deposits to the extent the pure interest rate exceeds the stated interest rate. Consider next the loan to Borrower. With loans taken into account, Bank takes a $1,000,000 deduction in 2012 and reports $1,080,000 of receipts in 2013. With a 5% discount rate, the 2013 inclusions have a higher present value than the 2012 inclusion. 1,080,000/1.05 = 1,028,571. This is the flip side to the depositor case; now there is a hidden service element on loans made to the extent the stated interest rate exceeds the pure interest. Again, cash flow reporting system neatly picks it up automatically and without having to determine the pure rate.

entities (i.e., corporations), not just financial institutions, to report financial transactions on the cash-flow method; only individuals would use the exemption method. One obvious advantage of the MCT approach is that it would not be necessary to distinguish financial service companies from other reporting companies for purposes of determining whether debt must be reported on a cash flow basis.[48] However, there is a more profound reason for requiring all covered business entities to use the cash flow method: If Banks are required to use the cash flow method and other businesses use the exemption method, this could result in double taxation. The reason for this is that the exemption method effectively denies a deduction to businesses for the fees they pay to the Bank.

To illustrate this point, consider the following variation:

> ***Example #3***: Same as ***Example #2*** except that Customer is a covered corporation that sells its products to ultimate consumers. Assume that Bank is on the cash-flow method and that Customer is on the exemption method. In the alternative, assume (i) that the Bank charges Customer 5% on the loan, and, in addition, a 3% fee which is separately stated as such, and (ii) the fee is embedded in an overall 8% interest charge.

In both of these alternatives, since the Bank is using the cash-flow method, the Bank must include the $30,000 fee paid by the Customer. In the first alternative, under the exemption method, Customer ignores the borrowing transaction, but is entitled to deduct the $30,000 fee that is separately stated. This is appropriate because it has already been included by the Bank, and should be treated like any other input.[49] If the Customer were denied a deduction, these fees would be subject to a second tax at the business entity level. On the other hand, if the fees were not separately stated, but rather embedded in the interest charge, then

[48] See MCT at 5 ("distinction [between financial and non-financial companies] has less and less meaning as many traditional non-financial companies incorporate financial activities" in their portfolio of activities").

[49] In contrast, the individual Customer in Example 2 is not entitled to any deduction for the fees under the proposed system.

Customer would not be entitled to a deduction for the fees because under the exemption method they would be ignored.[50]

The GIT recognizes this anomaly and addresses it by requiring financial institutions to inform their business customers of the portion of the interest charge that represents a fee.[51] In this regard, the MCT borrowing rules are superior to those of the GIT. Under the MCT since the Customer is on the cash-flow method, both the fees and the interest would automatically be deducted without any need to make an allocation.[52]

Another advantage in having all business entities on the cash-flow method is it reduces the potential for game playing. To illustrate, consider the following example.

> ***Example #4:*** Investors set up two companies: Financial Services Company (FS Corp), which uses the cash-flow method for reporting financial transactions, and Regular Company (R Corp), which uses the exemption method. In the alternative, assume that on December 31, 2012, (i) FS Corp lends $1,000,000 to R Corp at a 3% interest rate, or (ii) R Corp loans FS Corp. $1,000,000 at an 8% interest rate. In each alternative, assume the transaction is closed out on December 31, 2013 with either (i) R Corp. paying FS Corp. $1,030,000, or (ii) FS paying R Corp. $1,080,000.

[50] See Mclure and Zodrow, Guided Tour, at note 22 and accompanying text, for another possible reason in support. The article expresses concern that unless you include borrowings, there will be large net deductions upfront raising (i) revenue loss concerns and/or (ii) issues in determining proper interest rate adjustments for loss carryforwards. Note how the same concern remains to the extent of equity contributions, but at least the issue is narrowed via the debt exclusion.

[51] GIT at 166.

[52] A concern might arise since overstating the fee component would help the customer but would not harm the Bank since the Bank is reporting all cash flows regardless of designation.

The alternatives described in ***Example #4*** are illustrative of the ways in which related taxpayers might try to take advantage of their different treatment of loan transactions. As illustrated above, this could be done in either of two ways: the cash-flow method party could lend to the related party for a low interest rate, or it could borrow from the related party at a high interest rate. In the example, R Corp will not have any tax consequences under either alternative since it uses the exemption method. However, in both alternatives, FS will have a tax loss in present value terms. In the first alternative, FS would claim a 2012 deduction for $1,000,000, with a 2013 inclusion of only $1,030,000. Since the appropriate inclusion should be $1,050,000, this transaction has reduced the tax base by $20,000. In the second alternative, FS would include $1,000,000 in 2012 and would claim a $1,080,000 deduction in 2013. Since the appropriate deduction should have been only $1,050,000, this transaction has reduced the tax base by $30,000. Obviously the system could not tolerate these transactions and related party/anti-abuse rules would have to be enacted. These would not be necessary under the MCT.

There is another side of the story which needs to be taken into account, however. While the MCT approach provides desirable consistency on both sides of the loans, it leaves a discontinuity between debt and equity contributions by investors in the business enterprise, albeit a lesser one than under the current classic corporate system discussed in Part IV. The difference is that debt is treated on a cash-flow basis while equity is treated under the exemption approach.[53] This debt/equity inconsistency could lead to a different set of avoidance concerns regarding capital contributions to the company.

> ***Example #5:*** Investors form X Corp by contributing $1,000,000 of capital. In the alternative, they contribute the capital either (i) all as equity, or (ii) half as debt with an interest rate of 8%.

[53] Note how equity cannot be treated on a cash flow base or else the tax would become a complete nullity, not only would there be no burden, but no tax would even be collected.

Under the GIT approach, it does not matter how the investors label their contribution of capital: all contributions and distributions are ignored. In contrast, under the MCT the debt capital contributed to X Corp. will be accounted for on the cash-flow basis and, because of the high interest rate, will reduce the tax base in precisely the same way the loan described in ***Example #4*** did, but in a different context. It would seem as though under the MCT, one would need an anti-abuse rule in this context to prevent this from occurring.

In sum, there is just an inescapable tension between three laudable goals: (i) taxing the imbedded service element on loans, (ii) loan consistency throughout the system, and (iii) pure debt/equity consistency. This discussion hopefully has illuminated the inescapable tradeoffs in this difficult area, which we think raises a close call. As discussed in greater detail below in Part IV.C, though, we find the GIT's debt/equity consistency particularly intriguing in selling the proposal as a response to the classic corporate income tax problems.

B. The Destination Principle, Border Tax Adjustments and the WTO

As discussed above, both the GIT and the MCT are designed to be based upon the destination principle for their business level tax. Under this principle, a business is entitled to exclude export sales from the tax base and is not permitted to deduct imports. Although theoretically in the long run it should not matter whether the U.S. adopts the origin or destination principle,[54] the destination principle has several practical advantages that some might consider essential to adoption. First, the destination principle lends itself to less gamesmanship, especially with respect to related corporations and transfer pricing. To illustrate, suppose a U.S. company buys an input from a related foreign corporation to use in its manufacturing business. Under the origin principle the U.S. company would be entitled to deduct the price it pays for the input. But because these companies are related, we cannot rely on the market to set the price for the input. Assuming that the U.S. is the jurisdiction with the higher tax rates, there would be a tendency for the U.S.

[54] This results since exports and imports should equal in the long run. Add cites. For a possible difference in the short term, see discussion infra at [].

company to pay an inflated price for the product to reduce its U.S. taxes. Under the destination principle no deduction is permitted for imported inputs; therefore, the price paid by the U.S. company is not an issue.

Another related problem that is particularly troublesome under the origin principle is the determination of where intangible property is actually created. The creation of this type of property is not connected to a particular plant or manufacturing facility. Under the origin principle, the well-advised will invariably produce intangible property in a low tax jurisdiction. Once again, this is not an issue under the destination principle: no matter where the intangible property is created, if it is purchased to be consumed in the U.S., it would be fully taxable.[55]

Finally, there is one last (mercenary) reason for preferring the destination principle: revenue. In recent years, the U.S. has been a net importer of goods. For this reason, the tax base under the destination principle will be significantly larger than it would be under the origin principle. Indeed, the President's Advisory Panel estimated that the difference in revenue under the GIT if it were origin based would be $775 billion less over 10 years than it would be under the destination principle.[56]

To the extent that the use of the destination principle is important in deciding whether or not to enact the GIT or the MCT, policymakers may consider it of critical importance how the World Tax Organization (WTO) would characterize these taxes under GATT 1994.[57] The issue under GATT 1994 is whether a prohibited export subsidy would arise from the combination of (i) the exclusion of the sales proceeds of exports, while (ii) allowing the exporter to deduct the cost of its inputs. Since the U.S. is a signatory to this agreement, if the WTO determined

[55]Tax avoidance is also possible under the destination principle. For example, David Bradford neatly referred to consuming in low tax jurisdictions as the " tourism problem.' See David Bradford, The X tax in the world economy, (NBER working paper).

