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# A Creditable VAT?

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## Introduction: The Bolivian Experiment

In the early 1990s, Bolivia tried to adopt a popular U.S. tax reform proposal: replacing its corporate income tax with a cash-flow-type consumption tax, broadly similar in structure to taxes proposed by a long line of theorists from Prof. William Andrews in 1974 to the President's Advisory Panel on Federal Tax Reform in 2006. Unfortunately, the Bolivian experiment ran into an insuperable obstacle: the U.S. foreign tax credit (FTC) rules. The U.S. Treasury decided that the Bolivian tax would not be creditable for U.S. corporations investing in Bolivia. Given the importance of U.S. foreign direct investment (FDI) for Bolivia, that was the end of the experiment.[1]

Why was the Bolivian tax ruled not creditable? The code does not put explicit limits on which taxes should be creditable, although it does refer to "income taxes."[2] Under the interpretive regulations, a creditable tax must contain three elements: It must be imposed on gross income (the gross income requirement), it must allow for deductions similar to those permitted under the U.S. income tax (the net income requirement), and it must incorporate a realization requirement.[3]

There are two basic ways of designing a cash flow tax, identified by the Meade Commission in the United Kingdom as the R (real) and R+F (real and financial) methods. Under the R method, all receipts are included in income and all expenditures are currently deductible, but financial transactions (borrowing and debt repayment) are ignored. Under the R+F method, loans are included in income and both interest and principal

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[1]Charles E. McLure and George Zodrow, "Creditability Concerns Doom Bolivian Flat Tax," *Tax Notes Int'l*, Mar. 11, 1996, p. 825.

[2]Section 901; *Biddle v. Commissioner*, 302 U.S. 573 (1938). For the historical background for this language, see Joseph Isenbergh, "The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes," 39 *Tax L. Rev.* 227 (1984); Glenn E. Coven, "International Comity and the Foreign Tax Credit: Crediting Nonconforming Taxes," 4 *Fla. Tax Rev.* 83 (1999). Taxes "in lieu" of an income tax can be creditable under section 903, and Treasury can by treaty render noncreditable taxes creditable. *See, e.g.*, the creditability of the Italian IRAP (a subnational tax similar enough to a VAT to raise an issue before the European Court of Justice) under the new Italy-U.S. treaty.

[3]Reg. section 1.901-2. None of those requirements apply to an in lieu tax.

payments are deductible. The net effect of the R and R+F methods is the same because the inclusion of loan proceeds in income is offset by the deductibility of principal and the interest deduction takes into account the time value of money between the borrowing and the repayment.

Bolivia initially proposed to adopt the R method tax as the simpler of the two, but the U.S. Treasury ruled that the tax would not be creditable because it does not allow for an interest deduction and thus violates the net income requirement. Bolivia then switched to the R+F method, which does allow for an interest deduction, but was told that this did not work either because the inclusion of loan principal in income violates the gross income requirement. Bolivia then gave up and retained its regular corporate income tax (which does not allow for expensing capital expenditures and is therefore much more complex than the cash flow tax).

I believe that result is unfortunate. Joseph Isenbergh proposed over 20 years ago that all taxes that are not royalties and are not offset by refunds or subsidies should be creditable, and I agree with him.[4] The creditability requirements significantly limit the ability of small developing countries like Bolivia that depend heavily on U.S. FDI to reform their tax system.

However, in this article I propose to use the Bolivian experiment to suggest another way in which a small developing country can benefit from the current U.S. rules. The most important tax in most developing countries is not the income tax, but the VAT. VATs are currently not creditable, but if they could be made creditable, that could provide a significant boost to U.S. FDI in developing countries.

## Designing a Creditable VAT

Why is the VAT not creditable? The problem is not the treatment of financial transactions: VATs do not include loan principal in income, and do allow a deduction for interest. VATs also fulfill the gross income requirement because they are imposed on gross receipts, and they fulfill the realization requirement because they are a consumption tax that depends on realization events.

The reason VATs are not creditable is simply that they do not allow a deduction for wages.[5] Not deducting wages can be a reason for disallowing an otherwise creditable tax, as the Russians discovered in the 1990s when they tried to limit the deduction for wages and were told that even by treaty that would make their corporate tax noncreditable (ironically, this happened about the same time the $1 million cap on deductible wages was enacted in the United States). Instead, Russia opted for taxing wages above the cap at 100 percent in the hands of the recipient.

