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By Reuven S. Avi-Yonah

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Back to 1913? The Ryan-Brady Blueprint and Its Problems

by Reuven S. Avi-Yonah

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In this article, Avi-Yonah examines President-elect Donald Trump's tax plan and the House Republicans' blueprint for fundamental tax reform. He argues that Trump's plan includes unrealistically large and regressive tax cuts and that the blueprint represents a regressive return to the type of tariffs that financed the U.S. government before the passage of the 16th Amendment — which, according to Avi-Yonah, is a betrayal of the working-class voters who elected Trump. He further argues that the blueprint is incompatible with our WTO obligations and tax treaties and that it cannot solve the problems of income shifting and inversions that it is designed to address.

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Introduction: Back to 1913?

From the Revolutionary War to the late 19th century, the federal government was financed primarily through regressive tariffs on imported goods. The exception was the income tax enacted during the national emergency of the Civil War, which was allowed to expire in 1872.

The rise of an industrial economy in the post-Civil War era led to significant increases in inequality, which the tariffs exacerbated by falling primarily on the working class. "Robber barons" like J.P. Morgan, Andrew Carnegie, and John D. Rockefeller did not consume most of their income, and their intangible wealth avoided state-level personal property taxes as well. This led to the great tax wars that occurred from 1894 to 1913, in which the Democratic Party pushed for the reenactment of a federal income tax. After the Supreme Court struck down such a tax in 1895, the Democrats continued their pressure, which resulted in the enactment of federal corporate and estate taxes in 1909 and culminated in ratification of the 16th Amendment in 1913 and the adoption of the existing federal income tax the same year.[1]

A century later, that progress is under threat. The "Better Way" blueprint for radical tax reform,[2] written by House Speaker Paul D. Ryan, R-Wis., and House Ways and Means Committee Chair Kevin Brady, R-Texas, represents a regressive retreat to the pre-1913 era because at its core is a consumption tax on corporations imposed on imports, just like the old tariffs. The blueprint tries to avoid that characterization by calling its business tax a corporate income tax. But precisely because it avoids acknowledging that it is a VAT and not an income tax, the blueprint runs into problems with both our WTO obligations and our tax treaties. Also, because it is not structured as a traditional credit-invoice VAT, the blueprint would not solve the tax avoidance problems that allegedly motivate its enactment.

The Trump Plan

Before considering the Ryan-Brady blueprint, it may be helpful to briefly summarize what is known about President-elect Donald Trump's tax plan, as set out on his campaign website.[3]

The Trump plan in general is not as radical as the blueprint because it "only" involves a drastic series of cuts in the existing income tax structure. Under the Trump plan, there would be a new standard deduction of $30,000 for joint filers and graduated rates of up to 33 percent, with a cap of $200,000 for itemized deductions. The alternative minimum tax and estate and gift taxes would be repealed. Capital gains and dividends would continue to be taxed at 20 percent, but the carried interest rule would be repealed.

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[1]For the history, see Steven Weisman, *The Great Tax Wars* (2002).

[2]Tax Reform Task Force, "A Better Way: Our Vision for a Confident America" (June 24, 2016) (blueprint).

[3]*Available at* https://www.donaldjtrump.com/policies/tax-plan.

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On the business level, there would be a 15 percent tax rate applicable not just to C corporations but also to other businesses. The Trump website says that the 15 percent rate "is available to all businesses, both small and large, that want to retain the profits within the business."[4] Further, all businesses could elect to either be taxed on the current income tax with a deduction for interest and capitalization of capital expenditures or to currently deduct capital expenditures but forgo the interest deduction.

Internationally, there would be a 10 percent tax imposed on the deemed repatriation of current assets held offshore by U.S. multinationals. Beyond that, the Trump plan is silent on the international provisions, except for the statement that "it eliminates *most* corporate tax expenditures except for the Research and Development credit."[5] Because deferral is by far the largest corporate tax expenditure ($811 billion over a decade, compared with $195 billion for the next-largest expenditure), this is consistent with abolishing deferral, which was Trump's original campaign position. However, Trump has abandoned that explicit proposal, and it is therefore more likely that he will follow Ryan and Brady in advocating territoriality (full exemption for future repatriated profits). "Most" is not "all."[6]

The main differences between the Trump plan and the Ryan-Brady blueprint are in the corporate part. On the individual side, the top rate on ordinary income is the same, and the capital gains and dividends rate is only slightly higher under Trump (20 percent versus 16.5 percent). The blueprint does not mention carried interest, but Trump's promise on this issue is meaningless because, under his plan, hedge fund managers could elect to be taxed at 15 percent rather than 33 percent on their business income, which is even lower than the 20 percent capital gains rate that carried interest provides.