[56] GIT at 172. Note how this seems to be a short-term revenue grab as a standard assumption is that exports and imports should equal in the long run. See discussion supra at [].

[57] By "GATT 1994" we are referring to the original terms of GATT as supplemented by the Uruguay Round. Among other things, the Uruaguay Round defined what constitutes a subsidy.

the combination constituted a prohibited subsidy, the ruling would effectively prohibit the use of the destination principle and require use of the origin principle.

Under GATT 1994, a subsidy is generally defined as a direct or indirect financial contribution by a government that confers a benefit. All export subsidies are prohibited.[58] Exactly what constitutes a prohibited subsidy is not entirely clear. In the case of taxes that are remitted on exports, the remission will constitute prohibited subsidy unless two criteria are met:

(i) The tax must be an indirect tax, as defined,[59] and
(ii) The amount of taxes remitted must not exceed the amount of taxes on goods sold domestically.[60]

Indirect taxes are defined to include "sales, excise, turnover [and] value added … taxes, other than direct taxes and import charges."[61] By contrast, direct taxes include "taxes on wages, profits, interests, rents, royalties, and all other forms of income …"[62] It is not entirely clear how two-tier VATs would be characterized by the WTO, but if they were characterized as direct taxes then the tax would be required to use the origin principle.

It is not immediately apparent why GATT 1994 distinguishes between direct and indirect taxes and treats them differently. Professor Graetz suggests that this distinction can be viewed as where the authors of GATT believed the true incidence of these taxes reside. On this view, indirect taxes, such as the credit invoice VAT are being passed on and borne by consumers. If this were the case, then it would be appropriate under the destination principle not to tax exports because they are being consumed abroad. The remission of the taxes previously paid simply allows the goods to enter the world market tax-free. In contrast, direct taxes, such as the corporate income tax, are presumed not passed on to consumers, but simply to reduce corporate profits. On this view, since the exports are not

[58] Sommers, fn7.
[59] General Agreement on Tariffs and Trade, Oct. 30, 1947, 55 U.N.T.S. 194, art III P 4.
[60] Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, Marrakesh Agreement Estabilshing the World Trade Organization, Annex I(g), Legal Instruments-Results of the Uruguay Round vol. 1 (1994).
[61] Id. at Annex I. n.58.
[62] Id.

bearing any of the corporate tax burden, remitting any portion of the corporate tax would amount to a prohibited subsidy.

Of course, life and taxes are not that simple. It seems likely that in almost all cases consumers do not bear the entire burden of the VAT, and that they do in fact bear a portion of the corporate income tax. Nevertheless, as a practical matter, both the GIT and the MCT must run this gauntlet and it is a difficult one. Although the WTO has never ruled on a two-tier VAT, most observers are not optimistic. With the help of several examples below, we make the case that a two-tier VAT should be border adjustable.[63] The main thrust of our argument is that if the economic consequences of a two-tier VAT are virtually the same as that of a credit invoice VAT, then they should be characterized the same for GATT 1994 purposes. Indeed to rule otherwise, would support Professor Graetz's characterization of "…the GATT 'direct-indirect" distinction [being] archaic and formalistic, and completely divorced from economic substance."[64]

As a starting point for our analysis, we note that the credit-invoice VAT is an indirect tax and is border adjustable. This is true even though it is collected at each stage of production. We also know that as an economic matter, the subtraction VAT generally is identical to its first cousin.[65] As such, it seems like the subtraction VAT should be WTO-compatible, although some doubts have been raised.[66] The further issue, though, is analyzing the impact of decomposing the subtraction VAT into two tiers, such as under the GIT or the MCT.

We will illustrate the principles and issues involved with a series of examples. As discussed above, the GIT and the MCT are both two-tier VATs and

[63] One caveat to this statement is that it might depend on the type of two-tier VAT. As further discussed below, the GIT version presents a stronger case for border adjustability than the MCT.

[64] Graetz at 1097.

[65] But see discussion supra at note [] regarding potential tax rate differences.

[66] See eg Shay and Summers, although they conclude the matter is of some doubt. See also note [] regarding some potential concerns if rates can vary under the tax (eg, across products or over time). But see Weisbach, supra note [], 56 SMU L. Rev. at 225 ("What about rebates at the border for a destination-basis tax? It is commonly stated that subtraction method VATs with differential rates cannot properly rebate taxes. . . . this is false - it all depends on the information that is collected on sales between businesses. Subtraction method VATs can be made to look exactly like credit invoice VATs.").

their treatment of material inputs and wages are identical. For this reason, in the following examples we will refer to them jointly as the "GIT/MCT." We assume throughout that all taxes are borne by the ultimate consumers.[67] In each example, we compare the tax treatment that would result if, in the alternative, the U.S. adopts a 10% credit-invoice VAT, a 9.09% subtraction VAT or GIT/MCT.[68] ***Example #6*** deals exclusively with material inputs by assuming no wages are paid. ***Examples #7 - #9*** focus on the treatment of wages.

> ***Example #6:*** X Company manufactures a product to be sold exclusively abroad. This year, X purchased material inputs from registered suppliers, which in the absence of any tax would cost $10,000 and would sell for a total of $12,000.

Under all three taxes, X will have paid $11,000 total when it purchased its inputs: $10,000 pretax price plus the $1,000 tax. When it exports its products, the $1,000 tax will be recouped as follows. Under the credit-invoice VAT, X will owe no taxes and will receive invoices from its suppliers that will entitle it to a (refundable) credit in the amount of the $1,000 tax paid. Under both the subtraction VAT and the GIT/MCT, X would have a tax loss of $11,000: X would not include the sales proceeds, but would be entitled to deduct the cost of the materials. At the tax rate of 9.09%, this would entitle X to a refund of $1,000. In all three cases, notice that X has received a refund of precisely the amount of taxes previously paid. This permits exports to leave our shores without either any extra tax or any tax subsidy.

As illustrated above, all these taxes operate in very similar fashion regarding material inputs. The GIT/MCT deviates when it comes to labor inputs by granting a business deduction for wages and requiring an inclusion by the workers. As discussed below, it is this treatment of wages which raises particular issues under the WTO. To explore these issues, ***Example #7*** introduces wages to the analysis.

---

[67] Although this is clearly not the case, the incidence of each of the taxes generally should be the same.

[68] As discussed earlier, these rates are equivalent since the credit-invoice VAT is calculated on a tax-exclusive basis and the subtraction VAT and the GIT/MCT are calculated on a tax-inclusive basis.

> ***Example #7:*** X again spends $10,000 for material inputs and also pays $6,000 in wages to its employees.[69] Assume now that this year's production would sell for a total of $20,000. Further assume that the GIT/MCT is coupled with a 9.09% flat tax on wages.

Let's consider first the credit-invoice VAT. Adding wages to the example does not change the analysis very much: X still owes no tax and is entitled to $1,000 refund. Since X only exports its products, it never pays taxes on the wages it pays to its employees.[70] Restated, the exclusion of the export sale proceeds, which reflects the value-added by the wages, eliminates the need for any additional adjustment. The analysis is pretty much the same for the subtraction VAT since X would not be permitted a deduction for wages: X would have a tax loss of $11,000 (from the deduction for the material inputs) and would be entitled to a $1,000 refund. The only difference between the two regimes is that X would recoup the previously paid taxes in the form of an $11,000 deduction, rather than a $1,000 credit.[71]

The GIT/MCT differs from the subtraction VAT in that it collects the tax at both the business level and the individual level. Should this difference in the long run have any impact on the incidence of the tax? The answer should be no: Market forces will determine how the burden is shared. For this reason, the burden imposed by the GIT/MCT seemingly should be identical to that imposed by the more conventional VATs. On our assumption that the entire burden of the tax will be borne by the ultimate consumer, the wage earners will have to receive an increase in wages sufficient to meet the nominal tax imposed. Therefore, under the GIT/MCT, we would expect that wages would increase from $6,000 to $6,600.

