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Defining Taxes in Economics, Accounting and Law
Mindy Herzfeld

November 23, 2021
Vanderbilt Hall – 208
Time: 2:15 – 4:15pm
Session 6

SCHEDULE FOR FALL 2021 NYU TAX POLICY COLLOQUIUM
(All sessions meet from 2:15 - 4:15 pm in Vanderbilt 208, NYU Law School)

1. Tuesday, September 14 – Jake Brooks and David Gamage, The Indirect Tax Canon, Apportionment, and Drafting a Constitutional Wealth Tax.

2. Tuesday, September 28 – Daniel Hemel, Law and the New Dynamic Public Finance.

3. Tuesday, October 12 – Jennifer Blouin, Does Tax Planning Affect Organizational Complexity: Evidence from Check-the-Box

4. Tuesday, October 26 – Manoj Viswanathan, Retheorizing Progressive Taxation

5. Tuesday, November 9 – Ruth Mason & Michael Knoll, [Untangling Undue Burdens]

6. Tuesday, November 23 – Mindy Herzfeld, Defining Taxes in Economics, Accounting and Law

7. Tuesday, November 30 – Alan Auerbach, Taxes and Low Interest Rates.

Defining Taxes in Economics, Accounting and Law

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I Introduction

Tax policy and practice occupy an uneasy space between several disciplines: accounting, economics, and law. The tension in how the different fields approach knowledge and its application differently, and the practical implications of those differences, can be illustrated by tracing the definition of the term "tax" and its evolution within the different bodies of professional learning. The exercise highlights the difficulty the law faces in accommodating a shifting understanding of changing economic theory. Likewise, while the principles of the income tax system have their origin in accounting standards, the divergence between the two – a result of the different goals of tax laws and accounting norms – creates opportunities for distortions and tax planning. This paper illustrates these themes through consideration of the ways the terms "direct" and "indirect" taxes, and "income" and "non-income" taxes have distinct meanings within the different disciplines, and how changes to the meaning of the terms over time create a divide between the law and optimal policies.

While tax law reflects both theoretical economics and accounting principles in its design, it deals poorly with changes in economic theory, which take a long time to be reflected in updated laws and agreements. Nowhere is this more evident than in the definition of a tax, where 18th century conceptions of the meaning of taxation have become ossified in the U.S. Constitution and where early 20th century understandings of the differences between taxes on income and consumption have solidified into global trade agreements with wide ranging political ramifications. Perhaps reflecting the inherently faulty exercise of building legal principles on shifting economic theories, as well as the politics that go into developing tax law, recent trends may indicate a shift away from legal dependence on economic definitions of tax and income in favor of relying on financial accounting principles to determine the tax base and taxing rights. This exercise is reflected in, among others, the OECD-brokered global tax deal agreed to [this fall and alternative minimum book tax proposal].

This paper considers the evolution of the meaning of the phrases "direct tax" and "indirect tax" from two perspectives – the constitutional requirement that direct taxes be apportioned among the states, and the distinction in global trade agreements between direct and indirect taxes for purposes of allowing a border adjustment in the case of one (indirect taxes) but not the other; the evolution of the meaning of the term makes it challenging to apply these cross-border agreements to 21st century fiscal questions. In the constitutional arena, the question has arisen lately because of the debate over the constitutionality of a recently proposed wealth tax. In the trade area, tensions have arisen over the fact that much of the rest of the world has a (border adjusted) VAT, whereas the United States relies almost exclusively on an income tax for revenue in the federal area. In no small part, this arbitrary distinction led Republican congressional leadership to propose a radical overhaul of the U.S. international tax rules in 2016 in the form of a destination-based cash flow tax.

Aside from struggling with an arbitrary distinction between direct and indirect taxes, the tax world faces the question of how to properly define an income tax. This question has become more acute in the United States in the context of the creditability of foreign taxes, as governments around the world try out new ways of raising revenue on new business models.[1] The OECD, as well, has to develop its own definition of an income tax for purposes of the newly agreed global minimum tax.[2] But recent research suggests that the distinctions between various types of taxes – whether they should be considered taxes on income or on consumption – is murkier than it may appear, and ongoing controversy over the incidence of the corporate tax – as to whether it falls on shareholders, labor, or customers – also prompts the question whether it makes sense to split taxes into two distinct categories of taxes on income and taxes on consumption. The law's arbitrariness and its disconnectedness from the reality of corporate profit calculations are part of what is behind the shift to accounting calculations as an alternative tax base. In this context, the paper reviews the U.S. tax law's distinctions between income and non-income taxes in the foreign tax credit area, including recently [proposed] regulations that would substantially revise this definition, and the OECD's recent attempt to develop a definition of income taxes ("covered taxes") for its own purposes. The accounting distinctions – and their history – are also explored.

This paper proceeds as follows. Part II lays out the history of the direct / indirect tax distinction in the Constitution and interpretive caselaw and then considers how the distinction matters in the context of current debates over wealth taxation. Part III discusses the history of the direct/indirect tax distinction in trade agreements within the context of EU-US trade disputes over export regimes, controlled foreign corporation regimes and the future of the WTO. Part IV describes the importance of the definition of an income tax for the U.S. foreign tax credit system and considers [proposed] regulations and some of the recently enacted foreign taxes that put pressure on this dichotomy, as well as the OECD's global minimum tax proposal. Part V reviews the importance of the distinction between income and non-income taxes for financial statement reporting purposes. Part VI concludes.

II Direct and Indirect Taxes

A. Binary Taxation & the Constitution

1. <u>The Text</u>

The term direct tax appears twice in the U.S. Constitution. Article I, section 2 provides that "direct Taxes shall be apportioned among the several States . . . according to their respective Numbers." Section 9 of the same Article provides that "[n]o Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."

The proportionality requirement means that if a tax qualifies as a capitation tax or direct tax, it is required to vary according to state, so that each state contributes an amount proportional to its population. In general, a capitation tax is understood to mean a tax imposed directly on a

[1] Jt. Comm. on Tax'n, *Background and Selected Policy Issues on International Tax Reform*, JCX-45-17 (Sept. 28, 2017).
[2] [expand?]

person.[3] The requirement that "direct taxes" be apportioned among the States has been tied to a sordid aspect of the founding of America's Constitutional democracy, namely the compromise that resulted in the three-fifths clause pursuant to which slaves were counted as three-fifths of a free person for purposes of determining the size of a state's delegation to Congress, the number of members it could have in the Electoral College, as well as the tax apportionment requirement.[4]

2. <u>The History of Direct Tax Terminology</u>

As the Joint Committee on Taxation has explained, while direct taxes on property and indirect taxes and duties on specific transactions have existed for millennium, the idea that direct taxes could also encompass taxes on income is relatively recent.[5] The use of the term direct tax in the Constitution is generally traced to a group of 18th century French economists who believed that land was the source of all wealth known as the Physiocrats,[6] and prior to that, John Locke (who believed that all taxes ultimately were taxes on land).[7] If one assumes that all taxes are ultimately borne by landowners, then taxes imposed on land are the only "direct" taxes.[8]

But others have plausibly argued that by the late 18th century, the definition of direct tax had expanded to include taxes on profits and wages, and the term had evolved to refer to the nature of the transaction on which the tax was levied.[9] According to this interpretation, taxes on the transfer of immovable property – a public transaction -- should be considered direct taxes, while taxes on transfers of stock or personal property or other income from capital should be considered indirect taxes because the transactions were generally "secret."[10] In a seminal paper that dissects the meaning of the term as used in the Constitution in order to support the case for the constitutionality of wealth taxes, Bruce Ackerman argues that the only taxes meant to be excluded from the term direct taxes are customs or import duties.[11]

The lack of clarity as to what exactly the Constitution's drafters meant when they referred to "direct taxes is perhaps best expressed by Edwin Seligman, a prominent fiscal economist in the earliest 20th century and one of the chief architects of the income tax, who wrote: "the exact distinction between direct and indirect taxation . . . was beyond peradventure of doubt not understood by the framers of the Constitution and those who adopted it. All that can be said is that, in a general way, import and export duties were considered indirect taxes, and that land and poll taxes were considered direct taxes; but farther than that it is impossible to go.[12]

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[3] [cite]
[4] *See* Bruce Ackerman, *Taxation and the Constitution*, 99 Col. L. Rev. 1 (1999).
[5] JCX-45-17 (September 28, 2017)
[6] Oxford English Dictionary [date].
[7] See discussion in Edwin R.A. Seligman, THE SHIFTING AND INCIDENCE OF TAXATION 101-09 (4th ed. 1921).
[8] Ackerman at 17. [Alexander Hamilton, in the Federalist, also counted capitation taxes and land taxes as "direct" taxes. See Federalist Papers No. 36 (1788); The Law Practice of Alexander Hamilton, at 353-54 (Julius Goebel 8c Joseph Henry Smith eds., 1980).
[9] See Ackerman at 18-19 [citing xx]
[10] See Ackerman at 18-19 [citing xx]
[11] Ackerman at 16.
[12] Edwin RA. Seligman, The Income Tax, (1911) note 21, at 569-70, cited in Ackerman n.50.

3. The Supreme Court Caselaw

The apportionment requirement has resulted in regular litigation over the meaning of the term direct tax, as the Supreme Court has at periodic intervals been asked to weigh in on the constitutionality of various taxes. Although the Court defined the term direct tax fairly narrowly throughout the 19th century, its decision in *Pollock v. Farmers Loan Trust Co.*[13] interpreted the term broadly to mean all taxes on income from property, whether real or personal. Striking down as unconstitutional the federal income tax law passed in 1894,[14] the decision eventually led to the adoption of the 16th amendment which allowed for a constitutionally sanctioned income tax.

