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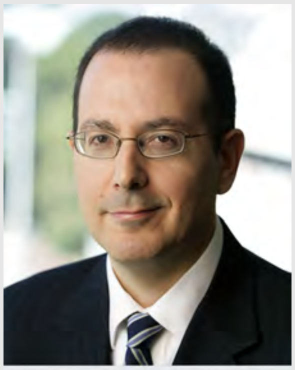

David M. Schizer

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This article is based on Schizer's keynote address at the 17th annual NYU-KPMG Tax Symposium on March 10.

In this article, Schizer argues that U.S. corporate and shareholder taxes need to be reformed, and the corporate rate should be much lower. In reforming this dysfunctional regime, according to Schizer, Congress should keep both of these taxes as a form of built-in redundancy; if one tax is avoided, the other can still be collected. More generally, Congress should be wary of Utopian solutions. Tax reform is more likely to change tax planning than to eliminate it entirely, Schizer concludes. For instance, although border adjustments would foreclose some strategies, they would encourage others.

The views in this article are the author's alone, and do not express the views of any institutions with which he is affiliated.

A litigator, a corporate lawyer, and a tax lawyer are at a funeral. The eulogy is beautiful, so they talk about what they want people to say at their funeral. The litigator says, "I hope they say I was a staunch advocate for my clients." The corporate lawyer says, "I hope they say that I got my clients the best possible deals." The tax lawyer says, "At my funeral, I hope they say three words: 'Look, he's moving.'"

For a long time, tax reform seemed to be dead, but now it is moving. This is a real opportunity that should not be wasted. This article focuses on a part of our tax system that is especially dysfunctional: the taxes on public companies and their shareholders. Most commentators agree that these rules are broken and that the United States should not have the highest corporate tax rate in the OECD.

But still, we should be precise about what the problem actually is. Three concerns are often emphasized, but only one of them troubles me. First, are we overtaxing U.S. companies? Although the 35 percent rate on the books is too high, firms usually pay a much lower effective rate, which the Government Accountability Office estimates as 12.6 percent on average.[1]

This brings us to the second concern, which does trouble me. Taxpayers change their behavior in problematic ways to avoid tax. For example, corporations shift profits overseas and keep trillions of dollars abroad. Would anyone deliberately design a tax system that discourages businesses from investing in the home country? Our system also treats firms in different sectors differently. It is a mistake to put a thumb on the scale in this way.

A third common concern is that public firms are taxed twice. The corporation pays one tax, and shareholders pay another. Yet as this article explains, this "double tax" should be viewed as a feature, not a bug.

So what is the right path forward? Congress should follow a three-part strategy. First, Congress should trade a low corporate rate for strict limits on familiar planning strategies. In this grand bargain, Congress should give U.S.

[1] GAO, "Corporate Income Tax: Effective Tax Rates Can Differ Significantly From the Statutory Rate," GAO-13-520, at 14 (2013).

companies the low rate they want, and should demand in return that they actually pay it.

Second, although fundamental change can be appealing, it should not be oversold. For example, advocates of border adjustments — which would tax imports and exempt exports — say this reform would allow the United States to have a high corporate rate, because a border-adjusted tax supposedly cannot be avoided.[2] But this is not the case. It is more accurate to say that a border-adjusted tax, such as the one proposed by House Republicans,[3] cannot be avoided with strategies that currently are pervasive, such as aggressive transfer pricing. But there will be new strategies. Although border adjustments would solve some problems, they would create others.

I am reminded of Antoine Lavoisier's Law of Conservation of Mass. He showed that mass is neither created nor destroyed in a chemical reaction; it just changes. This article offers an analogous principle: Schizer's Law of Conservation of Tax Planning. Planning is not eliminated in tax reform; it just changes.