---

[69] As developed below, the $6,000 wage amount assumes a credit-invoice or subtraction VAT. As discussed further below, it seems reasonable to conclude that the wages would rise to $6,600 under the GIT/MCT.

[70] This of course would not be true if X sold its products domestically (i.e., the value from the wages would be incorporated into the taxable sales price).

[71] Again, as noted previously, the two taxes generally work the same assuming constant tax rates. One difference is that if rates change over time as value is added, the credit-invoice VAT taxes the entire value at the rate in place at time of final sale, whereas not so under the subtraction VAT.

This will place the workers in precisely the same position as they would be under the more conventional VATs.[72]

On the assumption that X now has labor costs of $6,600 which are entitled to border adjustments, X's loss would increase by $6,600 to $17,600, thereby an additional $600 refund (up to $1,600). Note how this increased refund amount precisely equals both (i) the increase in its labor costs (which presumably get added to the price of the good sold), and (ii) the amount of tax paid by the wage earners to the government. The bottom line is that X, the workers and the government all would be in exactly the same positions as under the VAT. Accordingly, one would think that the WTO should characterize the GIT/MCT the same as the VAT: as indirect taxes.

To further illustrate this point, assume that the wage tax on individuals under the GIT/MCT was implemented through a wage withholding regime (similar to current wage withholding).[73] Under this regime, X would withhold $600 from the gross wages of $6,600, paying only $6,000 net to the workers. This then might make it easier to see the argument since the net wage payment stays the same. Again, all parties would end up in precisely the same position they would be under the conventional VATs: Although X would have an additional tax loss of $6,600, entitling it to an additional $600 refund, it would also owe the government $600 in withholding. So the workers get the same $6,000, X is out the $6,000 cash paid to the workers, and the government collects nothing, just like under the conventional VAT. And again, if everyone is in the exact same place as under the VAT (which is WTO compliant), why in the world should the GIT be problematic under the WTO rules?

There remains one final piece to the puzzle, however. The above analysis assumed a wage rate exactly equal to the business rate. But as discussed earlier, the principal reason for adopting a two-tier VAT is to inject some progressivity into the system. Let us now consider what happens when the wage tax under the GIT/MCT contains some progressivity, either (i) mild in the form of a subsistence exemption (essentially equal to an initial bracket of zero), or (ii) more robust in the

[72] At a 9.09% tax rate, the workers would owe $600 tax. $6,600 x .909 = $600.

[73] We thank Alan Auerbach for this insightful way of looking at the problem.

form of a classical progressive rate structure with increasing positive rates of tax.[74] To illustrate, consider the following:

> ***Example #8:*** Same as ***Example #7,*** except that under the GIT/MCT at the individual level, the first $11,000 of wages is exempt from tax.

At least superficially, this looks tax looks like it would violate both criteria required for a border adjustment. First, the tax at the individual level looks like a tax on wages with its own separate set of rates. By definition, a tax on wages is a direct tax and not entitled to a border adjustment. The analysis above, however, shows why this objection alone is not compelling. Second, as a result of the exemption, the amount of tax paid for by the wage earners will drop below $600 down to $0; therefore, if X were permitted to deduct $6,600 at the business level, the amount of the X's refund would exceed the total amount of tax paid on the other side by the workers and therefore might be construed as an impermissible subsidy.

Arguably, however, this analysis is incomplete along two interrelated lines. First, note how the analysis assumed a pretax wage increase to $6,600 (based on the regular tax rate) notwithstanding the subsistence exemption amount. And assuming that X passes that cost increase onto its consumers, the product bears an indirect tax even absent matching tax payments by the workers. As such, the extra $600 refund is needed to restore a no-tax result. Analyzed in this way, the GIT/MCT should still be an indirect tax entitled to border adjustments.

Second, we believe it would be more accurate to describe the GIT/MCT described in ***Example #8*** as a valued-added tax with a separate wage subsidy embedded into it. To further illustrate, let's now suppose that the credit invoice VAT described in ***Example # 7*** were paired with a wage subsidy to all individuals through a transfer payment in the amount equal to 10% of their first $10,000 in wages. Economically, this is precisely the same as exempting the first $11,000 of wages under the GIT/MCT. In addition, note how the rebated tax on the wages exceeds the amount of *net* tax paid by the workers, taking into account the wage

[74] Compare the limited progressivity of the Flat Tax to the more robust version in the X-tax. See discussion supra at [].

subsidy. And if the wage subsidy under the credit-invoice VAT would be WTO-compliant, we see no reason why the exemption under the GIT/MCT should not also be compliant.

Now let's return to ***Example*** #8 and consider the possibility that X might capture some of the tax benefits intended for workers under the GIT/MCT by paying something less than $6,600 in wages. This certainly is plausible, and if it did occur, then the deduction for wages might appear to be an impermissible subsidy since the tax refund from the wage deduction would exceed the price increase on wages due to the two-tiered VAT regime (i.e., the implicit tax). Let's assume for instance that the wage subsidy built into the GIT/MCT in ***Example #8*** causes wages to drop from the $6,600 to only $6,400. Allowing X a $6,400 deduction would generate a tax refund of $582 even though X bore an implicit tax of only $400. Once again, though, aren't the same results equally plausible under the conventional VAT with the wage subsidy? If X captures some of the benefits under the progressive wage tax, wouldn't the same economic forces allow X to capture a comparable portion of the wage subsidy benefits through a similar drop in wages below $6,000? For instance, a drop in wages to $5,818 would place X and the workers in an identical position.[75] If so, then GIT/MCT with the allowable deduction works exactly like the permissible VAT plus the wage subsidy.

Although as a general proposition, we believe the case for characterizing a two tier VAT as an indirect tax is very strong, a word of caution is appropriate. There has been significant commentary on this issue regarding the earlier two-tier VATs (the Flat Tax and X-tax). The general consensus seemed to have been that those taxes would not be considered border adjustable, at least not without some concessions by the international community.[76] Restated, sophisticated substantive

[75] For X, $5,818 under the conventional VAT with no tax refund equals $6,400 under the two-tiered VAT with a $582 refund. For the workers, $6,400 under the two-tiered VAT with no additional subsidy equals $5,818 under the conventional VAT with an additional 10% subsidy on that amount (i.e., an additional $582).

[76] See e.g., David Weisbach, Does the X-tax mark the spot?, 56 SMU L. Rev. 201, 213 (2003) ("Because of the wage tax, the x-tax would be an [impermissible] direct tax. . . . My view is that if the US is truly serious about the X-tax, and wants it to be destination based, there will be some accommodation at the international level"); Stephen Shay and Victoria Summers, Selected International Aspects of Fundamental Tax Reform Proposals, 51 U. Miami L. Rev. 1029, 1054 (1997) (Flat Tax impermissible direct tax due to separation out of wages); Reuven Avi-

equivalency arguments aside, the general consensus seemed to have been that the separation out of wages converted these taxes into impermissible "direct" taxes that would not be entitled to border adjustments absent some international accommodation.[77] To the extent that all two-tier VATs are considered direct taxes, implementing the GIT/MCT on a destination basis would seem to require some international accommodation. In this regard, the above arguments on economic equivalency might be helpful in achieving such accommodation.

C. Issues Related to MCT's Narrow Coverage

Up until this point in our discussion of border adjustments, we have not distinguished between the GIT and the MCT. Although these two taxes have much in common, they do differ in one way that may be important for purposes of GATT 1994. The GIT generally would subject all businesses to the new tax regime and would allow a deduction for amounts paid to registered suppliers.[78] The MCT, on the other hand, would be imposed only on corporations and other "large" entities, and it would allow a deduction for all domestic inputs. This could raise additional WTO concerns. Assume for instance that a corporation purchases an input from a partnership not covered by the tax for use in producing an exported product. Under the MCT, this input is still deductible even though the supplier is not subject to the tax. This is not permitted under a typical credit-invoice VAT or a subtraction VAT. Indeed, at least at first blush, this looks like what the WTO would view as a forbidden subsidy on substantive grounds, which might hamper even an accommodation.