On the business side, the main differences are that (1) the Trump plan would extend his 15 percent rate to all businesses, with a dividend and capital gains tax of 20 percent, whereas the Ryan-Brady blueprint would tax C corporations at 20 percent and passthroughs at 25 percent; (2) under the blueprint, mandatory expensing with no interest deduction would apply whereas under the Trump plan, they would be elective; and (3) the blueprint would be destination based, whereas the Trump plan would keep the current origin-based corporate tax. In general, the Trump plan (except for the elective expensing) is much more a traditional individual and corporate income tax than the Ryan-Brady blueprint, which at its core would eliminate the corporate income tax in favor of a subtraction-method VAT.

The Urban-Brookings Tax Policy Center (TPC) has estimated that the Trump plan would result in a revenue loss of $6.2 trillion over 10 years and that the federal debt would increase by at least $7 trillion.[7] This is not surprising given the sharp rate cuts and electivity (by definition, electivity exacerbates revenue losses because nobody would choose expensing and no interest deduction unless they would pay less). The Trump plan would also create a strong incentive to transform labor income taxed at 33 percent to business income taxed at 15 percent, most obviously in the hands of hedge fund managers given the elimination of carried interest.

The Ryan-Brady Blueprint

The blueprint is gaining new prominence because of the Republican ascendancy in Washington following the 2016 election. Since Trump would likely sign any tax reform passed by a Republican Congress, it is worth serious consideration.

The introduction to the proposal states:

> This Blueprint represents a dramatic reform of the current income tax system. *This Blueprint does not include a value-added tax (VAT)*, a sales tax, or any other tax as an addition to the fundamental reforms of the current income tax system. The reforms reflected in this Blueprint will deliver a 21st century tax code that is built for growth and that puts America first.[8]

This statement is important because, as will be discussed below, the business part of the proposal can be seen as a subtraction-method VAT. If it were a VAT, it would not violate tax treaties or the WTO rules. But because it declares itself to not be a VAT, it may have problems with both.

The individual tax section of the blueprint is not radical, although it is quite regressive and would lead to massive budget deficits.[9] It envisages a lower rate structure for ordinary income (up to 33 percent with a $24,000 standard deduction for joint filers), a capital gains, dividends, and interest rate that is half the rate for ordinary income (up to 16.5

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[4] *Id.* This is the rate that would apply to Trump's own businesses, which are passthroughs.

[5] *Id.* (emphasis added).

[6] Because accelerated depreciation and the research credit are off the table, the only significant corporate tax expenditure that both Trump and the House Republicans would probably repeal is the domestic manufacturing deduction (section 199).

[7] Jim Nunns et al., "An Analysis of Donald Trump's Revised Tax Plan," TPC (Oct. 18, 2016).

[8] Blueprint, *supra* note 2, at 15 (emphasis added).

[9] *See* Nunns et al., "An Analysis of the House GOP Tax Plan," TPC (Sept. 16, 2016), which estimates that the blueprint would decrease revenue and increase the debt by $3 trillion over the first decade.

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percent), and elimination of the individual AMT and the estate tax. For passthrough businesses, the blueprint proposes a rate of 25 percent, with special provisions to prevent shifting of wage income to passthroughs.[10]

The radical portion of the blueprint is the corporate section. In addition to cutting the corporate tax rate from 35 percent to 20 percent, the blueprint proposes three major reforms. First, corporations would be allowed to expense capital expenditures, resulting in a zero rate for the marginal return on investment:

> This Blueprint will provide businesses with the benefit of fully and immediately writing off (or ''expensing'') the cost of investments. This represents a 0 percent marginal effective tax rate on new investment. Elimination of the tax on business investment as a means to drive growth is the centerpiece of the legislation introduced by Rep. Devin Nunes of California, the American Business Competitiveness Act (H.R. 4377), which would introduce a business cash-flow tax.[11]

Second, corporations would be unable to deduct net interest expense:

> Under this Blueprint, job creators will be allowed to deduct interest expense against any interest income, but no current deduction will be allowed for net interest expense. Any net interest expense may be carried forward indefinitely and allowed as a deduction against net interest income in future years.[12]