So how should we respond to ever-shifting planning? The answer is the third component of the strategy that Congress should follow: base diversification. Congress should not rely on only one tax. Because every approach to taxing businesses has flaws, Congress should use more than one. Specifically, in addition to taxing corporations, Congress should continue to tax shareholders on dividends and capital gains.[4]

I. Advantages of Using Two Taxes Instead of One

Does it really matter whether Congress uses two taxes or one? At first blush, this seems unimportant. In taxing either corporations or shareholders, isn't Congress just taking money from one pocket instead of the other?

A. Different Planning: Firms and Shareholders

In fact, corporate and shareholder taxes are not interchangeable. Because these regimes define income differently, planning to avoid them is not the same. Therefore, corporations use one set of strategies, while shareholders use another. Repealing one tax avoids the distortions from that tax, but the other tax's distortions still remain. As a result, choosing which tax to impose is like navigating between Scylla and Charybdis.[5] Each causes distortions, and Congress is stuck with one set or the other.

To prove the point, let's start with two familiar ways to avoid a high corporate tax. The first is income shifting — earning income in jurisdictions with a low corporate rate. Estimates suggest the United States could be losing as much as one-third of its corporate tax revenue because of income shifting. Also, because sectors vary in their ability to shift income, the different effective tax rates across sectors distort capital allocation. Congress actually could solve these problems by repealing (or cutting) the corporate tax and replacing it with a higher shareholder tax. If the United States no longer has a corporate tax, firms would have no reason to shift income out of the United States. Notably, a high shareholder tax would not encourage firms to shift income. As long as shareholders are citizens or residents of the United States, they have to pay U.S. tax on dividends and capital gains, regardless of where the underlying corporate income was earned.

A second familiar response to a high U.S. corporate rate is that U.S. corporations change their tax residence to become foreign corporations. In doing so, they avoid U.S. tax on foreign earnings. As long as we have a high corporate tax rate, inversions are hard to stop, at least if Congress wants to allow cross-border mergers and acquisitions that aren't tax motivated. But if the corporate tax is eliminated or cut substantially, and this cut is funded with an increase in the shareholder tax, inversions would lose their appeal. A high shareholder tax won't motivate taxpayers to do inversions — U.S. shareholders would still pay tax on dividends and

[2] Alan Auerbach et al., "Destination-Based Cash Flow Taxation," Oxford University Centre for Business Taxation Working Paper 17/01, at 35 (Jan. 27, 2017).

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

[4] For a more comprehensive discussion of this idea, see David M. Schizer, "Between Scylla and Charybdis: Taxing Corporations or Shareholders (or Both)," 116 *Col. L. Rev.* 1849 (Nov. 2016).

[5] In *The Odyssey*, the Greeks had to sail between a man-eating monster (Scylla) and a deadly whirlpool (Charybdis).

capital gains, whether they invest in U.S. or foreign firms.

To deter income shifting and inversions, therefore, Congress might be tempted to repeal (or cut) the corporate tax and replace the revenue with a higher shareholder tax. Although that would solve those problems, Congress would face a different set of familiar problems as taxpayers seek to avoid shareholder taxes.

First, to avoid capital gains tax, shareholders could simply choose not to sell their stock. If they die holding it, or if they contribute it to charity, they would never pay tax on any appreciation in their shares. Second, firms could stop paying dividends. Indeed, if the tax rate inside the corporation is lower than the tax rate outside the firm (for example, the personal rate), money would grow faster inside, so taxpayers would not want to take it out. The corporation would function like an IRA. Third, under current law, tax-exempt shareholders do not pay dividend and capital gains taxes, while foreigners usually pay a reduced rate on dividends and pay no tax on capital gains. This is a significant issue, because estimates suggest that 75 percent of U.S. equities are held by tax-exempt and foreign shareholders.[6] An advantage of the corporate tax is that it reaches these shareholders indirectly (by taxing their share of a firm's earnings at the corporate level).