Prior to enactment the 1894 act, the Court had considered the constitutionality of a number of taxes levied on property enacted to finance the Civil War and the resulting need for government revenues. This line of cases repeatedly affirmed that only taxes on land and capitations (persons) should be considered direct taxes within the meaning of the constitution. In *Hylton v. United States*,[15] the Court held that a tax on carriages was constitutional on the grounds that it was not a direct tax, with Justice Paterson stating that "[w]hether direct taxes, in the sense of the Constitution, comprehend any other tax than a capitation tax and tax on land is a questionable point."[16] In his brief defending the tax, Alexander Hamilton emphasized the "uncertainty" and vagueness of the terms direct and indirect taxes, and lamented the inclusion of such vague terms making such an important point in the Constitution, also noting that one could "seek in vain for any antecedent settled legal meaning to the respective term."[17]

In *Veazie Bank v. Fenno*,[18] the Court considered the constitutionality of a tax passed by Congress in 1866 of 10 percent on the amount of notes issued by state banks. In considering whether the tax met the apportionment requirement applicable to direct taxes, the Court noted that "[m]uch diversity of opinion has always prevailed upon the question, what are direct taxes,"[19] also explaining that Adam Smith's work had recently been published when the Constitution was written, and that although it "refer[ed] to the characteristic difference between direct and indirect taxation, there is nothing which affords any valuable light on the use of the words "direct taxes" in the Constitution."[20] Reviewing the history of Congress' enactment of various taxes, in 1798, 1813, 1815, 1816, the Court determined that "personal property, contracts, occupations, and the like have never been regarded by Congress as proper subjects of direct tax."[21] It further explained that while "in the practical construction of the Constitution by Congress, direct taxes have been limited to taxes on land and appurtenances and taxes on polls or capitation taxes,"[22] perhaps "taxes on personal property by general valuation and assessment of the various

[13] Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895), aff'd on reh'g, 158 U.S. 601 (1895).
[14] Income Tax Act of 1894, [cite].
[15] 3 U.S. 1 (1796).
[16] *Id*. at 177.
[17] Ackerman at 24 [citing Hamilton brief]
[18] 75 U.S. 533 (1869).
[19] Id. at 541.
[20] Id. at 542.
[21] Id. at 543.
[22] Id. at 544.

descriptions possessed with the several states could meet the definition.[23] As this case illustrates as well, its not possible to separate the Court's analysis of the constitutional validity of a type of tax from the importance of the role that black slaves played in generating differences in wealth and income among the different states.[24]

The Court's most recent reconsideration of the meaning of direct tax came in its decision on the constitutionality of the Affordable Care Act.[25] In that case, which upheld the ACA's individual mandate as within Congress's power under the Taxing Clause, the Court concluded that the tax imposed by the ACA -- a tax on going without health insurance -- is not like a capitation or other direct tax under this Court's precedents, and so did not need to be apportioned by State. It said that a tax on going without health insurance does not fall within any recognized category of direct tax. The dissent, written by Justices Scalia, Kennedy, Thomas, and Alito, noted that "the meaning of the Direct Tax Clause is famously unclear," and said that its application to the ACA's mandate represented "a question of first impression that deserves more thoughtful consideration than the lick-and-a-promise" the decision provided.

[discuss originalism in 4th amendment v 8th amendment]

B. Wealth Taxation and the Constitution

Recent proposals by politicians such as Senator Elizabeth Warren for a wealth tax have revived the debate over its possible constitutionality, or lack thereof.[26] If a wealth tax is a direct tax, a

[23] Id. at 546.

[24] See also *Scholey v. Rew* , 90 U.S. 331 (1874) (holding that a succession tax on real property was not a direct tax because it was not a tax on land; *Springer v. United States*, 102 U.S. 586 (1880) (holding that a Civil War income tax was not a direct tax because it was not a tax on real property or capitations); Pacific Insurance Company v. Soule, 74 U.S. 433 (1868) (holding that a tax on insurance companies based on gross amounts of premiums received, assessments and dividends, undistributed sums, and income was not a direct tax, but a duty or excise). For a review of Supreme Court cases on the topic, see Alan O. Dixler, *Direct Taxes Under the Constitution: A Review of the Precedents* (2006), Report delivered to the Committee on Legal History of the Bar Association of the City of New York, available at http://www.taxhistory.org/thp/readings.nsf/ArtWeb/2B34C7FBDA41D9DA8525730800067017?OpenDocument Even after the *Pollock* decisions the Court continued to rule based on a narrow understanding of the term direct tax. See [*Nicol v. Ames*, 173 U.S. 509 (1899) (holding that a tax on commodities transactions was not a direct tax); *Knowlton v. Moore*, 178 U.S. 41 (1900) (holding that a legacies tax was not a direct tax); *Patton v. Brady*, 184 U.S. 608 (1902) (ruling that a tax on manufactured tobacco was not a direct tax); *Thomas v. United States*, 192 U.S. 363 (1904) (tax on sales of corporate shares not a direct tax); and Spreckels Sugar Refining Co. v. McClain, 192 U.S. 397 (1904) (upholding a gross receipts tax on oil and sugar refiners).]
http://www.taxhistory.org/thp/readings.nsf/ArtWeb/2B34C7FBDA41D9DA8525730800067017?OpenDocument
See also Ackerman n. 184, citing *Bromley v. McCaughn, 280 U.S. 124, 136 (1929)*.

[25] National Federation of Independent Business et al. v. Sebelius et al., 567 U.S. 519 (2012).

[26] See Warren Campaign, Ultra-millionaire Tax (Jan. 2019) https://elizabethwarren.com/plans/ultra-millionaire-tax ; S. 4490 -- Make Billionaires Pay Act (Aug. 6, 2020) https://www.taxnotes.com/federal-research-library/proposed-legislation/s-4490-make-billionaires-pay-act/2ct8x ; H.R. 8020; Make Billionaires Pay Act (2020) https://www.taxnotes.com/tax-notes-today-federal/accumulated-earnings/omar-bill-would-tax-billionaires-profits-during-pandemic/2020/08/10/2cthj?highlight=%22wealth%20tax%22; Emmanuel Saez and Gabriel Zucman, *Progressive Wealth Taxation* (Final Draft: October 13, 2019) https://gabriel-zucman.eu/files/SaezZucman2019BPEA.pdf . For surveys of proposals for taxing wealth, see Batchelder, Lily L. and

state with fewer wealthier individuals would have to pay the same amount of the tax, proportionate to its population, than a state (consider: California, New York, New Jersey, Florida) with high numbers of wealthy individuals.

The debate over the constitutionality of the wealth tax is not new. Ackerman's 1998 article argued for its validity based in part by discounting the "tainted origins" of the direct tax clauses as a criteria for measuring the validity of taxes in the modern day.[27] Ackerman argued that the proportionality requirement for direct taxes in the constitution, far from representing an" independent judgment about the proper system for direct taxation," was no more than a reflection of the compromises needed at the founding over slavery, in which "the South would get three-fifths of its slaves counted for purposes of representation in the House and the Electoral College, if it was willing to pay an extra three-fifths of taxes that could be reasonably linked to overall population." His thesis was based on the premise that the direct tax apportionment clause was grounded not in economic theory but "political expediency" and so could not and should not be used to invalidate a wealth tax.[28] He also claimed that "nobody who bothered to read the text in 1787 could suppose that "the only tax clearly excluded from the term 'direct tax' was an external tax or customs duties called the 'impost,'"[29] and that the narrow meaning of direct tax was "consistent with 100 years of Supreme Court history that declined to broaden the term direct tax to encompass a wider array of taxes on property."[30]

More recently, Glogower, Gamage and Richards have argued that why constitutional history and Supreme Court precedents instead support a measured interpretation of the apportionment rule. This measured interpretation preserves apportionment's role in the constitutional structure—and does not read the provision out of the Constitution—but also does not improperly inflate the rule into a fundamental limitation to Congress's taxing power. Under this interpretation, the

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Kamin, David, Taxing the Rich: Issues and Options (September 11, 2019); https://ssrn.com/abstract=3452274 or http://dx.doi.org/10.2139/ssrn.3452274; Jane Gravelle, *haring the Wealth: How to Tax the Rich* (upcoming NTJ). [See Ari Glogower, A Constitutional Wealth Tax, 118 Mich. L. Rev. 717 (2020); https://repository.law.umich.edu/mlr/vol118/iss5/2 ; John R. Brooks and David Gamage, Why a Wealth Tax is Definitely Constitutional (2020) https://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=3245&context=facpub ; James Wetzler, A Guide to the Wealth Tax Debate (Dec. 23, 2019) https://www.taxnotes.com/tax-notes-today-federal/tax-policy/guide-wealth-tax-debate/2020/01/15/2bns6?highlight=pollock%20farmers%20loan#2bns6-0000004 ; Jasper L. Cummings, Jr., Wealth Tax Constitutionality (Feb. 10, 2020 https://www.taxnotes.com/tax-notes-today-federal/property-taxation/wealth-tax-constitutionality/2020/02/26/2c43q?highlight=pollock%20farmers%20loan]

[27] Ackerman, at [xx]

[28] Ackerman at 4. Ackerman argued that "calling the appeal to "direct" taxation was merely a piece of statesmanly rhetoric aimed at avoiding the disastrous dissolution of the Founding dream of a "more perfect Union," and ascribed the inclusion of the second direct tax clause in the Constitution to the undertakings of George Read of Delaware, who he argues was motivated by a desire to "make it impossible for Congress to force Delaware to pay off its old requisitions without regard to its share of the total population." Ackerman at 13.

[29] Ackerman at [xx].

[30] For a contrasting view, see Calvin H. Johnson, *Apportionment of Direct Taxes: The Foul-Up in the Center of the Constitution*, 7 Wm. & Mary Bill Rts. J. 1 (1999). See also Erik M. Jensen, *The Apportionment of "Direct Taxes": Are Consumption Taxes Constitutional*?, 97 Colum. L. Rev. 2334 (1997).

Constitution allows Congress to enact an unapportioned wealth tax but would still require apportionment for some other forms of taxes.[31]

This paper is not an attempt to relitigate (or pre-litigate) the constitutionality of a hypothetical wealth tax by weighing in on whether it should or should not properly be considered to fall within the meaning of the term direct tax. Rather, it is simply to point out how the term has a meaning rooted in a specific period of time and within economic theory from three centuries ago, and how confusion over the meaning of the term from another era has become so enshrined as to constrain 21st century fiscal policy. No one would attempt to design fiscal policy today based primarily on Adam Smith's understanding of economics and yet the inclusion of such terminology in the constitution continues to drive decisions over U.S. 21st century tax policy.

II Direct v. Indirect Taxes: Trade Implications

While constitutional scholars argue over whether the meaning of the term direct tax encompasses anything other than a tax on real property and people, multilateral trade agreements to which the United States is a party have adopted another meaning of direct taxes and its opposite, indirect taxes. The Joint Committee on Taxation's explanation of direct taxes is consistent with the usage of the term in trade agreements, as a tax like capitation taxes, property taxes, or taxes on income from property that a taxpayer is unable to shift to another person; this is in contrast to indirect taxes, described as taxes on consumption or production of goods or services: sales or use taxes, value-added taxes, or customs duties, the cost of which a taxpayer can shift to others.[32] But the Joint Committee's distinction, while consistent with that found in WTO agreements, turns out to be as confusing and arbitrary as the constitutional one.