Yonah, Symposium on Designing a Federal VAT, 63 Tax L. Rev. 285 (2010)(the "Flat Tax and X-tax" . . . allowed a deduction for wages which made them WTO-incompatible if done on a destination basis).

Further note that some concern has been raised about WTO compatibility even under the subtraction VAT (without the wage separation). See Shay and Summers, supra; Cnossen. The text focuses on the wage separation as it is that component that raises the deeper concerns. Id.

[77] For the somewhat tenuous connection of the WTO direct/indirect connection to substantive incidence, see note [] supra.

[78] Under the GIT all businesses other than sole proprietorships would be subject to the new cash flow tax system at a 30% flat rate. Sole proprietorships would be taxed at progressive individual rates, maxing out at the 30% figure. See GIT at 162.

It would, however, be possible to draw upon the above analysis concerning wages to fashion a sophisticated argument justifying the deduction. As is the case with wages, the partnership is subject to U.S. tax, albeit under a different regime than the purchasing registered company: the income tax. The selling partnership here would report the sales proceeds in its tax base, matching the purchasing corporation's deduction. One difficulty with this argument, though, is that the seller is subject to an "income" tax regime, not a "consumption" tax regime. This is potentially problematic as (i) the non-subsidy argument rests on an assumed price increase for the tax on the other side of the transaction and (ii) traditional incidence analysis assumes that an "income" tax is less likely to get passed on to the purchaser via a price increase than a consumption tax.

Similar to the wage subsidy component of the wage analysis above, one might counter that the "income" taxation of partnerships can be decomposed into (i) a consumption tax, with (ii) a separable negative subsidy for capital investment.[79] Restated, suppose all U.S. partnerships were subject to the new consumption tax and there was a separate tax charge on capital investments by partnerships.[80] If that would pass WTO muster, why then should the MCT fall short if it just combines the permissible consumption tax and separate investment tax charge into one streamlined system? This is a very clever argument, although the MCT now must rely on so many sophisticated arguments and assumptions as to raise real concerns about WTO compliance or accommodation.

Finally, the MCT's limited coverage raises additional concerns separate from WTO compliance. The MCT imposes destination basis on some businesses (corporations and large partnerships) and origin basis on other businesses. This seems to raise a number of concerns, most prominently that there would be an incentive for businesses to place themselves under one or the other depending on the nature of their operations. For instance,[81] an importing business would seem to

[79] As noted elsewhere the big difference between the income and consumption tax is that the consumption tax allows an immediate deduction for investments, while the income tax requires capitalization with depreciation allowances over time.

[80] Note how corporate businesses also have an additional charge, albeit imposed on an individual basis (i.e., the extra individual investor tax).

[81] The different tax burdens under the two systems also would provide incentives to fall under one or the other.

have an incentive to go with the origin-basis system (e.g., avoid incorporation and the threshold size for large partnerships). On the other hand, an exporting business would seem to have an incentive to go with the destination-basis system (e.g., an incentive to incorporate). With this in place, on an overall basis, the US system would be very incomplete: the overall base would be less than either (i) all US consumption, or (ii) all US production. Somewhat related, the exchange rate mechanism used to explain the equivalency of origin and destination based taxes would seem to break down. Restated, the exchange rate adjustment described above would seem hampered by a regime where some businesses in the US are on the origin system while others are on the destination system.

Part IV. The GIT/MCT as a Solution to Corporate Integration

The GIT and MCT share one potentially very attractive feature: a novel response to the longstanding, and seemingly unsolvable, corporate integration problem. As briefly highlighted above in Part I, corporate profits can bear a "double" tax under our current income tax due to the imposition of a tax on both the corporation when it earns income and on its shareholders when it distributes these earnings. There is general agreement that this so-called "classical" system of corporate taxation is problematic. Nonetheless, and despite much effort over the years, a satisfactory solution has remained elusive for reasons described below in Subpart A. The GIT and MCT offer what many observers might characterize as an intriguing solution to this problem: combining a corporate consumption tax with an individual income tax on capital income, an idea that is more fully developed in Subpart B. Subpart C then addresses the current bias in favor of debt financing.

A. Excess Corporate Tax Problem under an Income Tax

Under our current classical system, corporate profits face two levels of tax. The corporate entity itself pays tax on its profits, and shareholders also pay tax on dividends and capital gains from the sale of stock. These two separate layers of tax can combine to result in a higher tax burden on corporate equity investments than capital invested outside the corporate form (e.g., through a partnership). This

raises efficiency concerns by the creation of incentives to retain earnings, to use excessive debt, and to invest in non-corporate entities, such as partnerships and LLCs. The following examples illustrate the problems created by our classical system and the difficulties in addressing them. Throughout these examples, assume that corporations and individuals are taxed on ordinary income at the rate of 35%, and that individuals are taxed at the rate of 20% on dividends and long-term capital gains.

The following example illustrates the basic bias created by the classical system.

> ***Example #9***: In December of Year 1, investors form X Corp. by contributing $1,000,000 of capital in exchange for all of its stock. X immediately uses this capital to purchase a business. During Year 2, X Corp. generates $200,000 of profits, pays $70,000 in taxes, and distributes its net earnings of $130,000 to its shareholders. The shareholders, in turn, are then taxed on the $130,000 dividend distribution, leaving them with only $104,000. Note that if the investors had made the same investment in a partnership or an LLC, the $200,000 earnings would have been taxed only once at the 35% rate, leaving them with $130,000 of after-taxes.[82]

It has been suggested that the ideal way to eliminate this disparity would be to tax corporate profits in essentially the same way that we tax partnership profits: there would be no tax at the corporate level, but each stockholder would report her pro-rata share of the corporation's profits each year as earned.[83] As a practical matter, however, this approach raises insurmountable administrative difficulties, especially for large corporations with diverse shareholders, including foreign

[82] Under tax partnership rules, the partnership would not owe any tax itself. Instead, the partners would pay one level of tax on the earnings. See IRC § 701. At an assumed regular rate of 35%, the partners would pay $70,000 of tax.

[83] See, e.g., Blueprints for Basic Tax Reform, pp. 68-75.

investors. For this reason, a consensus generally exists that it is not possible to accomplish corporate integration in this way.

Another relatively straight-forward way to eliminate double taxation would be to tax income at the corporate level, and exempt all distributions to shareholders. This approach generally would work well for corporate earnings distributed as dividends,[84] but problems arise as to how to tax shareholders when they sell their stock at a gain, especially when all or part of that gain reflects unrealized, untaxed appreciation inside the corporation. To illustrate, consider the following example:

> ***Example #10:*** Same as ***Example #9***, except ignore the Year 2 earnings. Suppose in Year 2 that X Corp.'s business prospects have improved due to the passage of a favorable regulatory regime. As a result of these regulations, the shareholders are able to sell all the stock for $1,500,000.

Since the X Corp. has not yet paid any tax on the $500,000, should the shareholders be required to pay tax on the gain of their stock? Integration proposals typically would tax this gain so as to shut down an obvious loophole under the income tax.[85] So even if we were to tax profits at the corporate level, we would still need to tax shareholders on (at least a portion of) the gain on the sale of their stock.

---

[84] Some concern might remain to the extent the corporation has not paid tax due to tax preferences, or tax avoidance strategies etc. For instance, suppose the corporation invests in tax-exempt bonds and it does not pay any tax on the interest income. If the corporation then distributes the interest income out to the shareholders, the question arises whether the shareholders should be taxed on such distribution. On the one hand, some might argue against any tax since the shareholders could have realized such income directly themselves without any tax. On the other hand, there might be some concern about a corporation's greater ability or willingness to avoid tax.

[85] There might be some implicit tax in the form of a discounted purchase price since the corporate basis is not increased to reflect the current sales price. As discussed below in note [], however, any such implicit tax would tend to be less than the desired actual tax.

Taxing shareholder stock sales raises overtaxation concerns, though, regarding corporate retained earnings. To illustrate, consider the following example:

> ***Example #11:*** Same as ***Example #10***, except that X Corp. also generates $130,000 of after-tax profit, all of which it retains to expand its business. As a result of the retained earnings and X Corp.'s improved prospects, the shareholders are able to sell all the stock for $1,630,000 for a gain of $630,000.