So to sum up: If we repeal the corporate tax and rely only on a high shareholder tax, firms would retain more earnings, and shareholders would defer selling stock. Tax-exempt and foreign shareholders would no longer pay tax indirectly through the corporate tax. To solve these problems, we could go back to the other end of the spectrum, eliminating the shareholder tax and relying only on the corporate tax. But then corporations would shift income abroad and change their tax residence. So we are navigating between Scylla and Charybdis. What should we do?

B. Tax Base Diversification

The answer is to keep both taxes. Initially, this may seem like a counterintuitive claim. If both taxes are distortive, isn't it better to get rid of at least one? It seems odd to contend that each tax is so flawed that we really need them both. But in fact, we need to diversify the tax base for three reasons.

The first is built-in redundancy. Engineers often rely on two systems, instead of one, for critical functions. In this spirit, an advantage of having two taxes is that if one is avoided, the other can still apply. For instance, when corporations avoid corporate tax by shifting income, shareholders still have to pay tax when they sell appreciated stock. Likewise, even if dividend and capital gains taxes do not reach tax-exempt shareholders, the corporate tax still taxes them indirectly.

A second reason to use both taxes is that repealing one of them is an overreaction. To deal with the distortions a tax causes, a rate cut often is sufficient. For instance, to stop income shifting, the corporate rate does not have to be 0 percent. Rather, 15 percent could be low enough because tax planning is not free. Taxpayers have to pay advisers and make changes that otherwise are not appealing. Given these costs, taxpayers will simply pay the tax if the rate is low enough.

Third, repealing a tax is not only an overreaction, but also a missed opportunity. After all, the government would like at least some revenue from the tax. Without this revenue, the other tax has to be even higher, and thus more distortive. For instance, if Congress does not collect any tax from corporations, it must collect even more tax from shareholders, which makes shareholders even more motivated to avoid dividend and capital gains taxes.

II. Balancing Corporate and Shareholder Taxes

In taxing both corporations and shareholders, Congress should coordinate the two taxes so that in the aggregate, Congress collects the combined rate that it wants. Ideally, the combined rate should equal the rate for passthrough businesses so taxpayers do not have a tax reason to favor one business form over the other.

[6] Steven M. Rosenthal and Lydia S. Austin, "The Dwindling Taxable Share of U.S. Corporate Stock," *Tax Notes*, May 16, 2016, p. 923 (estimating that taxable accounts held only 24.2 percent of U.S. equity in 2015).

A. Cutting the Corporate Rate

In addition to picking the right combined rate, Congress has to decide how to apportion this burden between corporations and shareholders. In striking that balance, Congress should use a lower rate for the more distortive tax. In my view, the corporate tax is especially distortive, so a 35 percent corporate rate is much too high. A 20 percent rate would be an improvement, and a 15 percent rate would be even better. To fund this cut, Congress should consider increasing the dividend and capital gains rate or, at least, not cutting that rate (which is now approximately 20 percent).

B. Shoring Up the Shareholder Tax

In deciding how high the shareholder rate can be — and, thus, how much the corporate rate can be cut — Congress should consider targeted reforms to make the shareholder tax less porous. Strategies for avoiding the shareholder tax are well understood, so a detailed discussion of reforms to plug these gaps is beyond this article's scope. But a few ideas should be mentioned briefly.

First, tax-exempt shareholders pay no dividend and capital gains tax, but are taxed indirectly through the corporate tax.[7] If Congress cuts this indirect tax, the lost revenue could be replaced with a new, direct tax. For example, Congress could impose a modest new tax of 10 percent on dividends and capital gains of tax-exempt shareholders.[8]

Second, as noted above, shareholders can avoid capital gains tax either by holding appreciated stock until they die or by contributing it to charity. To foreclose these planning opportunities, Congress could repeal the step-up in basis at death. Likewise, Congress could limit the charitable deduction for appreciated stock to the shareholder's basis.