In some respects, the lack of economic coherence to the distinction between direct and indirect taxes in trade agreements is even more relevant today than the constitutional distinction, because trade agreements bless – or penalize -- border adjusted taxes, or taxes that countries adjust (by giving a credit or other allowance for) for imports or exports[33] by permitting indirect taxes to distinguish between domestic and overseas sales, but prohibiting export incentives imposed by way of an income tax. In other words, multilateral agreements distinguish between direct and indirect taxes in their characterization of border adjusted taxes as impermissible export subsidies (in the case of border adjusted direct taxes) or not (for indirect taxes). The division provides the background for decades-long litigation over U.S. export subsidies and is also of contemporary importance given U.S. (bipartisan) concerns over bias at the World Trade Organization appellate body resulting in unfair treatment of U.S. companies.[34] And if the lack of economic grounding in the constitutional distinction is made clear upon delving into the importance race and slavery

[31] Glogower, Ari D. and Gamage, David and Richards, Kitty, *Why A Federal Wealth Tax Is Constitutional* (2021). Roosevelt Institute Issue Brief (2021), Ohio State Legal Studies Research Paper No. 623, Available at SSRN: https://ssrn.com/abstract=3784560.
[32] JCX-45-17 (September 28, 2017)
[33] [cite]
[34] [cite]

played in its importance, recent data-driven economics research shows that the distinction also loses meaning in the trade context.

A. Trade Agreements: Direct and Indirect

1. GATT, GATS and the ASCM

The WTO includes a series of agreements in which countries (members) agree to abide by specific rules applicable to cross-border trade, including rules restricting countries from imposing restraints on others' imports and rules prohibiting export subsidies.[35] Although both types of restrictions are imposed in the name of advancing free trade, they are neither parallel nor symmetrical,[36] and either or both sets of rules may apply to taxes impacting cross-border trade. WTO agreements describe three types of taxes: direct taxes, indirect taxes, and taxes occultes (hidden taxes).

The General Agreement on Tariffs and Trade (GATT), signed in the aftermath of World War II with the goal of preventing another breakdown of the global trading system and ultimately another world war,[37] generally restricts member countries from discriminating against residents of other countries in cross-border trade of goods.[38] Through the most favored nation (MFN) provision and the national treatment clause, it attempts to provide parity to residents of different countries engaging in cross-border trade.[39] On the import side, the rules are based on the principle of national treatment. In this context, GATT Art. III states that "internal taxes and other internal charges ... should not be applied to imported or domestic products so as to afford protection to domestic production." As a general principle, this means that any taxes (other than customs duties) imposed on imports may not be greater than the taxes imposed on the same domestically produced good (or services).[40]

Approximately 50 years after GATT's initial signing, it was extended via the General Agreement on Trade in Services (GATS)[41] to cross-border trade in services. GATS Art. XVII provides for a similar (albeit more limited) rule to GATT's anti-discrimination rules for trade in goods, requiring non-discrimination for trade in services.[42] GATS Art. XIV provides for exceptions to

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[35] [cite]

[36] See generally Itai Grinberg, *A Destination-Based Cash Flow Tax Can Be Structured to Comply with World Trade Organization Rules*, 70 Nat'l Tax J. 803-818 (2017) https://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=3031&context=facpub

[37] [cite]

[38] [cite]

[39] Herzfeld, *Tax Implications of the Trans-Pacific Partnership*, [cite]. See Leslie B. Samuels, "Treatment of Tax Measures Under International Trade and Investment Agreements: The GATS Compromise," in proceedings of the 102nd annual meeting of the American Society of International Law (2008).

[40] See generally Itai Grinberg, *A Destination-Based Cash Flow Tax Can Be Structured to Comply with World Trade Organization Rules*, 70 Nat'l Tax J. 803-818 (2017) https://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=3031&context=facpub

[41] GATS entered into force in 1995. https://www.wto.org/english/tratop_e/serv_e/gatsqa_e.htm

[42] See https://www.wto.org/english/tratop_e/serv_e/gatsqa_e.htm. See generally Nicolas Diebold, Non-Discrimination in International Trade in Services (2010).

the principles of most favored nation treatment and national treatment, with paragraphs (d) and (e) generally providing that the agreement cannot be construed in such a way as to prevent countries from adopting or enforcing direct tax measures.[43] This general exception to the MFN requirement contains its own caveats: tax measures cannot be applied in an arbitrary or unjustifiably discriminatory way between countries where like conditions prevail, or as a disguised way to restrict trade in services. There's also a general carve-out for tax treaties: tax measures may be inconsistent with the requirements of MFN treatment if the differences in treatment are derived from a tax treaty.[44] In general, tax measures aren't considered inconsistent with the requirements of national treatment if the differences in treatment are designed in a way to ensure the "equitable or effective imposition or collection" of direct taxes. Art. XIV(d), footnote 6, describes when measures will be considered to meet this criteria, such as when they apply to consumers of services supplied from another country to ensure the imposition or collection of taxes on those consumers. The footnote also says that in interpreting Art. XIV(d), tax terms or concepts are determined under the domestic law of the country taking the measure.[45] Most direct tax measures that don't apply against specific countries on a discriminatory basis would satisfy this exception and therefore are exempt from GATS' free-trade requirements.[46]

Later WTO agreements provide further guidance relevant to the interaction between countries' domestic tax rules and cross-border trade. The WTO Agreement on Subsidies and Countervailing Measures ("ASCM"),[47] effective in 1995, defined the term "subsidy;" it also defined and strengthened the procedures that countries need to follow to demonstrate serious prejudice in a foreign market. The ASCM expressly provides that the "Illustrative List" of prohibited export subsidies only prohibits a tax measure to the extent that it constitutes a subsidy as defined by Article 1 of the ASCM. Article III provides that for a tax measure to be prohibited, it must first constitute a subsidy under Article I of the ASCM.[48]

Annex I, paragraph (e) of the ASCM includes within the list of prohibited export subsidies "the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes." By contrast, under paragraph (g), the "exemption or remission, in respect of the production and distribution of exported products, of indirect taxes" does not constitute a prohibited export

[43] Herzfeld, Tax Implications of the Trans-Pacific Partnership, 82 Tax Notes Int'l 7 (Apr. 4, 2016).
[44] Herzfeld, Tax Implications of the Trans-Pacific Partnership, 82 Tax Notes Int'l 7 (Apr. 4, 2016)..
[45] Herzfeld, Tax Implications of the Trans-Pacific Partnership, 82 Tax Notes Int'l 7 (Apr. 4, 2016)..
[46] [(See Secretariat Note to GATS MTN.GNS/W210 (December 1, 1993), available at https://www.wto.org/gatt_docs/English/sulpdf/92140133.pdf.)]
[47] The Agreement on Subsidies and Countervailing Measures ("SCM Agreement") addresses two separate but closely related topics: multilateral disciplines regulating the provision of subsidies, and the use of countervailing measures to offset injury caused by subsidized imports. https://www.wto.org/english/tratop_e/scm_e/subs_e.htm#:~:text=Agreement%20on%20Subsidies%20and%20Countervailing%20Measures%20(%E2%80%9CSCM%20Agreement%E2%80%9D)&text=Multilateral%20disciplines%20are%20the%20rules,the%20WTO%20dispute%20settlement%20mechanism.
[48] Grinberg, DBCFT

subsidy, unless the exemption or remission exceeds the indirect taxes imposed on the production or distribution of similar products sold for domestic consumption.[49]

Footnote 58 defines direct taxes as "taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property." (note here that the WTO definition of direct tax is significantly broader than the narrower understanding of the term as used in the U.S. Constitution). The same footnote defines indirect taxes to mean sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges.[50] Footnote 59 indicates that a deferral of tax "need not amount to" an export subsidy where, for example, appropriate interest charges are collected, and also states that paragraph (e) is not intended to limit a member country from taking measures to avoid double tax on foreign-source income earned by its enterprises or another member's enterprises, thereby providing a stamp of approval to the foreign tax credit and tax systems that exempt foreign earnings from taxation. The same footnote also confirms that transfer pricing is a valid (not trade restrictive) exercise of a state's regulatory authority, noting that countries agreed that the prices used for tax purposes for cross-border transactions in goods among related parties should be equal the prices that would be charged between independent enterprises acting at arm's length. The agreement also makes clear that when remedies provided by trade agreements and tax agreements are in tension, tax remedies come first: the ASCM provides that in the case of a dispute over whether a tax measure constitutes a subsidy, the countries involved must first try to resolve any differences through bilateral tax treaties or other specific international mechanisms; only after those attempts have failed will dispute resolution mechanisms of trade agreements apply.[51]

In brief, a tax may only be border adjustable if it is an "indirect" tax. A border adjustable "direct" tax is a prohibited export subsidy; a member country that enacts one can be subject to trade sanctions. Whether a tax is an indirect tax or a direct tax therefore can have significant repercussions for a country.

2. Direct v. Indirect: The Rationale

As described above, under WTO phrasing, direct taxes include taxes on income (derived from personal property) or assets (but only if the asset is real property), while indirect taxes are taxes on consumption, but can also include taxes on personal property, such as inventory and equipment. Another way to think about how the WTO distinguishes between direct and indirect taxes is that while it considers direct taxes to be taxes on businesses that produce goods (which

[49] CRS Reports & Analysis Legal Sidebar Border-Adjusted Taxes and the Rules of the World Trade Organization: The Distinction Between Direct and Indirect Taxes (Part II) 03/22/2017 https://fas.org/sgp/crs/misc/bat-wto.pdf

[50] https://www.researchgate.net/profile/Tristan_Brown/publication/47528820_Rebates_Subsidies_and_Carbon_Regulation_The_ASCM_and_Climate_Policy/links/0046352c1896735600000000/Rebates-Subsidies-and-Carbon-Regulation-The-ASCM-and-Climate-Policy.pdf

[51] https://www.taxnotes.com/tax-notes-today-federal/value-added-tax/should-united-states-prefer-cash-flow-tax-vat/2017/06/12/186sz?highlight=wto%20%22direct%20tax%22%20%22indirect%20tax%22%20subsidy

businesses are also primarily responsible for paying those taxes), indirect taxes are taxes (somewhat counterintuitively) imposed directly on the consumer of the goods, or only indirectly on the producer. While both these types of taxes indirectly affect the ultimate price of a product, in the case of the "direct tax," it is more difficult to calculate the impact of the tax on the ultimate price of the good to the consumer.[52]

The rationale for allowing discrimination at the border for indirect but not direct taxes is based on the destination principle, which generally is based on the assumption that taxes on goods is imposed where consumed, rather than where produced. While indirect taxes -- levied upon on good's consumption -- can only ever be paid in the country of consumption, direct taxes –tied to a good's producer -- can only be paid in the country of production. The destination principle, by allowing a rebate for indirect taxes paid on exported goods (i.e., in cases where the country of consumption is not the same one as the country of production) helps prevent international trade from being subject to double taxation. In cases where a product is produced in a country with a VAT and exported to a country with no VAT (perhaps just a sales tax), the border rebate helps eliminate double taxation. That's because the VAT is attached to the product throughout the production process, regardless of where its sold (domestically or overseas). Without the rebate on export, the product would be double taxed: the VAT would apply on export and the sales tax on consumption in the country of consumption. Without the border adjustment on export, imported products would be disadvantaged relative to domestic products for the country with a VAT.[53] So the theory goes.