Third, the blueprint would be destination based. That is, it would be fully imposed on imports (with no deductions) and not be imposed at all on exports:

> This Blueprint eliminates the existing self-imposed export penalty and import subsidy by moving to a destination-basis tax system. Under a destination-basis approach, tax jurisdiction follows the location of consumption rather than the location of production. This Blueprint achieves this by providing for border adjustments exempting exports and taxing imports, *not through the addition of a new tax but within the context of the transformed business tax system*. The Blueprint also ends the uncompetitive worldwide tax approach of the United States, replacing it with a territorial tax system that is consistent with the approach used by our major trading partners. These two fundamental structural changes in turn allow other important aspects of the international tax rules to be simplified and streamlined significantly.[13]

This means that imports would be taxed and exports exempted. Further, the blueprint would enable dividends from foreign subsidiaries of U.S.-based multinationals to be fully exempt but would maintain the subpart F provisions for passive income, eliminating only the base company rule and section 956:

> Today, all of our major trading partners raise a significant portion of their tax revenues through value-added taxes (VATs). These VATs include ''border adjustability'' as a key feature. This means that the tax is rebated when a product is exported to a foreign country and is imposed when a product is imported from a foreign country. These border adjustments reduce the costs borne by exported products and increase the costs borne by imported products. When the country is trading with another country that similarly imposes a border-adjustable VAT, the effects in both directions are offsetting and the tax costs borne by exports and imports are in relative balance. However, that balance does not exist when the trading partner is the United States. In the absence of border adjustments, exports from the United States implicitly bear the cost of the U.S. income tax while imports into the United States do not bear any U.S. income tax cost. This amounts to a self-imposed unilateral penalty on U.S. exports and a self-imposed unilateral subsidy for U.S. imports.
>
> *Because this Blueprint reflects a move toward a cash-flow tax approach for businesses, which reflects a consumption-based tax, the United States will be able to compete on a level playing field by applying border adjustments within the context of our transformed business and corporate tax system***.** For the first time ever, the United States will be able to counter the border adjustments that our trading partners apply in their VATs. The cash-flow based approach that will replace our current income-based approach for taxing both corporate and non-corporate businesses will be applied on a destination basis. This means that products, services and intangibles that are exported outside the United States

[10]It would have been better to extend the business tax to larger passthroughs, as in the 1992 Treasury comprehensive business income tax proposal. *See* Treasury, ''Integration of the Individual and Corporate Tax Systems,'' at 39-40 (Jan. 1992).

[11]Blueprint, *supra* note 2, at 25.

[12]*Id.* at 26.

[13]*Id.* at 27 (emphasis added).

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will not be subject to U.S. tax regardless of where they are produced. It also means that products, services and intangibles that are imported into the United States will be subject to U.S. tax regardless of where they are produced. This will eliminate the incentives created by our current tax system to move or locate operations outside the United States. It also will allow U.S. products, services, and intangibles to compete on a more equal footing in both the U.S. market and the global market.[14]

The blueprint then addresses the potential WTO problem as follows:

> The rules of the World Trade Organization (WTO) include longstanding provisions regarding the use of border adjustments. Under these rules, border adjustments upon export are permitted with respect to consumption-based taxes, which are referred to as indirect taxes. However, under these rules, border adjustments upon export are not permitted with respect to income taxes, which are referred to as direct taxes. This disparate treatment of different tax systems is what has created the historic imbalance between the United States, which has relied on an income tax — or direct tax in WTO parlance — for taxing business transactions, and our trading partners, which rely to a significant extent on a VAT — or indirect tax in WTO parlance — for taxing business transactions. Under WTO rules, the United States has been precluded from applying the border adjustments to U.S. exports and imports necessary to balance the treatment applied by our trading partners to their exports and imports. *With this Blueprint's move toward a consumption-based tax approach, in the form of a cash-flow focused approach for taxing business income, the United States now has the opportunity to incorporate border adjustments in the new tax system consistent with the WTO rules regarding indirect taxes*.[15]

This approach is similar to the one taken by the 2005 advisory panel on tax reform in the growth and investment tax (GIT) proposal. Under the GIT, corporations would have been subject to a cash flow tax with expensing and no deduction for interest, but wages would have been deductible. The GIT was destination based, but for revenue estimating purposes, it was scored as if it were origin based because of concerns about WTO compatibility. This scoring method represented a difference of $1 trillion in revenue over the 10-year budget window.[16]

Is the Blueprint Compatible With the WTO?