Third, Congress could target this deferral with more ambitious reforms, such as mark-to-market accounting for publicly traded shares or an interest charge when shareholders sell. The advantages and challenges of these reforms are well understood, so they are not considered here.[9]

C. Shoring Up the Corporate Tax

Shoring up the corporate tax obviously would be desirable so that Congress would not rely solely on a rate cut to discourage avoidance of that tax. For instance, one familiar way to avoid the corporate tax is to capitalize the corporation with debt, because interest payments are deductible. To block this strategy, Congress could repeal (or limit) the interest deduction. For instance, the House plan would eliminate the deduction for net interest payments.[10]

Repealing the interest deduction would offer the important advantage of relying on two taxes instead of one. As long as a corporation can deduct interest payments, it is never taxed on the revenue funding these payments; instead, only the lender is taxed. For example, assume a firm earns $100, and uses it to pay $100 of interest to creditors. If the firm can deduct this $100 payment, it pays no tax. Instead, the lenders pay tax on $100 of interest income. This approach does not offer built-in redundancy. If lenders are tax exempt or foreign, U.S. tax is never collected on that revenue.

In contrast, if the interest deduction is repealed, tax would be collected from both the corporation and its lenders. For instance, if Congress wants a combined tax of 36.5 percent, it could reduce the corporate rate to 15 percent, repeal the interest deduction, and tax both interest and dividend income at the same 25 percent rate. Under this new system, a business's revenue generally would be subject to the same rate,[11] regardless of whether the business is capitalized

[7] To an extent, the incidence of the corporate tax may be on labor or consumers, instead of shareholders.

[8] While subsidies for charity are important, the deduction for charitable contributions arguably is a more effective subsidy than the exemption of a charity's investment income. *See* Schizer, "Subsidies and Nonprofit Governance: Comparing the Charitable Deduction With the Exemption for Endowment Income," Columbia Law and Economics Working Paper No. 558 (Feb. 10, 2017).

[9] For a more complete discussion, see Schizer, *supra* note 4, at 1891-1896.

[10] Blueprint, *supra* note 3, at 26 ("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.").

[11] If the firm earns $100 and pays $15 in tax, investors receive $85. After paying a 25 percent tax of $21.25, they have $63.75.

with debt or equity.[12] Obviously, there would be built-in redundancy. Also, because intercompany lending is often used to shift income to low-tax jurisdictions, repealing the interest deduction would make income shifting more difficult.

III. Border Adjustments

Yet even if firms could no longer use intercompany debt to shift income, they could still use other familiar strategies, such as transfers of intellectual property and aggressive transfer pricing.[13] While commentators have considered a number of responses to these strategies over the years, the House plan proposes a somewhat novel one — border adjustments[14] — which treat exports and imports differently.

Under a tax with border adjustments, a U.S. firm that exports goods or services could deduct its costs, but would pay no tax on export revenue. For example, if Exportco pays $60 to manufacture widgets in New York, and sells them for $100 in London, Exportco would have a $60 deduction and no taxable income.

In contrast, a U.S. firm that imports goods would pay tax in selling them in the U.S. market, but could not deduct the cost of these goods. For instance, if Importco buys gidgets in London for $60 and sells them in New York for $100, Importco would have $100 of taxable income and could not deduct its $60 cost.

Although border adjustments are a common feature of VATs, they have not generally been used in corporate taxes. Even so, House Republicans have included border adjustments in the destination-based cash flow tax (DBCFT) they have proposed. Border adjustments are a clear example of the Law of Conservation of Tax Planning. Although they would solve some problems, they would create others.

[12] If tax-exempts were subject to a 10 percent tax on interest and dividends from C corporations, the combined rate for these investors would be 23.5 percent. If the firm earns $100 of revenue and pays $15 of tax, the tax-exempt investors receive $85. After paying $8.50 in tax, the tax-exempts have $76.50.

[13] For a more complete discussion, see Schizer, *supra* note 4, at 1897-1901.

[14] Blueprint, *supra* note 3, at 27.

A. Advantages of Border Adjustments

On the positive side of the ledger, border adjustments would reduce the appeal of shifting a U.S. firm's income abroad and of changing its corporate residence. Border adjustments would allow Congress to score additional revenue. Congress also could take an ambiguous position on trade policy, which could appeal to supporters with competing views.