The WTO distinction and the classification within the global trading system of a rebate on VAT paid at the border as a measure that does not constitute a violation of trade agreements thus prevents double taxation. But note that this system only truly holds up if one assumes that the importing country imposes an indirect tax of its own at consumption. If the importing country doesn't impose such a consumption tax, the logic for allowing the rebate begins to collapse. And the supposed rationale for the distinction – that direct taxes are more difficult to calculate on a product-by-product basis – also may not be really valid.[54] Nonetheless, the end result stands today as a crucial aspect of the global trading regime: export subsidies in a country with a direct tax system but no VAT (like the United States) are prohibited, while border adjusted VATs (utilized by most other countries) are expressly permitted.[55]

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52 https://www.researchgate.net/profile/Tristan_Brown/publication/47528820_Rebates_Subsidies_and_Carbon_Regulation_The_ASCM_and_Climate_Policy/links/0046352c1896735600000000/Rebates-Subsidies-and-Carbon-Regulation-The-ASCM-and-Climate-Policy.pdf

53 https://www.researchgate.net/profile/Tristan_Brown/publication/47528820_Rebates_Subsidies_and_Carbon_Regulation_The_ASCM_and_Climate_Policy/links/0046352c1896735600000000/Rebates-Subsidies-and-Carbon-Regulation-The-ASCM-and-Climate-Policy.pdf

54 [Judith Stein, Pivotal Decade: How the United States Traded Factories for Finance in the Seventies (2011)]

55 https://www.researchgate.net/profile/Tristan_Brown/publication/47528820_Rebates_Subsidies_and_Carbon_Regula

The flip side of the rationale used to justify the validity of border adjusted VATs is the proposition that sales taxes, excise taxes and VATs don't introduce a distortion in the domestic market, where products are taxed the same regardless of whether produced in the country of consumption or overseas.[56] Here too, the theory starts to unravel when examined in a real world context. Recent economic work suggests that where the VAT is not fully enforceable (which is the case in most of the world but becomes more relevant the poorer the country), the distinction may not make much sense.

B. Consequences of Binary Distinction

1. The U.S. Export Subsidy History

A decades' long history of cross-Atlantic trade disputes chronicles the consequences of the differential treatment of direct and indirect taxes for export subsidies, with the United States struggling to develop a response to what it has viewed as the border adjustment preferences offered by the VAT regime for exports, not available for tax regimes that rely primarily on income taxes instead of the VAT. Although arguably the inclusion of the language in the agreement should have made this principle clear to the United States when it signed the agreement, there's history that suggests that a handshake agreement at the time of signing indicated to the United States that this differential treatment of the two types of taxes wouldn't be litigated by other countries.[57]

In any case, it didn't take too long from the time the domestic international sales corporation (DISC) regime was enacted in 1971 for it to be challenged as a prohibited export subsidy.[58] The challenges were sustained by a GATT panel in 1976, and a subsequent 1981 GATT ruling made specific findings sanctioning certain measures for the taxation of cross-border income, in conjunction with which the United States agreeing to repeal the DISC.[59] In 1984 the United States replaced the DISC regime with the foreign sales corporation (FSC) regime, which it argued was GATT-compliant and the [GATT 1981 Understanding]. Fourteen years later, subsequent to EU countries losing a series of cases at the WTO, the EU brought a case against

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tion_The_ASCM_and_Climate_Policy/links/0046352c1896735600000000/Rebates-Subsidies-and-Carbon-Regulation-The-ASCM-and-Climate-Policy.pdf

[56] Avi-Yonah, Reuven S. and Clausing, Kimberly A., *Problems with Destination-Based Corporate Taxes and the Ryan Blueprint* (February 5, 2017). U of Michigan Law & Econ Research Paper No. 16-029. At https://ssrn.com/abstract=2884903

[57] [cites] See Joint Committee on Taxation, "Background and History of the Trade Dispute Relating to the Prior-Law Foreign Sales Corporation Provisions and the Present-Law Exclusion for Extraterritorial Income and a Description of These Rules" (JCX-10-02)

[58] Some have characterized the DISC's enactment as a U.S. response to perceived disparities between U.S. and European exporters that resulted from tax system differences as European nations adopted territoriality. See Jeffrey F. Ryan, "An Analysis of the GATT-Compatibility of the New Foreign Sales Corporation," 26 *Santa Clara L. Rev.* 693 (1986)). See generally Herzfeld, *FDII and Export Subsidies: Trade Politics* 94 TAX NOTES INT'L 1043 (2019).

[59] See Gary Clyde Hufbauer, "A Critical Assessment and an Appeal for Fundamental Tax Reform," Peterson Institute for International Economics (Oct. 8, 1999) , available at http://www.iie.com/publications/papers/print.cfm?ResearchId=373&doc=pub .)

the FSC.[60] That regime was also ruled in violation of GATT, as was its next iteration, the Extra-Territorial Income regime, enacted in 2000.[61] Only in 2004, with the enactment of a general manufacturing deduction applicable to both domestically sold and exported goods (section 199),[62] did the United States appear to have been able to provide a subsidy for domestic manufacturing not in violation of its trade obligations.

But the result of this history was significant bitterness in the United States at the different legal treatment of the VAT border adjustment and export subsidies, reflected by President Donald Trump's campaign statements that [he was in favor of imposing a border adjusted tax] and consistent with U.S. Trade Representative Lighthizer's complaints about WTO bias.[63]

2. Impact on Recent and Future Proposals

In the summer of 2016, Republican leadership of the House of Representatives proposed a radical blueprint for reform of the corporate tax system. A lynchpin of this proposal was a destination-based cash flow tax -- a destination based tax not formally structured as a tax on consumption but with many of the economic indices of a tax on consumption -- which was in no small part a response to the formal distinction between direct and indirect taxes in the WTO agreements.[64] In introducing the proposal, the blueprint promised that "for the first time ever, the United States will be able to counter the border adjustments that our trading partners apply in their VATs."[65] The proposal immediately faced questions over whether, if enacted, it would be considered to violate U.S. trade obligations. A destination-based cash flow tax exempts profits generated from export sales from the tax base, so if a cash flow tax is a direct tax, it would violate paragraph (e) of the ASCM.[66]

In its contemporaneous analysis of the proposal, the Congressional Research Service described how the ASCM provisions and the distinction it makes between direct and indirect taxes could have implications for a border adjusted tax's compliance with WTO rules. The CRS suggested that while the ASCM is consistent with a border adjusted tax that exempts or remits an indirect tax (such as a VAT) in connection with the production or distribution of exported products so long as such exemption or remission does not exceed the VAT that is levied on domestically purchased goods, a border adjusted tax that exempts or remits a direct tax, like a corporate income tax, that would otherwise apply to exports regardless of the amount of exemption or remission, might violate the ASCM.[67] At the same time, the CRS said that it was unclear whether

[60] See statement of William A. Reinsch of the National Foreign Trade Council at House Ways and Means Committee hearing, June 13, 2002
[61] The FSC Repeal and Extraterritorial Income Exclusion Act of 2000, P.L. 106-519.
[62] The American Jobs Creation Act of 2004, P.L. 108-357.
[63] [cite]
[64] Herzfeld, *BEPS Alternatives: Evaluating Other Reform Proposals*, 83 TAX NOTES INT'L 253 (2016); Alan Auerbach et al., Destination-Based Cash Flow Taxation, WP 17/1 (Oxford Centre for Business Taxation 2017).
[65] A Better Way: Our Vision for a Confident America (Jun 24, 2016), available at 2016 TNT 122-22.
[66] https://www.taxnotes.com/tax-notes-today-federal/value-added-tax/should-united-states-prefer-cash-flow-tax-vat/2017/06/12/186sz?highlight=wto%20%22direct%20tax%22%20%22indirect%20tax%22%20subsidy
[67] CRS Reports & Analysis Legal Sidebar Border-Adjusted Taxes and the Rules of the World Trade Organization: The Distinction Between Direct and Indirect Taxes (Part II) 03/22/2017 https://fas.org/sgp/crs/misc/bat-wto.pdf

a WTO panel would consider a tax such as a destination based cash flow tax, which has characteristics of both an income tax and a consumption tax, as a direct or indirect tax.[68]

Alan Auerbach of UC Berkeley, one of the developers of the idea for a destination-based cash flow tax,[69] acknowledged in 2016 that compliance of the DBCFT with WTO rules was "an open question.[70] In addition to the fact that WTO rules limit border adjustments to "indirect" taxes, Auerbach admitted that the tax could violate WTO rules regarding the combination of border adjustments with a deduction for domestic labor costs. That's because of the different treatment for labor costs in the case of domestically produced goods as compared to imported goods –a border adjustment assessed on imported goods applies to the entire cost of the good, with no deduction allowed for the labor costs that went into their production of these imported goods, whereas a cash flow tax as imposed on domestically produced goods clearly permits a deduction for labor costs. But Auerbach argued that it made little sense, from an economic perspective, to characterize this difference as providing an improper benefit for domestically produced goods over imported ones because one could compare the DBCFT with an "equivalent policy of introducing a VAT and reducing payroll taxes, both elements of which are compatible with WTO rules." Any reduction in payroll taxes, which would encourage domestic production and employment by reducing domestic production costs, could in theory be characterized as a domestic subsidy, and yet the WTO rules don't prohibit such types of domestic incentives.[71] In sum, Auerbach argued that the DBCFT was "economically equivalent" to a VAT plus a reduction in payroll taxes, and that the distinction between direct and indirect taxes therefore should be understood to have "little meaning and no bearing on any economic outcomes."[72]

[Also in support of the DBCFT, University of Chicago professor David Weisbach similarly argued that, when it comes to taxing wages, cash flow taxes have more affinities to indirect taxes than do VATs, claiming that defining VAT as an indirect tax and a cash flow tax as a direct tax seems like an incoherent distinction.][73]

The DBCFT was not the first proposal for a major U.S. reform that included a border adjustment cash flow tax. The 2005 President's Advisory Panel on Federal Tax Reform also advanced the idea of a destination-based cash flow tax but the idea received even less attention than it did in

[68] https://fas.org/sgp/crs/misc/bat-wto.pdf
[69] [cite]
[70] Alan Auerbach and Doug Holtz-Eakin, https://www.americanactionforum.org/wp-content/uploads/2016/11/The-Role-of-Border-Adjustments-in-International-Taxation.pdf
[71] Alan Auerbach and Doug Holtz-Eakin, https://www.americanactionforum.org/wp-content/uploads/2016/11/The-Role-of-Border-Adjustments-in-International-Taxation.pdf
[72] Alan Auerbach and Doug Holtz-Eakin, https://www.americanactionforum.org/wp-content/uploads/2016/11/The-Role-of-Border-Adjustments-in-International-Taxation.pdf
[73] https://www.taxnotes.com/tax-notes-today-federal/value-added-tax/should-united-states-prefer-cash-flow-tax-vat/2017/06/12/186sz?highlight=wto%20%22direct%20tax%22%20%22indirect%20tax%22%20subsidy Roxan (below) argues that the DBCFT could alternatively be characterized as an additive VAT imposed only on the portion of value added accruing as profits, in which case a complementary tax on labor income (a payroll tax) would effectively complete it and remove the differential treatment of domestic and foreign labor. See Roxan at [xx].

