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Comment: What's on Second?

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The paper by Stephen E. Shay and Victoria P. Summers[1] presents a thorough and rich analysis of the numerous economic and practical international issues that would arise if the United States were to replace the current income tax with a destination- or origin-based consumption tax, such as the disguised value-added taxes ("VATs") of the Armey-Shelby "flat tax" (the "Flat Tax")[2] and the Nunn-Domenici "Unlimited Savings Account" tax (the "USA Tax").[3] Two of the paper's points are particularly interesting. First, such a major shift in tax policy by such an important participant in the international economy would have dramatic effects on foreign tax systems. Second, international transactions raise special concerns as to how transition to a changed tax system would, by itself, affect economic efficiency and the wealth of U.S. persons. These two points will be addressed in order. In both cases, importing some knowledge from outside the consumption tax literature—what's on second—provides helpful perspective.

I. IMPACT ON FOREIGN TAX SYSTEMS

Shay's and Summers' most striking point is that tax reform, as proposed, would impact foreign tax systems in ways that could unwind the current U.S. income tax treaty network. Given how important income tax treaties are to the international flow of capital, and given Shay's considerable experience in negotiating such treaties on behalf of the United States, this concern is troubling indeed. Nevertheless, the disruption that Shay and Summers find so troubling as a practical and transitional problem might in fact be desirable as a long-term economic matter.

The current U.S. income tax treaty network is an artifact of the first

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1. Stephen E. Shay & Victoria Summers, *Selected International Aspects of Fundamental Tax Reform Proposals*, 51 U. MIAMI L. REV. 1029 (1997).

2. Freedom and Fairness Restoration Act of 1995, H.R. 2060, 104th Cong. (1995); S. 1050, 104th Cong. (1995).

3. USA Tax Act of 1995, S. 722, 104th Cong. (1995).

half of the twentieth century.[4] During this period, the United States was pre-eminent in world markets, was overwhelmingly a capital exporter, and had one of the highest rates of corporate tax.[5] The United States used this position paternally. Its approach, including hanging tough on tax sparring, helped its treaty partners, particularly those less well off, to establish and maintain meaningful income taxes following the U.S. domestic model (including an unintegrated corporate tax). With hindsight, it is not clear that this approach was beneficial. It seems much less appropriate now. The United States currently plays a smaller role in international capital flows, imports considerable capital, and has a relatively lower corporate rate (which, as a practical matter, would be even lower, or zero, under the proposed tax reforms).

Shay and Summers focus on how the proposals would require foreign countries to deal with U.S transactions or U.S. multinationals themselves rather than, as currently, the U.S. tax system policing abuse of foreign taxes for the foreign countries. For example, Shay and Summers are concerned that the United States might become an income tax haven.[6] They also are concerned that U.S. investors might increase the leverage of their foreign holdings. These problems arise from two separate features of the proposals: going to a territorial system and shifting to a consumption tax.

Foreign tax systems fend for themselves today with regard to international transactions not involving the United States.[7] It is not obvious why the United States should stand alone. Optimal tariff theory and its progeny teach that, in international tax matters, a country can increase domestic welfare through self interest.[8] The United States has accommodated foreign countries gaming the U.S. Treasury with territorial sys-

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4. The following discussion draws heavily on Stanford G. Ross, *A Perspective on International Tax Policy*, TAX NOTES 701 (Feb. 18, 1985); Charles I. Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151 (1981).

5. The higher the U.S. rate, the more power the United States has to help foreign states by softening the impact of foreign taxes on international business location decisions through allowing credit for foreign taxes. To look at it another way, a company in an excess credit position for the foreseeable future would worry more about foreign taxes than one that could fully credit all foreign taxes. (Foreign tax credit baskets, of course, complicate this analysis.)

6. In any event, it is a little late to be concerned about the United States becoming a tax haven. Unilateral repeal of the U.S. "withholding" tax on portfolio interest in 1984 intentionally turned the United States into a galaxy-class tax haven. *See* I.R.C. §§ 871(h), 1441(c)(8) (1996); Charles E. McLure, Jr., *U.S. Tax Laws and Capital Flight from Latin America*, 20 U. MIAMI INTER-AM. L. REV. 321 (1989).

7. For example, the United Kingdom does a nice job of dealing with France's territorial system in the relevant treaty. *See, e.g.*, Income Tax Treaty, May 22, 1968, France-U.K., art. 11(6).

8. *See* Joel Slemrod, *Competitive Advantage and the Optimal Tax Treatment of the Foreign-Source Income of Multinationals: The Case of the United States and Japan*, 9 AM. J. TAX POL. 113 (1991).

tems (the often-noted irony of the DISC GATT controversy) and partial integration. A new U.S. international tax policy could be based on a fair and reasonable self interest, not tax isolationism.