Under the WTO's Agreement on Subsidies and Countervailing Measures (SCM agreement), a tax may be border adjustable only if it is an indirect tax. A border-adjustable direct tax is a prohibited export subsidy that can subject the United States to trade sanctions.

Annex 1 to the SCM agreement lists prohibited export subsidies. Item (e) on that list is "the full or partial exemption remission, or deferral specifically related to exports, of direct taxes[58] or social welfare charges paid or payable by industrial or commercial enterprises.[59]"

Footnote 58 to that provision states that for purposes of the SCM agreement:

> The term "direct taxes" shall mean taxes on wages, profits, interests, rents, royalties, and all other forms of *income*, and taxes on the ownership of real property;
>
> The term "indirect taxes" shall 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. [Emphasis added.]

Footnote 59 provides:

> The Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any Member may draw the attention of another Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultation created in the preceding sentence.

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[14] *Id.* (emphasis added).

[15] *Id.* at 28 (emphasis added).

[16] President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System" (Nov. 2005).

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> Paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.

The corporate tax regime of the blueprint can be seen as a version of a consumption tax — a subtraction-method VAT (although the blueprint explicitly denies that it is a VAT). The blueprint would impose tax on cash flow, allow expensing of capital expenditures, and disallow interest expense. Those are all also features of a subtraction-method VAT.

Because it is trying to appear to be a corporate income tax, the blueprint would allow a deduction for wages, and a subtraction-method VAT would disallow them. This feature alone probably makes the blueprint incompatible with the WTO rules.[17] Fundamentally, we need to consider the reason why a VAT, whether using a credit-invoice or subtraction method of calculating the tax, is border adjustable. Sales taxes, excise taxes, and VATs are border adjustable because the tax component in exports is measurable and the price of imports is measurable. By so limiting border adjustments, there is less of an opportunity for countries to subsidize exports or overtax imports.

The Ryan-Brady blueprint's treatment of purchases (including capital and inventory) and labor highlights the difference between a sales-subtraction tax on value added and the blueprint's tax on an income base.

If factors of production used at each stage of production and distribution of goods are totaled up, they should equal the retail sales price of the goods. A traditional VAT is imposed mainly on two factors of production: labor (about two-thirds of the base) and income. Under a sales-subtraction-method VAT, taxes are collected and remitted to the government by business at each stage of production and distribution. The resulting tax should be equal to the tax imposed on the retail price of taxable goods under a single-stage retail sales tax. Purchases taxed at a prior stage of production or distribution are deductible, so that this value is not taxed again. Under that method of calculating a VAT, the cost of labor is not deductible, so that factor of production can be included in the tax base.

In contrast, under the blueprint, a business could take an immediate deduction for its wage expense, leaving that factor of production out of the tax base. Workers bear tax at multiple rates on that labor income under the individual income tax.[18] Even if the tax paid by the workers may be viewed as a surrogate for a business's tax on labor, that surrogate tax cannot be accurately measured, and that cost should not enter the tax-inclusive prices of the business's outputs. Giving a full deduction for labor costs would effectively subsidize exports and overtax imports.[19]

Thus, the Ryan-Brady blueprint should be classified as a modified consumption-style tax imposed on an income base. As such, it is not a border-adjustable tax under the WTO rules, as currently interpreted. If the United States treated a blueprint-type tax as border adjustable, we could expect our international competitors to challenge the tax at the WTO before it took effect.

There are other problems with the blueprint as well. First, the blueprint explicitly declares upfront that it is not a VAT but a corporate income tax. Second, the retention of territoriality (on top of the destination basis) and subpart F and the taxation of corporate interest, dividend, and capital gains income make the blueprint look more like a corporate income tax. VATs are purely destination based and do not apply to any foreign-source income, so territoriality is not needed, and they do not tax interest or dividends or capital gains.

Ryan and Brady must hope that these problems can be resolved and the proposal defended in future

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[17] I owe the analysis that follows to professor Alan Schenk, the foremost expert on VAT in the United States and the drafter of the American Bar Association model VAT.

[18] Note that under the Trump plan, there would be a $30,000 zero bracket, and under the Ryan-Brady blueprint there would be a $24,000 zero bracket.