2016.[74] Like the DBCFT, the 2005 version (known as the Growth and Investment Tax, or GIT) raised concerns about WTO violations, particularly with respect to its treatment of imports under the national treatment standard.[75] This was because the GIT provided different allowances for deductions in the case of imported as compared to domestically-produced goods.[76] The GIT also implicated the possibility that it could create a WTO violation because it allowed domestic businesses full deductibility of labor costs, while imports would have been subject to tax without allowance of a deduction for labor costs, with the final result that less tax would have been collected from goods that were domestically produced than from imported goods.[77]

C. The Economics

The rationale for different treatment of direct taxes (income taxes) and indirect taxes (consumption taxes) in the WTO agreements may have made sense when these agreements were entered into, and perhaps have continued support from a pure economic theory perspective. But data driven economic analysis suggests that the distinction – insofar as its valid on theoretical grounds – weakens further if one takes into account the realities of how VAT applies in the real world, with its various exemptions and enforcement challenges.

Ian Roxan of the London School of Economics has argued that while standard economic theory implies that – assuming that all consumer goods and services are taxable at a single rate on a destination basis -- the VAT is shifted to the consumer (in which case it would properly be considered a consumption tax),[78] this theory becomes more questionable in cases where some goods (such as food and utilities) are subject to reduced rates of VAT (a ubiquitous feature in most jurisdictions that apply a VAT). Exemptions gives rise to differences in VAT rates as applied to different types of goods, which creates what's referred to as the VAT policy gap.[79] The gap arises because all imports -- including intermediate inputs -- are subject to VAT, and domestic VAT-compliant businesses are eligible for credits for VAT paid on imported intermediates, but businesses that are not so compliant are not eligible for input tax credits. This means that VAT paid on imported intermediates is in effect a final tax.[80]

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[74] That version (known as the GIT) would have allowed exporters to deduct the value of both inputs and labor associated with export sales, without taking the sales into account in calculating taxable cash flow. As a result, it appears that the effective remission of tax would exceed the amount levied on the same good or service when sold for domestic consumption, because importers could not deduct the type of labor expense that was deductible by exporters. Separately, to the extent that the deduction of inputs and labor associated with export sales (or the tradability or refundability of net operating losses) was considered a subsidy, foreign countries could argue that the GIT's border adjustment was impermissible because the deduction for labor would qualify the GIT as a "direct" tax. Grinberg, DBCFT

[75] Grinberg, DBCFT

[76] If you characterized the deduction disallowance instead as a charge imposed at the border, it could be treated as a tariff on imports in violation of the tariff schedule of GATT Article II. Grinberg, DBCFT

[77] Grinberg, DBCFT

[78] Citing to Ebrill et al., 2001

[79] https://ec.europa.eu/commission/presscorner/detail/en/QANDA_19_5513

[80] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3434836.

As Roxan explains, the many variabilities in how the VAT is applied in practice means that it can't be viewed solely as a consumption tax, nor as a tax on value added.[81] Instead, it incorporates elements of both: its a tax on consumption because under the credit system – in which a business receives a credit for VAT paid to its suppliers and its taxable business customers receive a credit for VAT charged to them -- the VAT doesn't impose a cost on a taxable business. But this theoretically pure consumption tax is distorted by exemptions, which by breaking the credit chain distort competition. When exemptions are granted for public interest goods (for example, health and education), the risks of distortion are minimized because the exemption applies only at the final step. But when the exemption is provided at an earlier point in the chain, the distortions are magnified. Transactions in financial services and land provide but one example of how exemptions distort the system. Financial services are generally exempt from the VAT, in part because no one has been able to figure out a good way to apply the tax to such transactions.[82] When financial services enter the chain, therefore, a VAT becomes more like a tax on value added than a tax on consumption.[83]

An understanding of how various exemptions throughout the chain of production play out in the incidence of the VAT illustrates how VAT exemptions -- introduced in different ways in different jurisdictions – represent more than just slight glitches in the system. Instead, they introduce significant distortions.[84] Once there is an exempt transaction in the chain of production (for example, in a transaction involving financing part of the production), the VAT can no longer be considered a pure consumption tax.[85] The loss of companies' ability to deduct VAT on inputs from tax-exempt firms results in cascading,[86] as the non-deductible input VAT becomes a net cost for the exempt business that's added to the consumer price. Because businesses that purchase exempt outputs are paying VAT but are unable to deduct it (because they are not actually paying it as a VAT payment), the cost is added to the base on which VAT is charged to

[81] Roxan, Ian, Is VAT Also a Corporate Tax? Untangling Tax Burdens and Benefits for Companies (March 16, 2020). LSE Legal Studies Working Paper 2/2020, Available at SSRN: https://ssrn.com/abstract=3555142 or http://dx.doi.org/10.2139/ssrn.3555142

[82] Roxan, Ian, Is VAT Also a Corporate Tax? Untangling Tax Burdens and Benefits for Companies (March 16, 2020). LSE Legal Studies Working Paper 2/2020, Available at SSRN: https://ssrn.com/abstract=3555142 or http://dx.doi.org/10.2139/ssrn.3555142

[83] If profit equals sales minus costs of production and wages, another way to think of value added is amounts distributable to shareholders as dividends plus amounts paid to employees as wages. Conversely, amounts available for consumption must be derived from either earnings or profits. Roxan, Ian, Is VAT Also a Corporate Tax? Untangling Tax Burdens and Benefits for Companies (March 16, 2020). LSE Legal Studies Working Paper 2/2020, Available at SSRN: https://ssrn.com/abstract=3555142 or http://dx.doi.org/10.2139/ssrn.3555142

[84] Roxan, Ian, Is VAT Also a Corporate Tax? Untangling Tax Burdens and Benefits for Companies (March 16, 2020). LSE Legal Studies Working Paper 2/2020, Available at SSRN: https://ssrn.com/abstract=3555142 or http://dx.doi.org/10.2139/ssrn.3555142

[85] Roxan, Ian, Is VAT Also a Corporate Tax? Untangling Tax Burdens and Benefits for Companies (March 16, 2020). LSE Legal Studies Working Paper 2/2020, Available at SSRN: https://ssrn.com/abstract=3555142

[86] Roxan, Ian, Is VAT Also a Corporate Tax? Untangling Tax Burdens and Benefits for Companies (March 16, 2020). LSE Legal Studies Working Paper 2/2020, Available at SSRN: https://ssrn.com/abstract=3555142 or http://dx.doi.org/10.2139/ssrn.3555142

the consumer, and ultimately, the consumer bears the additional cost.[87] Exempt financial services generally include transactions in shares, which means that input VAT associated with holding intercompany shares could be non-deductible. In this way, VAT becomes an extra cost for corporate group structures, with impacts not just on unique lifecycle events such as acquisitions and restructurings but ongoing events such as dividends as well.[88]

In short, the distortions introduced by VAT exemptions suggest that the case for the sharp distinctions made between the corporate income tax and the VAT in terms of the rationale for border adjustments may be less principled than usually portrayed. The first rationale often given -- that the VAT differs from the corporate tax is that it is levied solely on a consumption basis and so allows full immediate expensing for capital investment – becomes less meaningful given that most corporate income tax systems currently allow for accelerated or full expensing.[89] The second distinction -- that the corporate income tax, unlike the VAT, is imposed on a tax base that allows for a deduction for wages, may rest more on formalism than substance, if you consider that employees are also VAT taxpayers. Given the conflation of the tax bases, a corporate income tax plus a payroll tax at the same rate could be practically equivalent to a VAT.[90]

The nuances in how the VAT tax base can be better understood to approach the corporate income tax base when one takes into account the larger picture illustrates how the VAT as a tax on consumption can nonetheless operate as a tax on corporate income (which would be considered a direct tax in WTO parlance).[91] If a tax supposedly on consumption could alternatively be charactered as a tax on profits once consideration of the way in which its applied in practice – rather than theory – is incorporated into the analysis, a stronger case may be made that the difference in treatment of the two taxes in trade agreements may be unwarranted. As Roxan explains, the technical implications of the distortions that arise in the VAT due to exempt inputs, when combined with the tendency to impose the corporate income tax only on extra normal return on investments, suggests that the two types of taxes may have more equivalence than is generally understood.[92]

Another strain of economic literature highlights how theoretical treatment of the VAT as requiring a border adjustment to achieve parity between consumption of domestic and imported goods, and domestic production and imported inputs, also may have less principled rationale in the real world, when differences in VAT enforcement at the border and in purely domestic

[87] Roxan, Ian, Is VAT Also a Corporate Tax? Untangling Tax Burdens and Benefits for Companies (March 16, 2020). LSE Legal Studies Working Paper 2/2020, Available at SSRN: https://ssrn.com/abstract=3555142 or http://dx.doi.org/10.2139/ssrn.3555142
[88] Roxan, Ian, Is VAT Also a Corporate Tax? Untangling Tax Burdens and Benefits for Companies (March 16, 2020). LSE Legal Studies Working Paper 2/2020, Available at SSRN: https://ssrn.com/abstract=3555142 or http://dx.doi.org/10.2139/ssrn.3555142
[89] Roxan at [xx].
[90] Roxan at [xx]. The implications of this differential treatment is illustrated in a series of recent [European court] holdings on applicability of VAT to [financial services]. [discuss].
[91] Roxan, Ian, Is VAT Also a Corporate Tax? Untangling Tax Burdens and Benefits for Companies (March 16, 2020). LSE Legal Studies Working Paper 2/2020, Available at SSRN: https://ssrn.com/abstract=3555142
[92] Roxan at [xx].

contexts are taken into account.[93] Differences in compliance with VAT between imports and consumption of domestically produced goods have led some economists to argue that VAT is a less productive and efficient tax than the trade taxes it has replaced in many countries around the world.[94]

D. Binary Treatment and the Consequences for the Future of the WTO

In short, the economic distinction between direct and indirect taxes, which may once have held some validity in economic theory, is increasingly called into question by economics research that considers how consumption taxes apply in the real world. Yet the distinction between direct and indirect taxes is baked into global trade agreements and important policy consequences follow, ones that constrain countries' fiscal policy choices and create political fall-out from cross-border trade disputes.