But if that is the problem for the VAT, there's a simple solution: make wages deductible for VAT purposes, but impose a tax at the same rate on the wage recipient. In effect, all employees would become registered VAT taxpayers. Nor is it necessary to collect the VAT from the employees: The tax can be withheld and remitted by the employers because that certainly does not negate deductibility (otherwise no corporate income tax would be creditable because all corporate employers withhold on wages).

But, readers may object, what about the fact that the VAT is a consumption tax, not an income tax, and that the FTC under section 901 and *Biddle* is supposed to apply only to income taxes? The question is why the FTC is limited to income taxes, and the modern rationale is that they are direct taxes, borne by the taxpayer, whereas VATs are indirect taxes, borne by the consumer. Thus, the FTC is not needed to prevent double taxation in the case of VATs because they are shifted to the consumer.

However, that argument proves too much: If the condition for creditability were to prove that the economic burden of the tax falls on the taxpayer, most corporate income taxes would not be creditable, because it is notoriously impossible to prove that they are not shifted to consumers or employees. That's why the technical taxpayer rule requires only a showing that foreign law imposes legal liability on the U.S. taxpayer, not that the U.S. taxpayer actually bears the burden of the tax.[6]

In fact, I do not believe that there is a demonstrable difference in incidence between a VAT and a corporate income tax. If there were, corporate taxpayers all over the world would not spend huge resources on trying to avoid both. I believe the incidence of both depends on the market conditions faced by the taxpayer. But even if I am wrong, as a technical matter the FTC regulations do not depend on the economic incidence of the tax.

## The WTO Problem

The reader may now ask why this has not been tried. One reason may be that a VAT with a deduction for wages might not be border-adjustable (imposed on imports and rebated on exports) under the World Trade Organization export subsidy rules.

That, in fact, is the major problem with the tax reform panel's growth and investment tax (GIT) proposal. The GIT is a variation of David Bradford's X-tax, which is a corporate cash flow tax with a deduction for wages and a progressive rate structure imposed on the wage recipient. The panel argued that the GIT should pass WTO muster, because it is "equivalent to a credit-method VAT at a 30 percent rate, coupled with a progressive system of wage subsidies and a separate single-rate tax on capital

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[4]Isenbergh, *supra* note 2.

[5]Note that the technical reason the VAT is a consumption tax and not an income tax, namely the current expensing of capital expenditures, is not a problem for creditability — it was not an issue for Bolivia, or for the United Kingdom when it adopted current expensing of capital expenditures in its 1973 corporate tax reform.

[6]Reg. section 1.901-2(f). The FTC is allowed even when demonstrably the U.S. taxpayer does not bear the burden, as in gross-up provisions in loan agreements that shift any withholding tax to the borrower.

income. The Panel therefore believes that the Growth and Investment Tax Plan should be border adjustable."[7]

However, the panel clearly had misgivings about that conclusion, because it went on to state that "given the uncertainty over whether border adjustments would be allowable under current trade rules, and the possibility of challenge from our trading partners, the Panel chose not to include any revenue that would be raised through border adjustments in making the Growth and Investment Tax Plan revenue neutral."[8] That was a $775 billion difference, so it's a major problem with the GIT plan.

The panel was correct in its assessment that there might be a problem. General Agreement on Tariffs and Trade Article XVI prohibits subsidies "on the export of any product . . . which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market." However, a note to GATT Article XVI clarifies that the exemption of an exported product from taxes borne by the like product when destined for domestic consumption (such as zero rating exports for the VAT) "shall not be deemed to be a subsidy."

Article XVI was significantly expanded by the Subsidies Code included in the 1994 version of the GATT. The Subsidies Code defines a subsidy as including cases in which "government revenue that is otherwise due is foregone or not collected." To be actionable under the GATT, a subsidy must be "specific to an enterprise or industry or group of enterprises or industries." Also, a specific subsidy is prohibited only if it is "contingent, in law or in fact . . . upon export performance" or "upon the use of domestic over imported goods."

Annex I to the Subsidies Code includes an "illustrative list of export subsidies," which includes "[t]he full or partial exemption remission, or deferral specifically related to exports of *direct taxes* . . . paid or payable by industrial or commercial enterprises." What is a direct tax? Subsidies Code footnote 58 defines direct taxes to include income taxes and indirect taxes to include VATs.

The $775 billion question for the president's tax reform panel is thus: Is the GIT a direct or indirect tax? The GIT has three significant differences from a VAT: It uses the subtraction method, rather than the credit method; it allows a deduction for wages; and it imposes a separate tax on income from capital. Given those differences, which were all necessitated by the desire to make the GIT look more like an income tax, it seems unlikely that the GIT could survive a WTO challenge. Moreover, given that adoption of the GIT and abolition of the U.S. corporate tax would result in major shifts of capital from the European Union to the United States, such a challenge by the EU is exceedingly likely.