II. TRANSITION RULES

Transition problems are central to the debate over shifting to a consumption tax. Most importantly—and quite surprisingly—most of the gains in overall economic welfare claimed by consumption tax proponents would result, not from having an ongoing consumption tax (rather than an income tax) in the future, but from raising revenue as a consequence of the practical one-time tax on wealth (income) accumulated prior to the transition, which tax is inherent in a shift to a consumption tax.[9] This practical one-time wealth tax would arise as this old wealth, which could be enjoyed tax-free today, bears consumption tax as it is enjoyed. (Future income would bear a consumption tax, but no income tax, and thus, would not be subject to this practical wealth tax.[10]) A one-time wealth tax would permit lower tax rates for those taxes that reduce economic efficiency as a consequence of their ongoing incidence interfering with behavior. This transition concern was the number one public reason (among many) that the U.S. Treasury rejected a shift to a consumption tax in 1984.[11]

The most important international transition problem identified by Shay and Summers relates to how businesses would treat depreciable assets acquired before the consumption tax takes effect. Immediate expensing of all unrecovered basis of all such assets on the effective date would approximate proper consumption tax treatment, but also would break the bank. For this reason, the USA Tax and the Flat Tax would continue depreciation for pre-effective-date depreciable property. This would have the effect of adding an income tax on these assets to the consumption tax regime.[12] This extra tax confuses the economic analy-

9. *See* David Bradford, *Consumption Taxes: Some Fundamental Transition Issues*, in FRONTIERS OF TAX REFORM 123-50 (Michael J. Boskin ed., 1996).

10. The incidence of the wealth tax is unclear. If monetary policy allowed prices and wages to rise by the amount of the disguised VAT, old wealth would buy less, and the tax would probably be borne by owners of old wealth. For example, retirees' non-pension savings would buy less. To the extent a different monetary policy changed this result, the incidence would shift. For example, if old wealth were protected by prices being held constant, borrowers would be hurt as they lost the benefit of interest deductions (with no offsetting benefit from VAT-driven inflation pushing down the real burden of the debt).

11. *See* U.S. Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth* 212 (1984).

12. *See generally* David G. Raboy & Cliff Massa III, *Problems of Transition to a Value-Added Tax*, *in* THE VALUE ADDED TAX: ORTHODOXY AND NEW THINKING 103 (Murray L. Weidenbaum, David G. Raboy & Ernest S. Christian, Jr. eds., 1989).

sis considerably.[13]

Not surprisingly, this complicates the international picture. It is very unlikely that the transition income tax would function as a lump-sum tax, say on old depreciable assets. Without this effect, it would be impossible for exchange rates to fully adjust for the entire new U.S. tax system. As a result, for some time there would be a real difference between origin and destination bases for the business tax. Also, under a destination-based regime, like the business part of the USA Tax,[14] to prevent a windfall for old depreciable assets used to produce exports (rather than in domestic production), this extra income tax should apply as the current tax does, including as to exports, even though exports generally are exempt from consumption tax.[15] This would require difficult ad hoc rules to determine which export income relates to pre-effective-date assets.

The international transition problem that Shay and Summers apparently find most troubling is the treatment of the repatriation of income earned in offshore subsidiaries that, as of the effective date of the consumption tax, has yet to bear a full tax (by U.S. standards). The consumption tax proposals would exempt all dividends from subsidiaries, domestic or foreign. Shay and Summers view this as a windfall with respect to pre-effective-date low-tax deferred foreign income. Perhaps they are reminded of the 1984 exemption of deferred DISC income.[16]

At first glance, an exemption for income that has not been subject to a full tax is troubling. In fact, there is little reason to be specially concerned here.[17] Income is a concept, not a person, real or juridical. Concepts do not bear tax; persons bear tax.[18] The proposals would give owners of shares, not income, a tax break (compared to current law). Under the Flat Tax, individuals would get the greatest break, while shareholders that own over eighty percent of a U.S. corporation would

13. Thomas Barthold suggested this presentation of the old depreciable assets transition problem to me. The extra tax prevents windfalls. New depreciable assets will be more costly because of the VAT. Expensing reflects this. On the other hand, expensing old, "cheap," depreciable assets gives windfalls. To look at this from the other direction, old depreciable assets were purchased "cheap," because only depreciation was expected, so that expensing effects windfalls.

14. The USA Tax's business tax is not purely destination-based because of the limitation on the expensing of export-related assets.

15. Since foreign income would be exempt, old foreign assets should not be recoverable, although the proposals apparently provide that they are.

16. *See* Deficit Reduction Act of 1984, P.L. 98-369, § 805(b)(2).

17. The following analysis is based on George Mundstock, *Section 902 Is Too Generous*, 48 TAX L. REV. 281, 301-12 (1993).

18. Of course, only individuals really bear taxes, so that taxes on business entities are further shifted. For present purposes, however, looking at taxes on persons simplifies the discussion with no loss in accuracy.

get the least (since they currently bear little or no tax). Things are a bit different under the USA Tax. Under both proposals, however, the break for U.S. corporate shareholders of foreign corporations on pre-effective-date earnings would fall between domestic extremes, depending on the amount of taxes attributable to the underlying earnings. There is no reason to be more troubled by the foreign break than by the comparable domestic breaks. This is not like 1984, when selected foreign corporate dividends got a special break. In fact, one might find a break for income "trapped" offshore to be an attractive incentive to repatriate capital to the United States. If one is bothered by any benefit with respect to tax-haven activity, one can take comfort in the fact that the proposals would hurt tax-haven businesses by making them less valuable as a consequence of the prospective elimination of their relatively tax-favored status.