The failure of the direct v. indirect distinction to fully hold up once the theoretical economic principles are applied in the real world is not a theoretical academic concern. It provides another rationale for the litany of U.S. complaints against these agreements. [expand]

IV Foreign Income Tax

It didn't take long from the date of the passage of the income tax and the ratification of the 16th Amendment for Congress to realize that it needed to address the possibility of double taxation, or U.S. taxpayers being subject to the income tax once in the United States and a second time in another country on the same income. To address this situation, Congress in 1918 enacted a foreign tax credit, which generally allows taxpayers a credit against their U.S. income tax liability for foreign income taxes paid. Current section 901, the successor to sections 222 and 238 of the Internal Revenue Code of 1918, provides that the credit is allowed only for a foreign tax that constitutes an income, war profits, or excess profits tax, language that has been virtually unchanged since [originally enacted]. While foreign income taxes paid may be eligible for a foreign tax credit, taxes that don't meet the legal definition of an income tax are not, unless they are treated as taxes "in-lieu of" income taxes under section 903.[95]

The binary treatment of foreign taxes as income or non-income taxes has led to an almost 100-year history of muddled case law, politically-based technical rules, and other countries' attempts to recast their taxes to provide maximum benefits for U.S. corporations looking to invest overseas. Proposed foreign tax credit regulations issued in September 2020 represent the latest installment in this story.[96]

A. The History: Statute, Administrative Guidance and Case-Law

There's [no legislative history] specifically on the question of why the credit under section 901 is limited to income taxes, war profits, and excess profits taxes. But it makes sense given the

[93] [cite]
[94] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3434836., M Shahe Emran and Joseph E Stiglitz, "On selective indirect tax reform in developing countries," Journal of Public Economics, 2005, 89 (4), 599–623.
[95] On the arbitrariness of the binary nature of the foreign tax credit, see generally Jordan Barry and Ariel Jurow Kleiman, *Rationalizing the Arbitrary Foreign Tax Credit* (2021).
[96] REG-101657-20, 86 FR 13250 (2020).

context in which the credit was enacted. In an article crediting economist T.S. Adams as the driving force behind adoption of the foreign tax credit, Michael Graetz and Michael O'Hear note the general lack of attention paid to international taxation in the enactment of the income tax; from 1913-1918, the United States only allowed taxpayers a deduction for foreign taxes paid.[97] Graetz and O'Hear explain Adams' rationale for lobbying for the rule as being motivated by the problem of double taxation becoming more acute in the immediate aftermath of World War I, and describe "international double taxation [as] becoming a far more serious burden on Americans doing business or investing abroad:" top marginal rates on U.S. individuals were close to 80 percent, and excess profits tax rates could be as high as 60 percent. In this environment, according to Graetz and O'Hear, "[r]elief became a matter of some urgency." Scholars also cite support for the credit as driven by its being viewed "as a method to encourage foreign trade and to prevent revenue loss through incorporation of foreign subsidiaries or expatriation."[98] Others highlight the emergence of the United States as a capital exporting country.[99]

In short, the predecessor of section 901 – which grants a credit specifically for 3 types of taxes – income, excess profits, and war profits taxes – is a creature of [war]time: enacted shortly after the enactment of the federal income tax to provide relief from double taxation and encourage U.S. investment overseas. There's no indication that policy makers or politicians put much, if any, thought into the question of the economic incidence of different types of taxes, or had a well-developed a rationale for why one or another type of foreign tax might be more or less likely to be justified as creditable. The lack of coherent analysis of when a tax is an income tax, or not, in the foreign tax credit regulations has led to a series of contradictory and unprincipled judicial decisions and multiple iterations of Treasury regulations.[100]

Not long after the enactment of the predecessor of section 901, questions began to be raised as to what precisely constitutes a foreign income tax. In *Keen v. Commissioner*,[101] the Board of Tax Appeals upheld the taxpayer's claim for a credit for a French tax based on the rental value of an apartment, stating that "[w]hatever may be the nature of the tax, it is imposed upon what the French Government determines to be income. It is in no sense of the word imposed upon the ownership of property. It is a part of a statute which imposes income taxes upon citizens and

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[97] See Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 Duke L.J. 1021 (1997) (suggesting that "[t]he reasoning behind the international tax aspects of the 1913 Act is difficult to discern from the historical sources," and that the "decision in 1913 to tax the worldwide income of taxpayers may have simply followed the earlier decision to tax worldwide income in the 1909 federal excise tax on corporate income.") at n. 85.

[98] Roswell Magill & William C. Schaab, *American Taxation of Income Earned Abroad*, 13 TAX L. REV. 115, 118 (1958) (cited in Graetz & O'Hear n. 106).

[99] *See* Anthony J. Waters, *Definitional Problems of the Foreign Income Tax Credit*, 1 Md. J. Int'l L. 196 (1976). http://digitalcommons.law.umaryland.edu/mjil/vol1/iss2/ Today, common rationales for the foreign tax credit include alleviating double taxation, promoting U.S. business competitiveness, advancing the goal of capital export neutrality, and encouraging the use of income taxes in foreign countries. See Barry and Kleiman at 35-50. But see Shaviro at [xx].

[100] [See Joseph Isenbergh, The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes, 39 TAX L. REV. 227, 229-61 (1984); Glenn Coven, "International Comity and the Foreign Tax Credit: Crediting Nonconforming Taxes" (1999) https://scholarship.law.wm.edu/facpubs/495]

[101] 15 BTA 1243 (1929).

residents of France." In *Burk Brothers v. Commissioner*,[102] the Board upheld the creditability of a tax imposed by the British government in India that was titled an income tax, the tax base of which was attributable to the value of goat skins purchased by the U.S. taxpayer in India and shipped to the United States, where they were manufactured into leather goods.

The Supreme Court then weighed in on the issue, holding in *Biddle v. Commissioner*[103] that a foreign tax would need to meet the U.S standard of an income tax in order to qualify as a creditable income tax. According to the *Biddle* court, whether a foreign tax qualifies as an income tax depends on whether the tax constitutes an income tax as determined from an examination of the U.S. income tax laws.[104] Throughout the 1940s and 1950s, the IRS generally agreed with this expansive interpretation of the statute.[105]

Partly in response to a series of decisions in which the Board of Tax Appeals and the IRS denied taxpayer claims for creditability under section 901,[106] Congress enacted section 903 in 1942. Even if the requirements of section 901 have not been met, a taxpayer may still be able to claim a credit for foreign taxes paid if such taxes qualify under section 903, which allows a credit for a "tax paid in lieu of a tax on income" if it is "otherwise generally imposed by any foreign country." The legislative history suggests that the in lieu of tax was enacted because in "the interpretation of the term "income tax," the Commissioner, the Board [of Tax Appeals] and the courts have consistently adhered to a concept of income tax rather closely related to our own, and if such foreign tax was not imposed upon a basis corresponding approximately to net income it was not recognized as a basis for such credit."[107] The IRS issued regulations under section 903 in 1957,[108] providing that a foreign tax is creditable under section 903 only if the jurisdiction imposing the tax had in force a general income tax law, and the taxpayer would otherwise be subject to such general income tax, and the general income tax was not imposed on the taxpayer subject to the substituted tax.[109] Over the next two decades, the IRS issued a series of memorandums and revenue rulings that severely limited the circumstances in which a foreign tax could qualify as a creditable tax under section 903.[110]

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[102] 20 BTA 657 (1930).
[103] 302 U.S. 573 (1938).
[104] *Biddle v. Comm'r*, 302 U.S. 573 (1938).
[105] See discussion at Barry and Kleiman at 11-13.
[106] *See, e.g., Havana Electric Railway, Light & Power Co. v. Commissioner*, 29 B.T.A. 1151 (1934), *rev'd on rehearing*, 34 B.T.A. 782 (1936) (initially denying a foreign tax credit for a Cuban municipal tax imposed on gas and electric light plants); I.T. 2620, 11-1 C.B. 44 (1932) ("[I]t must be shown that the tax imposed by the foreign law is a tax on income, according to the United States concept…").
[107] S. Rep. No. 1631, 77th Cong., 2d Sess. 131 (1942). Under section 903, a taxpayer can claim credit for a foreign tax paid even if it is imposed on a gross basis and doesn't allow for reduction of the tax base for expenses. Reg. § 1.903-1(a) states that it is immaterial whether the base of the foreign tax bears any relation to realized net income.
[108] 21 Fed. Reg. 4407 (June 22, 1956); T.D. 6275 (July 1957).
[109] In *Missouri Illinois R.R. Co. v. United States*, 381 F.2d 1001 (Ct. Cl. 1967), the Court of Claims held that a tax imposed by the Mexican government on the gross amount of rental payments received by the taxpayer was creditable under section 903, because the taxpayer's liability was in lieu of it being subject to the general Mexican corporate income tax.
[110] *See* Rev. Rul. 76-215 (ruling that a foreign tax paid by a U.S. taxpayer to Indonesia was not a creditable tax, when the tax was computed based on the taxpayer's oil well production, even though the tax based allowed the taxpayer to recoup initial costs); Rev. Rul. 78-61 (denying a section 903 credit for an Ontario Mining Tax); Rev. Rul. 78-62 (reversing a series of revenue rulings on certain Cuban taxes that "were imposed independently of any

Largely in response to the increased activity (and corresponding increase in attempts to claim a foreign tax credit) of U.S. oil and gas companies overseas, [111] the IRS issued proposed regulations under sections 901 and 903 in 1979 that set out its narrow interpretation of a creditable foreign income tax. These regulations were the subject of much controversy and were withdrawn and reproposed in 1980.[112] Under them, a foreign tax met the requirements of in lieu of tax only if it was enacted in accordance what the regulations deemed "reasonable rules of taxing jurisdiction" regarding source of income and residence.[113] Those regulations were reproposed in 1983[114] and as reproposed (rejecting that standard) were adopted as final regulations later that year.[115]

Under the current regulations, in order to be creditable, the predominant character of the foreign tax must be that of an income tax in the U.S. sense. In addition to the "predominant character" test, the section 901 regulations also provide that a foreign tax qualifies as an income tax only if it is likely to reach net gain in the normal circumstances to which it applies,[116] a test that is only met if the tax satisfies realization, gross income, and net income requirements.

B. Creditable Taxes Today

The 40 year old well-established regulations defining a creditable income tax for purposes of the foreign tax credit have been under increasing pressure as other jurisdictions enact novel types of new taxes, partly in response to concerns over cross-border base erosion and partly in response to complaints that existing laws fail to tax sufficiently the income from remote digital sales. Some of these new taxes attempt to thread the line between the tax treaty definition of an income tax and the U.S. foreign tax rules. [Discuss: Digital Services Taxes, Indian Equalization Levy, UK Diverted Profits Tax, Puerto Rican Excise Tax.] In September 2020, the U.S. Treasury acted to address this concern.

Proposed Treasury regulations released in September 2020[117] would revise Reg. § 1.901-2 to prescribe new guidelines for when a foreign tax is considered a creditable tax. The proposed rules essentially grant a credit only for foreign taxes imposed on a tax base closely mimicking the U.S. income tax base. Among the key changes is a new nexus requirement that "a foreign tax conform to traditional international norms of taxing jurisdiction as reflected in the Internal Revenue Code." The regulations also narrow the definition of the type of foreign tax that may qualify as a creditable tax by providing that to constitute an income tax for U.S. tax purposes,

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realized gain"); Rev. Rul. 78-234 (denying a credit under Section 901 for a tax on "gross amount of management or professional fees received by nonresidents" under Section 901 without addressing Section 903).