1. Income shifting.

Border adjustments obviously would change the tax rules for cross-border activity. The key issue would no longer be where economic value is created, but where that value is consumed.

Under current law, whether economic value is created in the United States or abroad is an important question. For example, assume a U.S. high-tech firm holds IP and a foreign manufacturing facility in a foreign subsidiary. This subsidiary sells smartphones to a U.S. subsidiary for $95 each, which sells them to U.S. consumers for $100. Under current law, although the $5 markup is taxed currently in the United States, the $95 of value created overseas generally is not. U.S. tax is deferred until the foreign subsidiary distributes this cash to its U.S. parent. Therefore, by generating economic value offshore and not bringing back the cash, U.S. firms can defer U.S. tax indefinitely. U.S. multinationals currently keep approximately $2.5 trillion of untaxed earnings overseas.[15]

In contrast, if border adjustments are introduced, the full $100 purchase price paid by a U.S. consumer would be taxed in the United States. In selling imported goods to U.S. consumers, a U.S. firm could not deduct the cost of an import (that is, the $95 paid to the foreign affiliate). So moving production offshore — by moving real activities or using planning strategies — would not reduce the U.S. firm's tax bill anymore.[16] On the contrary, the firm would be better off with domestic production because the costs would be deductible. This is a significant advantage of border adjustments, because income shifting is difficult to stop under current law.

[15] Jeff Cox, "U.S. Companies Are Hoarding $2.5 Trillion in Cash Overseas," CNBC Finance, Sept. 20, 2016.

[16] Auerbach et al., *supra* note 2, at 30-32.

A justification for border adjustments, then, is that firms could not move consumption abroad as easily as they currently shift production. Because the United States has the largest and most profitable consumer market in the world, firms would still want access to that market, even if they have to pay U.S. tax in order to do business there. With border adjustments, firms also would no longer have a tax reason to avoid repatriating cash.

2. Inversions.

Just as border adjustments would eliminate the advantage of shifting production, they would eliminate the advantage of shifting corporate residence. Under current law, the tech company described above has an incentive to become a foreign firm so the tax on its foreign earnings would be eliminated, instead of merely deferred, because foreign firms are taxed only on their U.S. earnings, while U.S. firms are taxable on their worldwide income (although they can defer tax on foreign earnings).

Again, border adjustments would eliminate this difference — sales to U.S. consumers are supposed to be taxed, regardless of where the seller is incorporated. As a result, corporate inversions would lose their U.S. tax advantage.[17]

3. Extra tax revenue from a trade deficit.

Some supporters of border adjustments also emphasize the extra revenue the system would raise. Because U.S. imports exceed U.S. exports, the tax revenue picked up from taxing imports would exceed the revenue lost from exempting exports. Given the size of the U.S. trade deficit, introducing border adjustments is estimated to raise more than $1 trillion dollars over 10 years.[18] Of course, this number could change if the trade gap narrows, which is a goal of the Trump administration. But as a matter of fiscal accounting — which has political significance in tax reform — the fact that Congress can score this revenue is a political advantage of border adjustments.

4. Ambiguous impact on trade.

Border adjustments can benefit from another political head wind as well. Because they tax imports and exempt exports, they seem to favor domestic production and exports over imports. President Trump's campaign endorsed this sort of trade policy, so the administration might ultimately accept border adjustments as part of its trade strategy (although they have not endorsed border adjustments so far, as the House of Representatives has).