[19] Example: Assume that a domestic grape grower has no business inputs. He has labor costs of $30 and a profit of $10. He pays a blueprint-type 10 percent tax on income of $10, or $1. He sells his grapes to a wine producer for $41, tax inclusive ($30 + $10 + $1). The wine producer pays $41 for the grapes, pays for labor of $45, and has a profit of $15. He sells the wine to local consumers for $101 plus the $1.50 blueprint tax on $15 of profit, or tax-inclusive prices of $102.50. The total tax remitted by the grower and producer is $2.50.

If, instead of selling domestically, the producer exported the wine, the exporter should recover any tax paid on that product. Under the Ryan-Brady blueprint, the exporter presumably can deduct from taxable sales the full export price for the wine, inclusive of the tax paid to the grower, or $101. This deduction effectively reduces the exporter's blueprint tax by $9.18 ($101 x $10/$110 = $9.18). There is an $8.18 difference between the $9.18 blueprint tax reduction on export and the $1 tax reduction attributable to the input tax paid to the grower that is available under a VAT. That difference gives the exporter a windfall tax reduction on his exports. The exporter receives a tax benefit for an imputed tax on wages not subject to tax under the blueprint tax.

The same effect would occur on imports if the imports were taxed at the same assumed tax-exclusive value of the import. At the border, the 10 percent tax presumably would be imposed on the $100 value, or a tax of $10 instead of a tax of $2.50, equivalent to the tax that would actually be borne and presumably passed on to consumers of a domestic sale.

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WTO litigation or they may expect that the United States would lose and then the corporate tax would have to be fully converted into a VAT with no labor deduction, with the resulting increase in regressivity. Arguably, calling the blueprint a corporate income tax should not change its treatment, although the WTO panel is likely to take labeling into account. Exempting some foreign-source income and taxing some other foreign-source income can be seen as a way to prevent double taxation, compatible with footnote 59, although that is explicitly in the context of a direct tax. It would be better to just rely on the destination basis and eliminate territoriality, subpart F, and the foreign tax credit altogether, as in a regular VAT.[20] But that would reveal the business tax to be a VAT, which Ryan and Brady are determined not to do. The likely outcome is years of WTO litigation and a probable adverse outcome with massive trade sanctions imposed on the United States.

What About Tax Treaties?

There are three problems with tax treaties in the blueprint. The first is the FTC. Under the blueprint, full territoriality would be adopted (100 percent exemption for dividends from controlled foreign corporations), which would mean no direct or indirect credit for foreign taxes imposed on that income. That would violate article 23 of our existing treaties. But because the idea is to prevent double taxation through exemption, which is fully compatible with article 23A of the OECD model, a treaty override with later renegotiation could be justified, even if the proposed tax is an income tax subject to the treaties (if it is a VAT, the treaties do not apply).[21]

The second problem is that if the business tax is an income tax covered by the treaties and we are serious about taxing goods and services imported into the United States on a destination basis, we must eliminate the permanent establishment limitation in article 7 because we need to be able to tax importers without a PE (or physical presence required under domestic law). I believe this is a long-overdue reform, bringing the income tax treaty into the 21st century and the age of electronic commerce, but it is a drastic unilateral step.[22] We could do this as a treaty override and then renegotiate the treaties to include a de minimis provision, which is common in the VAT setting, to preclude low-volume importers from having to file tax returns.

The third problem is that if the business tax is an income tax, to levy it on a destination basis and include all imports, it must be imposed not just on goods and services (under article 7) but also on intangibles that produce royalties (article 12) and other types of deductible payments that can substitute for royalties (for example, payments on derivatives, which are generally "other income" under article 21). Although interest and dividends are not deductible, allowing royalties and derivatives to escape the tax on imports invites abuse because there will always be lower-tax jurisdictions. While denying the deduction works in a business-to-business context, it does not apply in a business-to-consumer context. This requires another treaty override that can be avoided if the business tax is a VAT.