[111] Reg. § 1.901-2(a). See Commissioner v. American Metal Co., 221 F.2d 134 (2d Cir. 1955); F. W. Woolworth Co. v. Commissioner, 54 T.C. 123 (1970), nonacq. on another issue, 1971-2 C.B. 4; In Bank of America Nat'l T. & S. Ass'n v. United States, 459 F.2d 513, 515, 518 (Ct. Cl. 1972), cert. denied, 409 U.S. 949 (1972).

[112] 45 Fed. Reg. 75647. See, e.g., See *Restrictive IRS Interpretation of Foreign Earned Income Act Criticized*, 8 Tax Notes 675 (May 28, 1979).

[113] The 1980 proposed regulations received extensive comments from taxpayers, and the requirement that an in lieu of tax could only qualify as such if it followed reasonable rules of taxing jurisdiction was not included in the final regulations.

[114] 48 Fed. Reg. 14641

[115] T.D. 7918, 48 Fed. Reg. 46272. In its current form, Reg. § 1.903-1(b)(1) provides that a tax is creditable under section 903 only if it is a tax and it meets the substitution requirement.

[116] Reg. § 1.903-2(b).

[117] REG-101657-20.

that is, a tax on net gain, the base of a foreign tax should conform in essential respects to the determination of taxable income for Federal income tax purposes.

Treasury's rationale for issuing the new rules is that expansive new taxes adopted by other countries require a tightened definition of an income tax. The preamble to the proposed regulations describes how several countries have adopted or are considering various "novel extraterritorial taxes that diverge in significant respects from traditional norms of international taxing jurisdiction as reflected in the Internal Revenue Code." It justifies the new rules on the grounds that other countries' new taxes have made it is "necessary and appropriate to require that a foreign tax conform to traditional international norms of taxing jurisdiction as reflected in the Internal Revenue Code in order to qualify as an income tax in the U.S. sense, or as a tax in lieu of an income tax, in order to ensure that the foreign tax credit operates in accordance with its purpose to mitigate double taxation of income that is attributable to a taxpayer's activities or investment in a foreign country.

C. The Irrationality of Binary Treatment

In a [recent] article, Jordan Barry and Ariel Jurow Kleiman note that, "the blurring of tax bases, combined with the foreign tax credit's all-or nothing approach, has placed increased weight on the question of whether a foreign tax is an income tax."[118] As was the case for the somewhat arbitrary distinction between direct and indirect taxes, there's little economic rationale for this divergent treatment of income and non-income taxes for foreign tax credit purposes, and Barry and Kleiman suggest that a better way to determine when a foreign tax should be considered a creditable tax for foreign tax credit purposes is not by analyzing a tax either as a wholly-creditable "income tax" and a non-creditable non-income tax, but instead by separating the tax into component parts, or providing a graduated partial credit.[119] Its because there's no real economic rationale for treating a tax as either wholly an income tax or not that the foreign tax credit's "all-or-nothing design" is, they argue, economically arbitrary.[120] Because of this, there's no justification for crediting 100 percent of something that's been classified as a foreign income tax, but zero percent of other foreign taxes.[121]

Kleiman and Barry's alternative test, based on their argument that there's no policy justification for limiting the foreign tax credit to "pure" income taxes, would require splitting up the income and non-income tax parts of foreign taxes using an economic analysis, on the grounds that "the foreign tax credit should turn on economic substance, not form." Under the "leveling over" approach, taxes would be deconstructed and partially creditable based on the extent to which they might be considered an income tax; they also identify other approaches, such as a full credit for income taxes and a partial credit for other types of taxes, such as taxes on gross revenues or

[118] Barry and Kleiman at [xx].
[119] Barry and Kleiman at 59.
[120] Barry and Kleiman at 29.
[121] Barry and Kleiman at 52-56.

wealth taxes.[122] A more radical alternative to the irrationality of the foreign income tax credit than the ideas proposed by Barry and Kleiman is to do away with the system altogether.[123]

The challenges associated with deconstructing foreign taxes to determine creditability under existing law and proposed new rules highlight how the tax law's deviation from economic theory results in outcome and unprincipled law. While in the case of direct and indirect taxes, the law incorporated economic theories in existence at a moment in time, and has had difficulty adapting to changes in those theories, the foreign tax credit's implicit distinction between income and non-income taxes, illustrates how the absence of economic theory to ground the law also creates problems. The litigation over the meaning of the term "income tax" and the recently proposed regulations reflect the law's outcome driven approach in the area and the continued absence of economic theory to justify the distinction.

IV Income v. Non-Income Taxes: Accounting Treatment Differences

The income tax base starts from financial accounts, with specified deviations from there.[124] In theory, then, the accounting definition of a tax as an income or non-income tax might be relevant for the legal definition. Accounting standards require preparers of financial statements to separate out income taxes from other types of taxes, with significant implications that follow for financial statements. The accounting classification of taxes into income and non-income taxes is thus relevant from two sides: its analysis may be helpful for developing a legal distinction, and differences in the accounting and legal definitions of income taxes can present opportunities for tax planning or financial statement management. Moreover, there's an ongoing trend in international taxation in particular to place greater reliance on financial statement definitions of income and expenses in computing the tax base. This suggests that understanding the accounting standards' as relevant to the distinction between income and non-income taxes should be given greater weight in the law than often provided.

Unlike income taxes, which are reported as a separate line item in the income statement and receive a relatively detailed explanation and have to be reconciled in a footnote, indirect taxes are lumped together with general operating expenses to arrive at net earnings (or earnings before interest, tax, depreciation and amortization). Not only is there less transparency for investors as to indirect taxes paid, there's less transparency for governments as well. Indirect taxes are not subject to the disclosures required by FIN48 and the reconciliations required in schedule M of the form 1120. They are also not disclosed on the country-by-country reporting filings most countries have implemented pursuant to the OECD BEPS project.[125] Categorizing a tax as a direct or indirect tax therefore can have important financial statement impacts for companies and investors, with implications for tax authorities as well. And despite the economic questions that continue to swirl over the incidence of the corporate tax, for accounting purposes a tax is

[122] Barry and Kleiman at [x].
[123] Daniel N. Shaviro, *Rethinking Foreign Tax Creditability*, National Tax Journal, December 2010, 63 (4, Part 1), 709.

[124] See regulations under section 312.
[125] [cite]

generally (with some limited exceptions) treated in a binary fashion: either a direct tax, in which case its included in the income tax line item and provision, with all their ramifications including increased (albeit limited) disclosures, or an indirect tax, the accounting for which provides corporate managers with much more flexibility in reporting. Ultimately, the binary treatment of direct and indirect taxes for accounting purposes allows corporate managers more flexibility in managing earnings and less transparency to governments seeking information about corporate taxes paid.

To some extent, questions over the nature of the different types of taxes and how to classify them (as income taxes or not) the context of financial statement preparation parallel the challenges with the characterizing taxes for purposes of the U.S. income tax law, trade laws, and the Constitution.

A. Corporate Income Taxes in Financial Statements: The History

As the corporate income tax became more prevalent in the early decades of the 20th century,[126] accounting systems started to confront the question of how to appropriately reflect the corporate income tax as an expense in financial statements.[127] In the aftermath of the economic expansion that followed World War II, as the number of corporate shareholders grew, the pressure for improved transparency in income statements also increased.[128] Within the broader context of concerns over income measurement, debates over the proper accounting treatment of corporate income tax expense became more heated.[129] Accounting scholars have noted that few issues in the history of accounting standard setting have caused as much "commotion" as that of accounting for deferred income taxes.[130] To some extent, the accounting debate parallels the debates over the nature of the corporate income tax when first enacted: whether it should be considered a tax on the corporation itself, or a tax on shareholders that was paid at the corporate level.[131]

The question over whether the income tax should be considered a tax on the corporation or the shareholder was reflected in the accounting debate over whether income taxes paid by a business should be considered expenses of doing business or as part of the distribution of income to

[126] Although a corporate tax was passed in 1909, through World War II the primary source of revenues continued to be local property taxes; during World War II, the marginal corporate income tax rate increased from 19 to 38 percent. See Corporation Tax Law (1909). Sommerfeld and Easton, 1987, pp. 168- 170.
[127] See Roxanne Johnson, The History of Accounting for Income Taxes: The Major Issues and the Actions – an Overview, 12 the Accounting Historians Notebook (1989).
[128] Carey, 1970, pp. 58-59
[129] Sally M. Schultz and Roxanne T. Johnson Source: The Accounting Historians Journal , December 1998, Vol. 25, No. 2 (December 1998), pp. 81-111 Published by: The Academy of Accounting Historians Stable URL: https://www.jstor.org/stable/40697527 See [Bailey, 1948, pp. 10-14; Shield, 1957, p. 53]
[130] Bevis, Donald J.; Perry, Raymond E.; and American Institute of Certified Public Accountants. Accounting Principles Board, "Accounting for income taxes, an interpretation of APB opinion no. 11;" (1969). Guides, Handbooks and Manuals. 4. https://egrove.olemiss.edu/aicpa_guides/4
[131] Reuven Avi-Yonah, "Antitrust and the Corporate Tax, 1909–1928," SSRN (May 27, 2020); Avi-Yonah, "Corporations, Society and the State: A Defense of the Corporate Tax," 90(5) *Va. L. Rev.* 1193 (2004).

government entities.[132] The distinction mattered for the accounting treatment. If the corporate income tax was inherently tied to the distribution of profits, the amount of income taxes paid in each period might be best identified as a portion of financial income unavailable to the firm's owners.[133] If so, only the laws in effect in that period would be relevant, and the existence of temporary differences would not be relevant in preparing financial statements. But if income taxes are business expenses, accrual accounting would require that temporary differences be reflected in financial statements.[134] While the question was debated heavily throughout the 1940s, the accounting profession eventually agreed on the latter view.[135]

The Committee on Accounting Procedure ("CAP"), formed in 1936,[136] issued its first pronouncements in 1939. One of the first of these addressed a tax allocation issue related to refunds of bond issues, which became a hot topic at this time because of the decline in long-term interest rates. In computing taxable income, companies deducted the unamortized discount and redemption premium on bonds refunded, while for financial reporting (book) purposes, these amounts were often charged directly to retained earnings or amortized over the remaining life of the original issue.[137] In Accounting Research Bulletin (ARB) 2 (1939) and ARB 18 (1942), CAP recommended that bond discounts written off to retained earnings be reduced by the related tax savings, although the preferable treatment was to amortize the discount, reduced by the tax savings, over the original life of the bonds.[138] The treatment of the tax savings on the bond refund reflected the two different conceptions of the income tax – as an expense of earning income properly reflected in the corporate books, or as an expense on distributions to investors.