If the shareholders were taxed on the entire $630,000 gain, there would be a double tax on $130,000 – the amount of X Corp.'s retained earnings. For this reason, corporate integration proposals typically provide for a shareholder basis increase for retained earnings. In our example, the shareholders would increase their basis by the $130,000 to $1,130,000. This would reduce their taxable gain to $500,000. While this is clearly the "right" result, such an approach raises the same administrative difficulties associated with treating corporations as if they were partnerships.[86] That is, these basis adjustments would require large corporations to make difficult, if not impossible, shareholder allocations.[87]

There is one last problem with integrating by taxing profits at the corporate level along with a shareholder tax on stock sales.[88] When a corporation has unrealized appreciation, selling shareholders might be disadvantaged compared to sellers of non-corporate businesses since buyers might reduce the stock purchase

[86] The problem arguably is somewhat lessened as the allocation is limited to retained earnings rather than all taxable income.

[87] Consider, e.g., a large corporation with (i) a diverse shareholder base, (ii) very frequent trading, and (iii) multiple classes of stock.

[88] Alternative integration approaches of a dividend paid deduction or shareholder-credit for paid corporate taxes raise similar issues regarding shareholder gains, although they would address the lack of individualized progressivity under the shareholder exemption approach. The shareholder-credit approach also raises issues of how to allocate the taxes paid.

price.[89] The reason for this is that the corporation's basis in its assets will not reflect the current fair market value even though (i) the buyer has purchased the company at the current value and (ii) the appreciation has been taxed.[90] The basis shortfall results since the tax has been imposed at the shareholder level, rather than the corporate level, highlighting again the difficulties in coordinating the individual and corporate income taxes. In sum, the selling shareholders still can be hit twice: (i) the actual, direct shareholder tax paid to the government, and (ii) the indirect, imputed tax in the form of a reduced sales price.[91]

In theory, corporations could be allowed to increase their asset basis when its owners sell at a profit, justified on grounds that the gain has already been taxed. In fact, the partnership pass-through tax regime does just that.[92] But such an approach would not work well in our large corporate setting for two reasons. First, implementing basis step ups for sales of stock in large corporations raises again the above administrative concerns. Second, a corporate-level basis increase would not

[89] Note how the problem stems from the realization requirement. As such, the textual discussion might suggest an alternate solution of taxing public companies based on the increase, if any, in their market capitalization for the year (without any additional tax on shareholders). See eg Joseph Bankman, A Market-Value Corporate Income Tax, Tax Notes, Sep. 11, 1995; Michael Knoll, An Accretion Corporate Income Tax, 49 Stan. L Rev. 1 (1996). While an intriguing possibility, this would be a very significant change from our current regime, and we accordingly set it to the side on those grounds. In this regard, consider the status quo bias against making substantial changes all at once. See discussion supra at note[].

[90] This might suggest that maybe we need not tax shareholder sales: i.e., that the discounted purchase price serves as an "imputed tax." The problem, though, is that such imputed tax generally would be less than the real tax since the lost value from the lack of a corporate basis step up generally is less than the cost of a current tax on all unrealized corporate gain (since the lack of basis increases taxes over time, rather than all at once).

[91] The selling shareholder is worse off than under a single-level integrated income tax due to a combination of the two. One way to see this is that the selling partner in the partnership context bears one full level of income tax on the sale of the partnership interest assuming no purchase price reduction (due to the basis adjustment mechanism described above). If the selling stockholder faces a purchase price reduction due to the absence of such basis adjustment, the selling stockholder therefore bears more than a single integrated tax. Note how this assumes that the excess tax is borne by the shareholder. To the extent the excess shifts elsewhere, someone else would then bear the brunt of the excess tax.

[92] See IRC §§ 743, 754.

necessarily solve the selling shareholder's double whammy problem since, unlike the partnership context, the benefits of the basis increase would inure pro rata to all the corporation's shareholders, rather than just the new owner.[93] As such, unless the buyer is buying all the stock, the buyer would still have reason to discount the purchase price, albeit by a lesser amount.[94]

B. GIT/MCT Response—Corporate Consumption Tax Plus Individual Income Tax

As just demonstrated corporate integration under an income tax is an elusive goal. However, the GIT/MCT may present a very intriguing solution to the corporate integration problem: maintain two levels of tax, but convert the corporate tax into one based on consumption. The principal reason that this might be appealing is that, unlike an income tax, a consumption tax generally does not burden capital investment.[95] For this reason, the existence of the GIT/MCT will not reduce a corporation's normal rate of return from what it would have been in the absence of the tax. The only burden on corporate earnings will be imposed at the shareholder level, thereby fully integrating the corporate tax. ***Example #12***, which is based on facts very similar to those of ***Example #9***, illustrates these points. For purposes of ***Example #12***, assume that the corporate income tax has been replaced with a corporate consumption tax with a 35% rate. For ease of exposition, also assume that the system provides for refunds whenever an entity reports a loss for tax purposes.[96]

---

[93] This results since the effect would be a reduction of the corporation's tax bill. This differs in the partnership setting since the benefits from the extra basis can be specifically allocated to the purchasing partner given the pass-through nature of partnership taxation. See IRC § 743.

[94] In addition, this would then seem to give a windfall to the other shareholders.

[95] As discussed in greater detail below, a consumption tax generally burdens just "economic rents."

[96] In reality, the system probably would not allow current refunds on losses, but instead could provide a present value equivalent via loss carryforwards increased by an interest factor. See MCT at [], GIT at []. As shown in note [], this alternative also results in the lack of any corporate tax burden for normal capital investment, assuming utilization of an appropriate interest rate.

> ***Example #12***: In December of Year 1, investors form X Corp. by contributing $650,000 of capital in exchange for all of its stock. Anticipating its refund of $350,000 for Year 1, X Corp. purchases a business for $1,000,000.[97] During Year 2, X Corp. generates $200,000 of profits, pays $70,000 in taxes, leaving it with $130,000, which it distributes to its shareholders.[98]

Let's now compare these results with those of ***Example #9***. First of all, at the corporate level, the results are almost identical: X Corp. invested $1,000,000 and received a 20% return on which it paid $70,000 in taxes. But what is different is that in ***Example #9***, X Corp. invested $1,000,000 of its own capital, while in ***Example #12***, it only invested $650,000. It financed the balance of purchase price of the business with the refund it was entitled to receive from expensing the cost of the business. Focusing just on X Corp.'s investment of $650,000, X Corp.'s after-tax return of $130,000 is 20%. Since X Corp.'s pre-tax and after-tax rates of return are both 20%, the corporate level tax imposes no burden.

But what about the $70,000 of "taxes" that X Corp. paid to the government? Although the $70,000 is labeled taxes, this payment is more properly viewed as the government's return on its investment of $350,000 that it made by permitting expensing.[99] Not by coincidence, this amounts to a 20% return on its investment. Indeed, under this regime, the government is no more than a limited partner.

---

[97] Assuming no other relevant items, X Corp would have a 1,000,000 tax loss, thereby generating a $350,000 refund at the 35% rate. Again, we make an assumption of refundability on the $1,000,000 "tax loss" on new investment by a new corporation for ease of exposition. In reality, the system could provide a present value equivalent via loss carryforwards increased by an interest factor. In this regard, perhaps a more realistic example would consider a new investment of $1,000,000 by an already existing business that otherwise would have $1,000,000 of taxable income. In this case, a new investment of $1,000,000 would save $350,000 of otherwise payable taxes.

[98] Note that there would not be any current tax if the corporation retained the earnings (since the reinvestment would generate additional deductions).