Tax Avoidance, Income Shifting, and Inversions

The Better Way proposal argues that:

> Taken together, a 20 percent corporate rate, a switch to a territorial system, and border adjustments will cause the recent wave of inversions to come to a halt. American businesses invert for two reasons: to avail themselves of a jurisdiction with a lower rate, and to access "trapped cash" overseas. Those problems are solved by the lower corporate rate and the territorial system, respectively. In addition, border adjustments mean that it does not matter where a company is incorporated; sales to U.S. customers are taxed and sales to foreign customers are exempt, regardless of whether the taxpayer is foreign or domestic.[23]

I do not believe the blueprint proposal would completely stop the incentive for U.S. corporations

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[20]Alternatively, instead of taxing imports in full, the tax could be imposed only on net profits, as in a single-sales-factor formulary apportionment. This solution has its own issues (*e.g.*, the need to override the arm's-length standard, looking through thin margin distributors) but creates fewer WTO problems. *See* Charles E. McLure Jr. and Walter Hellerstein, "Does Sales-Only Apportionment Violate International Trade Rules?" *Tax Notes*, Sept. 9, 2002, p. 1513; and Reuven S. Avi-Yonah, "The Case for a Destination-Based Corporate Tax," 41 *Int'l Tax J.* 11 (2015).

[21]An important related question is how our treaty partners will react to such sweeping changes and treaty overrides (which they regard as violations of international law). Given that the new U.S. tax (20 percent rate with expensing, territoriality, border adjustments) will create a strong attraction for foreign-based multinationals to shift profits into the United States, it is likely that they will (a) refuse to give credit for the U.S. tax under tax treaties because it is not an income tax, (b) apply their CFC rules to U.S. operations by their multinationals, which cannot invert in response because of exit taxes. The likely end result will be a collapse of the treaty-based international tax regime. *See* Avi-Yonah, "The International Implications of Tax Reform," *Tax Notes*, Nov. 13, 1995, p. 913; Avi-Yonah, "From Income to Consumption Tax: Some International Implications," 33 *San Diego L. Rev.* 1329 (1996).

[22]Avi-Yonah, "International Taxation of Electronic Commerce," 52 *Tax L. Rev.* 507 (1997).

[23]Blueprint, *supra* note 2, at 26.

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to shift income overseas, because even with a 20 percent rate and expensing, rents (for example, from intangibles like Apple's "Irish" profits) could still be located in zero-tax jurisdictions and then repatriated tax free. Although that problem could be minimized if it were limited to rents from exploiting foreign markets (which would be exempt even if carried out from the United States), I am doubtful that the line between U.S. and foreign markets could be drawn precisely insofar as services and intangibles are concerned. Even a normal (credit-invoice) VAT has problems with imports of services and intangibles. Inversions might also continue to avoid the retained application of subpart F.

The fundamental problem with the blueprint is that even though it advocates a VAT, in order to make it look more like a corporate income tax, it is a subtraction-method VAT rather than the credit-invoice method VAT adopted by every other country. In principle the two methods achieve the same result domestically. For example, assume a grape grower sells grapes to a wine producer for $40. The wine producer then makes the grapes into wine that it sells to consumers for $100. In a normal credit-invoice VAT of 20 percent, the grape grower will pay $8 on its sale to the wine producer ($40 x 0.2 = $8), and the wine producer will pay $12 on its sale to the consumer, with a credit for the $8 paid by the grape grower ($100 x 0.2 = $20 - $8 = $12). The total VAT paid would be $20 ($8 + $12 = $20). In a subtraction-method VAT, the grape producer will pay $8 ($40 x 0.2 = $8) (it has no deductible costs, so the full $40 is taxable), and the wine producer will pay $12 ($100 - $40 = $60 x 0.2 = $12) for the same $20 of total VAT.

The same result obtains in principle in the international setting when the grapes are imported from another country. In a credit-invoice VAT, the grape grower will not pay tax on its export (which is zero rated) and will not receive a refund, because it has no input credits. The wine producer will pay VAT of $8 on its imported grapes and then pay $12 on its sales of the wine ($100 x 0.2 = $20 - $8 = $12), with an input credit of $8. In a subtraction-method VAT, the grape grower will have exempt income of $40, and the wine producer will pay $8 on its import (or just not get a deduction) and $12 ($100 - $40 = $60 x 0.2 = $12) on the sale of the wine.