However, such a challenge is much less likely if a small developing country were to amend its VAT along the lines described above.[9] First, the impact on the world economy and the visibility of the reform would of course be much smaller than if the world's biggest economy adopted the GIT plan (which, unlike the small developing country, would require the United States to abolish the corporate income tax). Second, the only change from a traditional VAT would be the deductibility of wages; the VAT would be credit method and would not include a tax on capital income. Finally, under the WTO rules, a VAT is clearly border-adjustable but is not defined either in the WTO rules or in any WTO decision. Arguably, any tax labeled a VAT is border-adjustable under the WTO rules.[10] Thus, I do not believe there would be a WTO issue if a small developing country adopted a modified VAT along the lines described above.

### Proposal for a Small Developing Country

What would be the U.S. response if a small developing country tried to modify its existing VAT along the lines set out above (that is, making wages deductible to the employer for VAT purposes, but taxable to the employees at the same rate)?

Treasury would probably rule that the VAT is not creditable because (a) the FTC is limited to income taxes under section 901 and the regulations; (b) the VAT is a consumption tax; and (c) making wages deductible does not convert the VAT from a consumption to an income tax, especially because the effect of the deduction is arguably negated by imposing a withholding tax at the same rate.

Treasury might also be influenced by the thought of what would happen if other countries followed the small developing country's lead. Martin Tittle has estimated that if all VATs were creditable (subject, of course, to the section 904 limitation), that could lead to an annual revenue loss of $8 billion to $16 billion.[11]

But that's not the end of the story. Bolivia had to give up on its tax reform once the cash flow tax was ruled not creditable, because it was replacing a creditable corporate income tax. But the VAT is currently not creditable, so the small developing country would not lose anything by trying.

The next step therefore would be for a U.S. taxpayer with business operations in the small developing country to pay the modified VAT, claim the credit on its tax return, and take the IRS to court. Given the history of section 901 and the regulations thereunder, I believe there is a good chance the taxpayer would win and the modified VAT would be ruled creditable.[12]

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[7]Report of the President's Advisory Panel on Federal Tax Reform (2006), pp. 171-172.

[8]*Id.* at 172.

[9]In fact, the WTO export subsidy prohibition in SCM 3.1(a) never applies to least-developed countries and also does not apply to some developing countries that have requested relief. *See* Reuven S. Avi-Yonah and Martin B. Tittle, "Foreign Direct Investment in Latin America: Overview and Current Status?" Inter-American Development Bank (Dec. 2002).

[10]The tax reform panel could not call the GIT a VAT because of the negative political repercussions.

[11]Martin B. Tittle, "A Projection of the Maximum Revenue Loss From Foreign Tax Credits for Value-Added Taxes," (*forthcoming in Tax Notes International*) *see also* Martin B. Tittle, "U.S. Foreign Tax Creditability for VAT: Another Arrow in the ETI/E-VAT Quiver," *Tax Notes Int'l*, May 26, 2003, p. 809.

[12]For the history, see Isenbergh, *supra* note 2.

If that were to happen, other countries might modify their VAT in the same way. The United States would then have to either change the code and regulations to make the modified VAT not creditable, or accept the result.

Like Isenbergh, I believe the correct policy answer is that all foreign taxes that are not royalties, not refunded or subsidized, and not soak-up taxes should be creditable up to the section 904 limit because there is no meaningful difference between creditable and noncreditable taxes. Thus, I would argue that the United States should accept the result and grant the credit for all foreign taxes. That would have two positive results: It would mean that the United States will get out of the business of telling other countries what tax reforms they can or cannot adopt, and it could also lead to a significant increase in FDI to small developing countries in which the VAT is the main source of revenue.

Finally, such a result would mean that the EU would benefit because the United States would credit its VAT (if the EU modified it) while the EU would not have to credit the United States's (because the United States does not have one). That might make it more appealing for us to follow the rest of the OECD in adopting a VAT in addition to the income tax, which as I have argued elsewhere is a desirable step in its own right.[13]

[13]Reuven S. Avi-Yonah, "Risk, Rents, and Regressivity: Why the United States Needs Both an Income Tax and a VAT," *Tax Notes*, Dec. 20, 2004, p. 1651. If the United States did adopt a VAT, that would make it easy to raise much more than $16 billion.