[99] Another way of saying this is that investments can be increased without real cost when made ("grossed up" in the lingo) with such immediate expensing under the consumption tax, which eliminates any burden from sharing the profits with the government. In this regard, compare again the results of Examples 9 and 12. The government collects $70,000 of net tax in both

To really drive home the point, let's focus now on the return to the shareholders given that they are the ultimate capital investors in the enterprise. Suppose now that X Corp. sold the business on day 1 of Year 3 for its original purchase price ($1,000,000), and then distributed the after-tax proceeds to the shareholders.[100] If it did, X Corp would have gain of $1,000,000 on which it would owe $350,000 in "taxes."[101] This would leave the X Corp. shareholders with $780,000 of assets ($650,000 net from the sale available for distribution plus $130,000 net earnings previously distributed from Year 2),[102] an amount that is precisely equal to their initial capital contributions plus 20%.[103]

---

examples (here in Ex. 12 calculated as $420,000 on disposition less the $350,000 savings on initial investment). The key difference, though, concerns the timing aspect. The $350,000 savings in Ex. 12 occurred earlier than the $420,000 payment. And it is this timing benefit which eliminates the burden of the tax in Ex. 12**.** Thus, while a taxpayer similarly could grossup risky investments under an income tax, the taxpayer would have to fund the grossup himself, which cannot be done cost-free as here. For instance, the taxpayer would have to relinquish investments in risk-free assets or would have to borrow funds, thereby incurring an interest charge to do so. See Bankman & Griffith, Is the Debate Between an Income tax and Consumption Tax A Debate about Risk? Does it Matter, 47 Tax L. Rev. 377 (1992); Noel B. Cunningham, Taxation of Capital Income and the Choice of Tax Base, 52 Tax L. Rev. 17 (1996) (income tax burden based on taxpayer's borrowing rate). For a further discussion of how this minimizes the reach of the income tax, see notes [] and accompanying text supra.

[100] This $1,000,000 sales price reflects the lack of any additional gain or loss on the investment; in this regard, recall how the prior distribution of the year 2 after-tax proceeds.

[101] Again, there would not be any current corporate tax if X reinvested the sales proceeds (as this would generate additional deductions).

[102] To maintain consistency with the income tax analysis, the textual analysis does not assume that the corporate tax would be passed on to consumers through a price increase. As shown below in this footnote, making such price change assumption would not alter the "no-burden" result, although the pathway of the analysis might vary. With such assumed price increase, the investors still receive back $780,000 on their $650,000 investment under the following alternate analysis. When X Corp pays $1,000,000 for its inputs, they receive only $650,000 of pretax value since their purchases bear $350,000 of tax. (Note that the textual tax rate of 35% is a "tax inclusive" rate, which equals a 53.85% "tax exclusive" rate.) But again, they still need only $650,000 of capital from the shareholders to fund the purchase – matching the pretax value -- since their investment deduction of $1,000,000 provides tax savings equal the $350,000 tax built into their inputs. And when X Corp sells goods for $1,200,000 receipts, their pretax sales are only $780,000 as $420,000 equals the tax collected and paid to the government (again at a 53.85 tax exclusive rate). Since X Corp's deduction for its inputs offsets the tax imposed on the acquisition, there are no net tax consequences on the acquisition of the inputs. Likewise,

With this understanding in mind, let us now return to the GIT and MCT. By converting the corporate tax into a consumption tax, the proposals alleviate double taxation concerns given the above removal of the corporate tax burden on normal returns.[104] At first blush, then, the proposals might appeal as a way to maintain collections from both the corporate and individual taxes without the current excess tax burden. In addition, this integration approach appeals on administrative grounds since it avoids the complicated need to allocate retained earnings for shareholder basis increases.[105]

---

when X Corp sells its goods with pretax value of $780,000, no tax is imposed on the corporate investment as the tax is passed onto consumers. In some ways, this is an easier explanation for why the consumption tax might not burden investment (i.e., it simply gets passed on to consumers). In addition to maintaining an easier comparison to the income tax (which generally does not assume the passage of the tax onto consumers), the textual analysis provides a more robust justification for the no-burden claim since (i) it does not rely on a complicated incidence analysis, (ii) it avoids a possible critique as to why simply changing the corporate tax to provide immediate expensing should have such a dramatic shift in incidence (i.e., a full increase in the price of goods), and (iii) as discussed infra at [] it helps to explain the standard assumption that the consumption tax does burden economic rents. In any event, the different explanations in the text and this footnote combine to show that the consumption tax's "no-burden on investment" claim does not rest on any incidence assumptions since we end up in the same place regardless.

[103] As noted above, the system probably would not allow current refunds on investment, but instead would provide the present value equivalent of loss carryforwards with interest. To see how this would maintain the no-tax burden result, let's now assume that X Corp would not receive the $350,000 from the government on initial investment. Instead, X Corp borrows $350,000 from the bank at a 10% interest rate, combines that with the shareholder contributions and invests $1,000,000 at the end of year 1. For ease of exposition, assume now that X Corp sells the business on the last day of year 2 for $1,200,000 (i.e., the same 20% pretax profit). If the $1,000,000 deduction carry-forward is increased by the 10% interest rate, X Corp will pay tax of only $35,000 [35% x (1,200,000 – 1,100,000)]. X Corp also owes the bank $385,000 ($350,000 principal plus $35,000 interest). This leaves the same $780,000 as in Example 12 available for distribution to the shareholders.

[104] As discussed below, the consumption tax does burden supranormal returns, sometimes referred to as economic rents.

[105] Compare the discussion in Part A regarding integration proposals involving a corporate *income* tax and individual income tax. Retained earnings do not require complicated basis increases under the GIT/MCT approach since, as noted above, they forestall current tax collections since reinvested proceeds give rise to immediate offsetting deductions.

On the other hand, though, this corporate tax change then seems to put all the pressure on the shareholder tax to impose the desired burden on capital investment. Unfortunately, though, this seems to restore the earlier difficulties in integrating via a single shareholder tax: i.e., recall the earlier administrative difficulties with having shareholders report corporate earnings as generated each year. Now the GIT and MCT avoid those difficulties by maintaining the current version of the shareholder tax whereby shareholders report their income only upon receipt of dividends or stock sale gains. But this then seems to allow excessive deferral as there would not be any current burden on corporate retained earnings absent stock sales by the stockholders. Note that the deferral potential is not as good as consumption tax treatment[106] since the shareholder cannot deduct their initial investment when made.[107]

[106] The GIT would allow investors to invest certain amounts through tax-free savings accounts, thereby achieving an explicit and complete exemption of any second-level tax. The GIT claims that these accounts would mean that "relatively few families would pay the 15% tax on interest, dividends and capital gains that would apply to assets held outside these ["tax-free" investment] accounts." GIT at p.160.

[107] In this sense, this is like a non-deductible traditional IRA account. Nonetheless, the deferral can provide valuable time value of money savings. One way to conceptualize the TVM savings is that the annual return on the initial invested capital does bear a burden at the stated rate, but subsequent earnings on such reinvested earnings do not bear any burden (so long as the corporation retains the earnings and the shareholders retain their stock). This relates to the point that newly invested capital bears a double tax burden under a corporate income tax combined with a shareholder income tax, while retained earnings capital does not bear such a burden. Cites. The following example might help illustrate. Suppose X Corp distributed the $780,000 from Ex 12 to its shareholders after one year of operations. The shareholders would owe 26,000 of tax (.20 x 130,000), leaving $754,000. This equals a 16% after-tax return after imposition of the individual tax (equal to the 20% pretax return less the full shareholder statutory rate of 20%). And if the shareholders then reinvested in another corporation which also generated a 20% pretax return distributed after one year, the shareholders would end up with 874,640, reflecting again an annual 16% after-tax return on everything. [754,000 would generate a 904,800 distribution, shareholders would owe 20% x 150,800= 30,160 of tax]. But suppose now that X Corp does not make the distribution after one year of operations. Now X Corp would generate $240,000 before tax (.2 x 1,200,000). Assume X Corp now liquidated. It would owe 35% of $1,440,000 or $504,000, leaving it $936,000 to distribute. The shareholders would now have a net profit of $286,000, which would incur $57,200 of tax, leaving 878,800. While higher than the 874,640, it does not equal a full 20% return (a full 20% return would have

Tax deferral then also links to a second possible under-taxation aspect of the GIT/MCT: their maintenance of the capital gains rate for shareholder income.[108] Given the removal of the corporate tax burden on normal returns,[109] this might seem surprising since double taxation concerns often are used to justify the reduced rates.[110] A second capital gains justification might explain, though, the GIT/MCT's maintenance of the lowered rate despite the general lack of any corporate tax burden: lock-in. Under a realization income tax, shareholder incentives to retain appreciated stock increase as the stated rate increases. This results since deferral reduces the true cost under time value of money of principles, and higher rates raise the timing stakes. In similar fashion, increased shareholder rates on dividends provide greater incentives for corporations to retain their earnings. As such, the lowered shareholder rates under the GIT/MCT might appeal as a way to minimize the shareholder (corporate) incentives to retain appreciated stock (retained earnings). But while lock-in might justify reduced shareholder rates, the end result of the burden resting solely on a deferred shareholder tax at reduced rates might seem like too high a price to pay for corporate integration.[111]

---

generated $936,000). In essence, the 20% annual return on the original invested capital of 650,000 continues to bear the income tax burden each year, but earnings on retained earnings grow tax free. 650,000 x 1.16 for first year grows to 754,000. Of the 754,000, 650,000 grows the next year at only 16% while the 104,000 of (after-tax) RE grows at 20%. (650,000 x 1.16) + (104,000 x 1.2) = 754,000 + 124,800. This generalization holds true for longer periods as well.