This works fine insofar as goods are concerned, at least in a country like the United States that levies tariffs at the border. But when services and intangibles are involved, tax avoidance becomes harder to prevent in a subtraction-method VAT. In a credit-invoice VAT, an importing business will have an incentive to pay tax on imported services and intangibles because otherwise it would not get a credit against tax on the ultimate sales to consumers. Sales of services and intangibles by importers directly to consumers are a problem even in credit-invoice VATs, as the EU experience with telecommunication services by U.S. providers illustrates.[24]

But a subtraction-method VAT like one embedded in the Ryan-Brady blueprint has a more serious problem because there is no tax credit, so everything depends on taxing imported services and intangibles at the border (or denying a deduction for the import). Suppose Google sells advertising services from its Irish subsidiary into the U.S. market. Would the IRS be able to distinguish between this income and income from the sale of the same services to the rest of the world? Suppose that Google Ireland sells advertising services to a U.S. business and a German business. The fee that the U.S. business pays for those services is not deductible because it's for an import of services, and the business must pay 20 percent on its sale of the advertised product without recouping the advertising cost unless it increases the price of that product. The German business deducts the fee for corporate tax purposes at 30 percent. Moreover, Germany reverse charges for VAT purposes, so the German business pays a 19 percent VAT on the fee, but it gets an input credit for that against the VAT on the sale of the advertised product to consumers. Even though Google does not pay tax in either case, it would prefer the German situation because there the fee is deductible against corporate tax and the VAT is clearly an input credit charged to the ultimate consumer, so the business "importer" of the service can afford to pay more. Now assume that the U.S. and German businesses are affiliated. In that case, there would still be an incentive to shift Google Ireland's exports of services from being

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[24]For the serious problems raised by application of a VAT to cross-border trade in services and intangibles, see OECD, *International VAT/GST Guidelines* (2015) (recommended by the council in September 2016). In a credit-invoice VAT, exports are zero rated in the country of origin, so a business importer does not get a tax credit on the purchase. If there is an output tax to the final consumer, it is simply charged and paid (like a typical retail sale under the U.S. retail sales tax). This means that unlike the typical VAT situation, the entire collection, even in a business-to-business (B2B) context, depends on the final sale to the consumer. And experience with retail sales taxes has illustrated that at high rates, this becomes an avoidance problem (as anyone living in states that border states that do not tax sales can attest). The real problem in the business-to-consumer (B2C) domain is simply that there is no jurisdiction to enforce the B2C tax because there is no jurisdiction over the remote supplier. In the B2B context, the answer is the reverse charge, in which the business purchaser self-assesses the tax and therefore gets an input tax credit on any further sale. In the B2C setting, relying on the consumer to self-assess the tax amounts to a tax on honesty (like the U.S. state use tax, in situations where there is no collection by the remote seller).

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imports into the United States to being imports to Germany. But what about Microsoft Ireland selling software directly to U.S. consumers and earning royalties? If that were the reason for retaining subpart F on passive income from U.S. sources, the result would be to encourage inversions to avoid subpart F (which already has an exception for active royalties).

Overall, not only is the blueprint regressive and complex, it also raises the same income-shifting and inversion problems as under the current income tax. This feature eliminates the only remaining argument in its favor.

Conclusion

If the blueprint were honest about its intentions, it would declare the business tax to be a VAT. That would solve the WTO problem (because VATs are border adjustable) and the treaty problems (because VATs are not covered by income tax treaties). Moreover, the VAT could then be structured as a normal credit-invoice VAT, and the potential for tax avoidance would be greatly reduced.

But the House Republicans cannot do so politically because such a step would reveal the blueprint for what it is: a step back to the pre-1913 era of regressive tariffs as a way to finance the U.S. government on the back of the working class, with the rich getting an immense tax cut. At a time when the United States threatens the world with a return to explicit tariffs on imported goods, we should not be adding the Ryan-Brady tariff and eliminating a century of progressive taxation based on ability to pay.

What should be done instead? I believe a good, short-term tax reform would increase taxes on the rich and include a base-broadening but rate-cutting corporate tax reform. This view reflects the fact that corporate income and residence are easier to shift offshore than individual income and residence. I would suggest taxing all individual income — including dividends and capital gains — at ordinary income rates, adopting a mark-to-market regime for capital gains of the top 1 percent,[25] and reducing the corporate tax (if fiscally responsible) with no deferral, accelerated depreciation, or domestic manufacturing deduction (the three largest corporate welfare provisions). That — and not the Ryan-Brady or Trump plans — is an appropriate tax reform for Democrats to advocate in the "second Gilded Age." ■

[25]David S. Miller, "How Mark-to-Market Taxation Can Lower the Corporate Tax Rate and Reduce Income Inequality" (Oct. 20, 2015).

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