In ARB 23, issued in 1944, CAP concluded that income taxes were an expense, a view which became widely adopted.[139] It recommended an allocation to maintain a proportional relationship between tax expense and pretax financial reporting income for material and extraordinary differences between tax and financial statement income. Allocation between different periods was considered appropriate if an item was recognized in different periods on the tax return and

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[132] Bevis, Donald J.; Perry, Raymond E.; and American Institute of Certified Public Accountants. Accounting Principles Board, "Accounting for income taxes, an interpretation of APB opinion no. 11;" (1969). Guides, Handbooks and Manuals. 4. https://egrove.olemiss.edu/aicpa_guides/4 Viewing taxes as an expense was consistent with proprietary theory while considering them a distribution of earnings reflected entity theory. Nürnberg [1971, pp. 8-14] See Roxanne Johnson, The History of Accounting for Income Taxes: The Major Issues and the Actions – an Overview, 12 the Accounting Historians Notebook (1989)

[133] Bevis, Donald J.; Perry, Raymond E.; and American Institute of Certified Public Accountants. Accounting Principles Board, "Accounting for income taxes, an interpretation of APB opinion no. 11;" (1969). Guides, Handbooks and Manuals. 4. https://egrove.olemiss.edu/aicpa_guides/4

[134] Schultz & Johnson at 83

[135] Although there were apparently "many articles in the accounting literature arguing the merits of these two positions," (Bevis and Perry) these articles are not easy to track down. Carey [1944, p. 425], the managing editor of the Journal of Accountancy and a noted chronicler of accounting history, published a symposium [1944] on this issue.

[136] Davidson and Anderson, 1987, p. 116

[137] Schultz & Johnson at 82

[138] Schultz & Johnson at 82

[139] Shield, 1957, p. 53

financial statements.[140] ARB 23 raised questions about how to best reflect nonrecurring material and extraordinary timing differences in financial statements, i.e., in surplus accounts, deferred-charge accounts, or reserve accounts.[141] In 1953, the accounting organization AICPA issued ARB 43, a consolidated set of accounting procedures, which treated income taxes as an expense to be allocated in the same manner as other types of expenses.[142]

The CAP continued to support accounting for tax expenses by allocating them between periods in ARB 27 (1946) and ARB 42 (1952), which recommended recognition of deferred taxes when the tax code allowed accelerated depreciation. These accounting pronouncements reflected the position that the preferred approach to accounting for deferred tax expense was to debit tax expense and credit a separate deferred tax account on the balance sheet. But the accounting bodies acknowledged that in practice, companies regularly charged real and personal property taxes against the income of various periods, including in the year in which paid (cash basis), the year ending on assessment (or lien) date, the year beginning on assessment (or lien) date, or the year set out on the tax bill. Also, while some taxpayers charged the amount to income in full at one time, some did so ratably on a monthly basis, and sometimes did so based on prior estimates which they then adjusted during or after the period.

ARB 43 [stated] that real and personal property taxes are unlike excise, income, and social security taxes, which are directly related to particular business events; [it said that] real and personal property taxes are based upon the assessed valuation of property (tangible and intangible) as of a given date, as determined by the laws of a state or other taxing authority. For this reason, the bulletin said that the legal liability for such taxes is considered to accrue at the moment of occurrence of some specific event, rather than over a period of time. ARB 43 clarified that an accrued liability for real and personal property taxes, whether estimated or definitely known, should be included as a current liability, subject to estimating an obligation subject to a substantial measure of uncertainty. For real estate taxes applicable to property being developed for use or sale, those would generally be regarded as an expense of doing business, and so could be charged to operating expenses, shown as a separate deduction from income, or distributed among the several accounts to which they might apply, such as factory overhead, rent income, or selling or general expenses. Because the liability for property taxes often has to be estimated at the balance-sheet date, ARB 43 stated that it might be necessary to adjust the prior-year provision when the amount was determined, adjustments that should ordinarily be made through the income statement.

Debates over the accounting treatment of corporate income taxes became even more important with the enactment of accelerated depreciation in the Internal Revenue Act of 1954, which

[140] Schultz & Johnson at 83. The SEC initially came out against inter-period tax allocation, with Accounting Series Release (ASR) No. 53 (1945) taking the position that in most cases the tax provision should reflect only the taxes actually payable for the current period.
[141] Johnson, at 30. [AIA, 1944]
[142] Bevis, Donald J.; Perry, Raymond E.; and American Institute of Certified Public Accountants. Accounting Principles Board, "Accounting for income taxes, an interpretation of APB opinion no. 11;" (1969). Guides, Handbooks and Manuals. 4. https://egrove.olemiss.edu/aicpa_guides/4

increased the gap between taxable and accounting income[143] and led to significant recurring timing differences. The accounting profession responded by issuing ARB 44 in the same year. That bulletin said that preparers did not need to recognize deferred income taxes unless it was reasonably certain that the reduction in taxes during the earlier years was merely a deferment until a relatively few years later, and then only if the amounts are clearly material." This meant that tax allocation was not required for depreciation differences related to normal additions and replacements or ones that had an indefinite duration.[144]

B. Current Guidelines

Current accounting treatment of income taxes is governed by ASC 740, which applies to the accounting for all taxes imposed on an entity by a taxing authority based on the entity's income, regardless of how a tax is labeled by a particular jurisdiction. Because the standard looks to substance rather than form, it requires companies to exercise judgment in making the determination of whether a tax is an income tax within scope. Taxes that are not income taxes within scope are accounted for in accordance with other rules generally applicable to the recognition, measurement, and disclosure of assets and liabilities, income, and expenses. As a result, there may be significant differences between how taxes are accounted for when ASC 740 is considered to apply and other situations. For example, there's no recognition of deferred taxes in the case of non-income-based taxes, and no recording of expense items or income associated with non-income-based taxes in the income tax expense line in the statement of operations. There's also no reflection as to any uncertainty about the recognition and measurement of a non-income-based tax in a particular jurisdiction for non-income taxes, as would be required for income taxes under the guidance of ASC 740-10.[145]

Under the guidance, taxes that may be considered taxes in lieu of an income tax, such as an excise or other type of tax (such as excise taxes imposed on the net investment income of not-for-profit entities) may be considered to meet the definition of a tax based on income and so fall is within the reporting requirements applicable to an income tax. In contrast, the accounting guidelines say that taxes that may be imposed based on a percentage of assets or sales on qualifying entities are not considered in lieu of taxes because they are not based on a measure of income, and so are not within the scope of ASC 740.[146] The accounting guidelines also allow for a split approach for so-called hybrid tax regimes, for example, a tax that may be imposed on the

[143] Johnson at 30.
[144] Schultz & Johnson at 83. See Carey, J.L. (1944), "What are Corporate Income Taxes?," Journal of Accountancy, Vol. 77, No. 6: 425-426; Carey, J.L. (1970), The Rise of the Accounting Profession (Vol. 2): To Responsibility and Authority 1937-1968 (New York: AICPA); Johnson, R. (1993), "A History of Accounting for Income Taxes," in Coffman, E.N., Tondkar, R.H., and Previts, G.J. (eds.), Historical Perspectives of Selected Financial Accounting Topics (Boston: Irwin): 271-28; Powell, W. (1959), "Accounting Principles and Income-Tax Allocation," New York Certified Public Accountant, Vol. 29; ARB 43: Restatement and Revision of Accounting Research Bulletins ARB 43 STATUS Issued: June 1953 Effective Date: June 1953 (replaced ARBs issued September 1939–January 1953) https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176156418463&acceptedDisclaimer=true
[145] Deloitte, Accounting for Income Taxes.
[146] Deloitte, Accounting for Income Taxes.

greater of one of two alternative calculations: one based on income and the other based on revenue, or capital. Under the accounting guidance (ASC 740-10-15-4 and the related implementation guidance), a portion of the tax may be treated as an income tax, and a portion not.[147]

C. The Rationale

The best explanation for the divergent treatment of income and non-income taxes in financial statements is that it derives from the matching principle, pursuant to which items of expense must be matched with items of income. [expand][148]

This matching principle is reflected in a 2019 accounting standards update which includes guidance on the proper treatment of state franchise taxes. That explanation revises ASC 740-10-15-4 to state that the guidance applicable to income taxes does not apply to franchise taxes (or similar taxes) to the extent such taxes are based on capital or a non-income-based amount and there is no additional portion of the tax based on income. The revised language would also state that if a franchise tax (or similar tax) is partially based on income (for example, an entity pays the greater of an income-based tax and a non-income-based tax), deferred tax assets and liabilities are recognized and accounted for in accordance with the rules applicable to income taxes.

More broadly, the accounting standards reflect the primary goal of financial statements, which is to provide investors, creditors, and other stakeholders with relevant and reliable data to enable them to make well-informed investment decisions.[149] To achieve this goal, financial accounting standards provide preparers with flexibility and discretion in presenting their income calculations and also permit different industries to develop different standards. Ultimately, the best explanation for why income taxes are broken out separately from other types of taxes and itemized as a discrete item below in the income statement is due to the fact that if something is a tax on income from operations, the income must be calculated first before the tax can be calculated. Following this rationale, the distinction in the accounting world may have more of a principled rationale than the other disciplines.

In treating tax expenses for accounting purposes based on their substance rather than their terminology, and taking into effect the actual incidence of the tax rather than a theoretical economic analysis of the tax, the accounting approach appears closest to classifying taxes based on a coherent principle. But it also gives significant discretion to preparers in delineating types of taxes, discretion which may be hard to swallow in the context of enforcement of the tax laws or trade rules. [This discretion may become more important if additional disclosures are required

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[147] Deloitte, Accounting for Income Taxes.
[148] Liability has to be recorded for withholding tax under FAS5
"Geographical matching" – matching in the income statement – embedded in the concept of intraperiod tax allocation – doesn't run through income runs through cumulative translation adjustment account
[149] See Graham, Raedy, and Shackelford, 2012

with respect to income taxes, as is under consideration by the Financial Accounting Standards Board.]

[discuss recent developments: alternative min book tax/OECD reliance on financial statements]

VI Conclusion

Constitutional law, the tax code, trade agreements and accounting standards have all wrestled with how to define and distinguish between different types of taxes. The law has struggled to incorporate and adapt to changing economic theories, with resulting inconsistencies, uncertainties and litigation. In other places, its adopted an outcome driven approach, with a lack of principle that has also created challenges for the government to write rules and taxpayers to apply them. Differences between legal definitions and accounting standards create opportunities for tax planning and earnings management.

Recent developments may suggest a shift in tax law from one based on economic theories and politically motivated technical rules to one more rooted in accounting standards. While such a shift may perhaps help address the challenges associated with ossified economic standards in law, it may also portend other, future, challenges. Accounting standards are – at least with respect to the definition of an income tax – more principled based than the legal standard, but also leave more room for individual judgment in application to particular circumstances.