Yet in theory, border adjustments actually should not favor exports and domestic production over imports because exchange rates are supposed to adjust to offset any difference in tax treatment.[19]

Specifically, if U.S. exports become more competitive — because no U.S. tax is imposed on them — foreign buyers should begin buying more U.S. exports. To do so, they would need U.S. dollars. But as more foreigners buy dollars, the dollar's value should rise. A more expensive dollar would weaken the competitive position of U.S. exports. As a result, this currency adjustment would offset the tax cut for exports.[20]

The mirror image should happen for imports. Border adjustments initially would make imports less competitive, because U.S. tax would apply to them (with no deductions for the cost of producing them). As a result, U.S. consumers should begin buying fewer imports and thus would have less demand for foreign currencies. In response, these currencies would become cheaper, which should reduce the dollar price of imports,[21] making them more competitive. This

[17] *Id*. at 32.

[18] David S. Miller, "How Donald Trump Can Keep His Campaign Promises," *Tax Notes*, May 22, 2017, p. 1105 (Part 1), and May 29, 2017, p. 1305 (Part 2).

[19] Auerbach et al., *supra* note 2, at 19-23.

[20] For example, assume a U.S. tech company sells smartphones abroad. The exchange rate is $1 per euro, and the firm wants to sell the phones in Europe for $100 (and, thus, for €100). Assume then that border adjustments are enacted, so the tech company no longer has to pay a 25 percent tax. As a result, the company can charge only $80, instead of $100, making U.S. exports more competitive. In response, European consumers buy more dollars. If the dollar's value increases by 25 percent — so $1 equals €1.25 — the $80 phone again costs €100. In other words, a 25 percent tax cut is perfectly offset by a 25 percent increase in the dollar.

[21] For example, assume a U.S. importer sells French wine in the United States. The exchange rate begins at €1 per dollar. This means a €100 bottle of wine sells for $100. If border adjustments are implemented, the U.S. firm can no longer deduct the cost of this import, and thus must pay a 25 percent tax. This means the cost is now €125. But this higher price reduces the demand for imports. If the euro weakens by 25 percent, so a euro now costs only 80 cents, a €125 bottle of wine would again sell for $100.

currency adjustment would offset the tax disadvantage of imports.

In other words, if border adjustments lead to a stronger dollar, this shift in exchange rates should reduce — and, in theory, fully offset — the advantage that border adjustments would otherwise create for exports over imports. A key question, considered below, is whether exchange rates actually would adjust fully. If they do, border adjustments would not favor exports and domestic production over imports. As a result, the tilt away from imports would be more symbolic than real. This actually could be a political advantage for those who do not really want to discourage imports but need to gesture in that direction for political reasons.

B. Problems With Border Adjustments

The advantages described above — and, in particular, the fact that income shifting and inversions would lose much of their appeal — are significant. But border adjustments should not be oversold. Because border adjustments would solve these problems, some advocates imply that they would solve all problems. Specifically, they claim that border adjustments would eliminate the pressure on countries to cut their corporate tax rates:

> The pressure to have a low rate of tax in order to compete with neighbouring countries disappears when all adopt a DBCFT, since . . . location decisions by business should be independent of the rates at which each levies its DBCFT. Each country could therefore raise its tax rate without fearing an exodus of either real economic activity or taxable profit.[22]

This is too optimistic. Even though border adjustments shut down some planning strategies, they create new ones.

To be clear, the goal here is not to say that border adjustments are fatally flawed, but to make two points. First, if Congress wants to enact border adjustments, these issues need to be addressed in order to head off unintended consequences. Second, in a tax with border adjustments, the corporate rate remains important. Border adjustments are not a magic bullet to allow countries to have as high a rate as they want. There would still be competitive pressures to cut the corporate rate — something the United States has to do. But in a border-adjusted system, these competitive pressures would manifest themselves differently.

1. Direct sales by foreign businesses to U.S. consumers.

A border-adjusted tax is supposed to reach imports. While the logistics are straightforward when a U.S. firm imports goods and sells them to U.S. consumers, the logistics become more difficult when U.S. consumers buy directly from foreign firms.

To see this problem, let's start with the easier case in which the importer is a U.S. firm instead of a U.S. consumer. For example, assume a U.S. tech firm pays $95 to a foreign firm for smartphones and sells them for $100 to U.S. consumers. With border adjustments, the U.S. tech firm pays tax on $100, without deducting the $95 cost.