[108] The MCT contemplates the possibility of extending the higher current ordinary rate on interest to dividends and capital gains. MCT at p.13. If distributions under the MCT are taxed at a preferential rate, this could become a serious problem by creating a bias in favor of operating in corporate form, rather than as a partnership which will continue to be taxed at ordinary rates. See the conclusion for a further discussion of this point.

[109] Again, as discussed below, the consumption tax does burden supranormal returns, sometimes referred to as economic rents.

[110] Add cites.

[111] Again, given the release of the corporate tax burden on normal returns. Restated, the current shareholder system allows for similar deferral and lowered rates, but this is in the context of a corporate income tax. But see discussion below how the difference arguably relates only to the normal interest return. In addition, note how our current income tax does have some features more consistent with a consumption tax. See note [] and accompanying text.

So does this just take us back to square one? Not necessarily since the above analysis might overstate the differences between a corporate income and consumption tax.[112] The following two key qualifications will be discussed in turn below: (i) how the consumption tax does burden supranormal returns, also known as economic rents, and (ii) how the income tax also arguably fails to burden normal returns above the normal interest rate. And it is our belief that these two factors restore the ultimate appeal of the GIT/MCT, especially when coupled with (i) the uncertainty over who bears the burden of the current corporate income tax,[113] (ii) the fact that the GIT/MCT maintains tax collections on normal corporate returns despite the lack of any true burden, [114] and (iii) the fact that the current corporate "income" tax allows current expensing of certain investments.[115]

Let's now consider first the possibility of economic rents, defined as above-market returns attributable to ideas, managerial skill, or market power.[116] A long history of scholarship highlights how a consumption tax generally burdens these returns, in contrast to regular investment.[117] This follows from the above analysis in Example 13 showing how X Corp avoided any burden on its normal profits by increasing the amount of their investment to take into account the forced

[112] Again, note how our current income tax does have some features more consistent with a consumption tax. See note [] and accompanying text.

[113] See discussion supra at [].

[114] Since there is no burden under the corporate tax component, one might suggest that the corporate tax under the GIT/MCT is both unnecessary and needlessly complicates the law. As such, why not just eliminate it entirely? By doing so, the tax system would be vastly simplified and problems discussed above concerning border adjustments would disappear. This position is not totally without merit, but proves too much. It is certainly true that eliminating the corporate tax would simplify the tax system enormously and moot the border tax adjustment issue. Nevertheless, eliminating the corporate tax in the context of retaining an individual income tax is not very attractive for at least two reasons. First, repealing the corporate tax entirely would reduce significantly revenue, which would have to offset by increasing other taxes, or cutting spending. More importantly, repeal would eliminate the tax burden on economic rents (discussed below at []).

[115] See, eg, IRC §§ 168(k), 179 (both of which allow current expensing of certain investments, subject to applicable limitations).

[116] see William M. Gentry & R. Glenn Hubbard, Distributional Implications of Introducing a Broad-based Consumption Tax 6-7 (Nat'l Bureau of Econ. Research, Working Paper No. 5832, 1996).

[117] Add cites.

partnership share with the government.[118] By definition, though, economic rents are limited opportunities which should already be fully invested, and therefore cannot be increased at will. As such, the government cannot be excluded from these opportunities, with such forced partnership here reducing the taxpayers' share of these inframarginal profits. With this in mind, we now refine the above analysis to highlight how the economic rent component should remain burdened even under the corporate component of the GIT/MCT, just like under the income tax.[119]

Moving beyond economic rents, the prior scholarship line has shown how normal profits above the normal interest return also are treated similarly under the income and consumption taxes, albeit via a comparable *lack* of any burden in this case. Restated, the income tax does impose an additional burden relative to the consumption tax, but it is limited to just the normal interest return on invested capital, rather than the entire normal return.[120] This can be explained in two

[118] In example 12, recall how the shareholders contributed only $650,000 of capital, yet X Corp made a $1,000,000 investment after taking into account the government's $350,000 share (in the form of tax savings).

[119] An interesting question therefore concerns the percentage of returns which constitute economic rents. For one attempt to measure this, see Gentry & Hubbard, supra note [], at 40-41 ("The switch from a pure income tax to a consumption tax is likely to be less regressive than commonly assumed. Despite the claim that consumption taxes do not tax capital income, replacing depreciation allowances with expensing only eliminates the taxation of the opportunity cost of capital and not capital income attributable to inframarginal returns and luck (either good or bad). Because wealthier households receive a larger portion of what is often called their capital income in the forms treated similarly by income and consumption taxes (ex post returns to risk taking and inframarginal returns), a consumption tax is less regressive than would be suggested by assuming a consumption tax exempts all parts of capital income. Our distributional analysis suggests that more than one-third of the reduction in the share of taxes paid by very high-income households in switching from an income tax to a consumption tax is offset by this effect.).

[120] Like the consumption tax analysis, this assumes constant rates (as well as the ability to scale up investments without impacting pretax costs). An additional problem with grossing up under the income tax arises from the limitations on deductions for losses (a lack of a "full loss offset"). The lack of a full loss offset impedes grossing up since the investor would be taking on greater downside risk with a full grossup. This could be alleviated by allowing loss carryforwards with interest under the income tax too, but such a notion generally is utilized only in connection with consumption tax proposals. Also in contrast to a consumption tax, an income tax also imposes

interrelated ways, both of which stem from the following key conceptual difference between the income and consumption taxes: while the consumption tax grants an immediate deduction for capital investment, the income tax defers the recovery of such costs over time (via depreciation allowances or basis recovery on sale). As such, the difference between the two taxes reduces to timing of cost recovery, suggestive of a more fixed interest-like return.

The somewhat related second point is that this highlights how corporations can gross up their investments to counteract the government sharing ratio under an income tax as well since they eventually will receive the government's funding share via the later cost recovery allowances. And while it is true that they have to fund the government's investment share upfront, this is again suggestive of a more fixed interest-like cost.

A concrete example should help illustrate. Let's return to Example 9 but now assume that the shareholders put in only $650,000 of capital like in Example 12. X Corp, though, still makes the $1,000,000 investment by also borrowing $350,000 at an assumed interest rate of 10%. X Corp generates $200,000 of profits before interest, or $165,000 after interest. X Corp owes $57,750 of tax,[121] leaving $107,250 available for distribution to the shareholders. This equals a 16.5% after-tax return after imposition of the corporate tax.[122] While less than the 20% after-tax return under the consumption tax, it is higher than the 13% after-tax return in Example 10.[123] The key difference is that X Corp did not gross up its investment in Example 10 by borrowing so the full 20% pretax return was reduced by the statutory rate.[124] In contrast, by borrowing to gross up here, the corporate tax burden was reduced to just the stated rate of 35% times the 10% interest return on the invested capital.[125]

---

a burden due to inflation absent appropriate indexation for inflation. Noël B. Cunningham, The Taxation of Capital Income and the Choice of Tax Base, 52 Tax L. Rev. 17, 24-29 (1996).

[121] 165,000 x .35.

[122] $107,250/650,000.

[123] $130,000/1,000,000.

[124] 20% x .35 = 7%. 20% - 7% = 13%.