However, this result becomes much harder to achieve if consumers buy directly from a foreign firm.[23] Under U.S. treaties, a foreign firm does not pay tax in the United States unless it has a sufficient presence — a so-called permanent establishment — in the United States. Online sales, for instance, would not qualify. Unless the United States renegotiates 68 treaties, or imposes a new excise tax directly on consumers, these goods would not be taxed.

Unless this issue is addressed, it could become a gaping hole in the tax base; indeed, tax could be avoided not only on imports, but also on domestically produced goods. For example, assume a U.S. tech company pays $40 to produce smartphones in the United States and sells them to an independent foreign firm for $99. Under a border-adjusted system, the U.S. firm would deduct $40 and would not be taxed on $99 of revenue, which is from an export. Assume the foreign firm uses a website to make online sales to U.S. consumers for $100 (that is, the foreign seller is an independent agent with no U.S. PE). Unless treaties are renegotiated or an excise tax is

[22] Auerbach et al., *supra* note 2.

[23] Miller, *supra* note 18, Part 1, at 1115-1116.

imposed, these goods — produced in the United States and eventually sold to U.S. consumers — would not be subject to U.S. tax. The "round trip" through a foreign agent eliminates the tax.[24]

Obviously, round trips are more appealing if the corporate rate is high. As a result, the tax rate would remain relevant in a system with border adjustments. Also, base diversification would continue to be important. If firms could avoid corporate tax by interposing a foreign agent, Congress would have all the more reason to tax the firm's shareholders, because dividend and capital gains taxes would not depend on whether profits were generated through exports or imports. In other words, even with border adjustments, two key recommendations of this article — built-in redundancy and a lower corporate rate — would still be necessary.

2. Defining an export.

Second, if exports are not taxed, U.S. firms obviously would want to classify goods and services as exports. As a result, more nuanced source rules would be needed to define exports. In principle, the test would presumably ask where a good or service is purchased. But is the key question where payment is made, where the good or service is used, or where the buyer's legal residence is?

As examples of the conceptual and practical challenges that would arise in this sort of inquiry, consider legal services and investment advice. Under current law, services are sourced based on where the service provider is. But in a destination-based system, the focus might instead be on where the client is. So what happens if a U.S. law firm provides legal services to a multinational incorporated in the Cayman Islands whose markets are in Europe and the United States, whose CEO is in New York, and whose general counsel is in London? Is this legal advice a tax-free export? Similarly, what if an asset manager living in Connecticut works for an asset management firm incorporated in Bermuda that has Asian investors? Is the asset manager's advice — and the management fee she earns (for example, 20 percent of profits) — an export?

Depending on the precise shape the rule ultimately takes, there could well be ways to treat these high-value activities as tax-free exports.[25] Again, the motivation to do so would be greater if the tax rate is high.

3. Exporters as tax accommodation parties.

A third planning strategy in a border-adjusted system, which David Miller has emphasized, is that exporters would become tax accommodation parties.[26] Because their U.S. costs would still be deductible, but their export income would be tax free, their exports would generate tax losses. Exporters obviously would be motivated to use these losses. For instance, they might merge with firms that have positive U.S. income or hold passive assets whose income would be sheltered.

Also, exporters might position themselves as trade intermediaries, buying imported goods and immediately selling them to importers. For example, if a U.S. tech firm exports phones to Europe, it would have deductions for the cost of producing phones, but no income from these exports. To use these deductions, the tech firm could buy wine from French wineries and immediately resell it to U.S. wine distributors. Because the phone manufacturer could not claim a deduction for the cost of this wine, which is imported, it would have taxable income in selling wine to U.S. wineries (which would be sheltered by deductions from its phone business). This helps the wine distributors, who would then have tax basis in the wine, because they would buy it from a U.S. firm (the phone manufacturer), instead of from a foreign producer. In this hypothetical, there obviously would be no business reason for a phone manufacturer to become a wine importer, but border adjustments would create a tax incentive to intermediate in this way. Again, the higher the tax rate, the more appealing this planning strategy would become.

4. Tax-free exports and the benefits principle.

Although the idea of exempting exports is inherent in a destination-based system with border

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[24] Under the OECD's approach to VATs, the question whether a sale is an export generally depends on a "nominal customer," without regard to the possibility of resale.

[25] Miller, *supra* note 18, Part 1, at 1120-1121.

[26] *Id*. at 1120, 1121.

adjustments, the case for forgoing tax on exports is debatable. In creating this economic value, firms benefit from services provided by the U.S. government. Under a "benefits theory" of taxation, these firms should share in the cost of those services.

Also, if the United States does not tax exports, other countries are likely to exert taxing jurisdiction over this activity. So the result might not be tax-free activity, but a transfer of taxing jurisdiction to other countries.

Moreover, even if Congress is willing to cede taxing jurisdiction for some exports, the analysis might be different for particular types of exports, such as oil and gas produced in the United States. Because the home country usually taxes the export of energy and other extractive industry products, the United States may want to adhere to this global practice.

5. WTO rules and retaliatory tariffs.

The House Republicans' proposal may violate WTO rules.[27] These rules do not permit less favorable treatment for imports. The issue with the House proposal is that it allows wage costs to be deducted for domestically produced goods, but not for imports.[28] If the WTO finds a trade violation, other countries are likely to introduce retaliatory tariffs on U.S. goods.

6. Different treatment for different sectors.

As noted above, if the dollar fully adjusts, the competitive position of imports and exports should not be affected by border adjustments. But there are at least two reasons why the dollar might not fully adjust (or, at least, why the adjustment could take time). First, the dollar is the world's reserve currency, so its value reflects a broad range of factors, of which border adjustments would be only one.

Second, the exchange rate could fully offset a tax only if the tax is imposed at a single rate. But the House proposal actually would not apply a single rate to the entire economy, because different rates are proposed for C corporations (for example, public companies) and passthrough entities (for example, partnerships). Because the exchange rate could fully offset only one of these tax rates, it could not offset border adjustments for every firm.

If the dollar does not fully adjust, border adjustments would in fact undercut the competitive position of imports and would give an advantage to exports (unless retaliatory tariffs are introduced). As a result, border adjustments would favor companies that generate exports (for example, high tech) over those that rely on imports (for example, retail). These differences across sectors could distort capital allocation.

To sum up, border adjustments are an intriguing idea, but not a magic bullet. Although they solve some problems, they create others. In response to this trade-off, a plausible approach is to develop responses to the challenges described above so Congress could reap the benefits of border adjustments while managing the costs. Alternatively, another plausible approach is to abandon border adjustments, on the theory that the complexity and the risk of unintended consequences are too daunting. Either way, a low corporate tax rate is still needed, and collecting tax from both corporations and shareholders is still advisable.

IV. Conclusion

In the coming months, Congress has an opportunity to fix our dysfunctional system for taxing public companies and their shareholders. Our corporate rate is too high, so it prompts all sorts of distortions. Congress ends up collecting a much lower effective rate, and firms change their behavior in undesirable ways to reduce their tax bills.

But the fact that we *can* do better doesn't mean we *will* do better. Congress should be wary of utopian solutions that claim to solve all problems. Even as reforms fix some glitches, they are likely to create new ones. So Congress should keep our tax base diversified by taxing both corporations and shareholders. Congress should reduce the corporate rate substantially, entering into a grand bargain to trade low rates for tougher rules that shut down familiar planning strategies. Fixing these flaws in our system is hard work. But if we can muster the political will to do it, we will have a better tax system and a brighter economic future. That would be an historic achievement. ■

[27] *Id.* at 1118.

[28] Notably, this issue does not arise for VATs, because they do not allow a deduction for wages. As a result, border adjustments are quite common in VATs and do not violate WTO rules.