[125] 10% x .35 = 3.5%. 20% - 3.5% = 16.5%. Another way to see this is to focus on fact that there is $22,750 less for distribution under the corporate income tax (130,000 - $107,250). It is no

With these points in mind, we now further refine the above analysis to highlight how the possible excess deferral concern under the GIT/MCT relates then to just to the normal interest return. And with such enhanced understanding, we support the GIT/MCT approach to corporate integration notwithstanding its imperfections. We see it as an achievable, workable compromise between a possibly more robust income tax burden in theory (again though, really limited just to the normal interest return) and a pure consumption tax (which again would burden economic rents, but no other capital returns).[126]

As further support, we highlight again how the approach favorably maintains collections from all capital returns notwithstanding its lighter burden on capital investment. This package seems particularly attractive given our current revenue needs[127] and the competitive desire to improve our attractiveness for capital investment.[128] In addition, the GIT/MCT integration approach favorably avoids the need for messy shareholder allocations. It also minimizes the required changes to current law, thereby acknowledging the status quo bias.[129] Thus while sympathetic in theory to possible adjustments for further improvement,[130] we would endorse the MCT/GIT integration approach as presently constituted.

---

fluke that 22,750 = the stated 35% rate times the 10% interest rate times the $650,000 of invested capital (.35 x .1 x 650,000 = 22,750).

[126] While a pure consumption tax proponent might prefer to see the shareholder tax removed, this approach nonetheless might garner support from them on grounds that it is an improvement over the current double income taxation regime.

[127] It seems terribly unlikely that corporate tax reform could be enacted unless it were (at a minimum) revenue neutral.

[128] See earlier competitiveness discussion at [].

[129] The status quo bias cautions against making substantial changes all at once, favoring instead a more incremental approach. See eg Lillian R. BeVier, The Communications Assistance for Law Enforcement Act of 1994: A Surprising Sequel to the Break Up of AT&T, 51 Stan. L. Rev. 1049, 1062 n.37 (1999) ("The status quo bias exhibited by legislative institutions is in large part the sum of the biases of individual legislators."); William Samuelson & Richard Zeckhauser, Status Quo Bias in Decision Making, 1 J. Risk & Uncertainty 7, 33 (explaining individuals' status quo bias as a combination of "(1) rational decision making in the presence of transition costs and/or uncertainty; (2) cognitive misperceptions; and (3) psychological commitment stemming from misperceived sunk costs, regret avoidance, or a drive for consistency.").

[130] In particular, Professor Ed Kleinbard recently presented an intriguing proposal to link a corporate consumption tax with an improved shareholder tax which would impute an interest

C. Debt Bias

A final word concerns the current incentive to capitalize with debt, as briefly highlighted earlier in Part I's discussion of the problems with our classic corporate system. As touched upon at the end of Part III.A, the GIT and MCT deviate a little bit regarding the debt bias. As noted there, the GIT maintains full neutrality at the corporate level since it would exempt the cash flows on both equity and debt capital. In contrast, by taking into account cash flows on debt (but not equity), the MCT could provide some corporate tax incentive to substitute debt with a high interest rate in lieu of equity. As noted there, we find the GIT's equalization quite appealing given our long history with debt/equity concerns. In fairness to the

---

return on shareholder investments. Edward D. Kleinbard, The Sorry State of Capital Income Taxation, available at []. With such imputation, shareholders would be taxed currently – and at ordinary rates -- even absent any dividends or stock sales. While we find such an approach intriguing in theory, we like how the GIT/MCT avoids introducing complicated shareholder calculations into the mix. See discussion right above regarding the virtues of more narrow changes. Such an approach also raises interesting questions in design, such as whether gains in excess of the imputed interest return should be subject to tax. Compare, e.g., Professor Kleinbard's earlier version of his proposal (The Business Enterprise Income Tax: A Prospectus, Tax Notes (2005)) with his later version (The Sorry State of Capital Income Taxation, supra).

In the other direction, consideration could be given to improving the tax via corporate-level rules. For instance, the GIT/MCT approach might be enhanced via utilization of rules imposing an extra tax on corporations which excessively retain their earnings. If this could be done effectively, lock-in concerns regarding retained earnings might be addressed sufficiently to allow utilization of the regular tax rate on dividends (but not stock sale gains). The difficulty is that we already have such an "accumulated earnings tax," which generally is thought to be ineffective, at least as concerns public companies. See eg, Brealey & Meyers, Principles of Corporate Finance 434 (5th Ed 1996)("public companies are almost always able to justify their retentions to the IRS"); Fischer Black, the Dividend Puzzle, J. of Portfolio Management 5 (1976). Thought could be given to expanding such rules, at the extreme taxing corps on all of their retained earnings (as a substitute shareholder tax) but this seems to go too far (eg, on excessively incentivizing distributions to avoid the high-level corporate rate). In addition, to avoid excess taxation, we would then seem to need complicated shareholder basis increases for the extra corporate tax [confirm that my understanding is correct that current AET does not give basis increases which means triple tax—regular corporate tax, AET, then another round at shareholder level].[Also, would we now be imposing too much tax on economic rents?]. Again, the GIT/MCT compares favorably in dodging these issues.

MCT, though, we note that it does compare quite favorably to current law regarding debt incentives since it generally removes the current extra level of tax.

Moving beyond the corporate level consequences, we should now consider also the tax treatment of debt and equity to the investors (i.e., the lenders and shareholders). The GIT and MCT generally maintain equivalent debt/equity treatment at the investor level too by imposing the same 15% rate of tax on interest, dividends and capital gains.[131] If anything, equity might be favored compared to debt at the investor level under the MCT and GIT given the deferral possibility on retained earnings discussed above.[132]

Part V: Conclusion

The GIT/MCT dual approach of a corporate consumption tax plus individual income tax appeals in several regards. First, it addresses long-standing corporate income tax integration problems by generally removing the burden of the corporate tax. Also, by maintaining tax collections while generally relinquishing any burden, the approach simultaneously heeds revenue-raising and competitiveness concerns. Finally, converting the corporate tax to a consumption tax while maintaining the individual income tax minimizes the overall changes to current law compared to, e.g., replacement of the entire income tax with a consumption tax. Consider the classic adage is that an old tax is a good tax.[133] One favorable aspect of the GIT/MCT in this regard is that transition issues generally should be limited to the business-level tax.[134]

---

[131] GIT at p. 157. As noted above, the MCT also supports this rate equalization although it contemplates the possibility of extending the higher current ordinary rate on interest to dividends and capital gains. MCT at p.13.

[132] It seems like interest generally would be taxed on an economic accrual basis under the GIT and MCT, as per the current OID rules.

[133] This has been attributed back to Adam Smith. See eg Ramseyer & Nakazato, Tax Transitions and the Protection Racket, A Reply to Professors Graetz and Kaplow , 75 Va. L. Rev. 1155, 1157 (1989) (citing 2 A. Smith, An Inquiry into the Nature and Cause of the Wealth of Nations 920-21 (Campbell, Skinner & Todd eds. 1981).

[134] For instance, individual-level transition issues arise in proposals to convert the individual income tax into a consumption tax. In particular, how, if at all, should individuals be allowed to use basis in their investment assets against the new individual level consumption tax?

Finally, focusing the spotlight on minimizing changes also highlights one key distinction between the GIT and MCT.[135] The MCT would subject only corporations and large partnerships to the new corporate consumption tax, whereas the GIT would apply the revised corporate tax more broadly to most businesses. Based on the foregoing, the MCT then might seem to have the better of it on this point since it seems more consistent with current law in this regard. In particular, current law provides two different tax regimes in which only corporations and most publicly traded partnerships are subject to the current corporate income tax. On the other hand, though, the MCT's narrower application seems problematic given the desired movement of the entity tax to a destination-based consumption tax. The destination basis appeals as a way to minimize international tax avoidance, yet the MCT's multiple business tax regimes seems to raise real concerns regarding WTO approval for the destination basis. In addition to the WTO concerns, the MCT's narrower approach also seems to present other tax avoidance concerns given that corporations and large partnerships would face a very different tax regime than other businesses.

So at the end of the day, we see the real dilemma is in the choice between the GIT and MCT. In theory, we favor the GIT's more comprehensive and consistent coverage. But we are very mindful of the MCT's responsiveness to the status quo bias, and recognize its practical advantage in minimizing the changes to current law. Perhaps the two proposals dovetail via a two-step implementation: an initial adoption of the more limited MCT approach, followed up by a later extension of the regime to a broader range of business entities as well.

[135] As discussed in Part III.A, another key distinction concerns the treatment of investor loans to businesses. As discussed in that part, we see that distinction as raising a more difficult choice even setting aside the status quo bias as the two approaches have offsetting manipulation concerns.