Insight

Tax Topics – Destination vs. Origin Basis

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Pro-Growth Tax Reform and Trade

Over 160 Countries, including every OECD country except the United States imposes a Value-Added-Tax (VAT) or an equivalent.[1] OECD countries have increasingly relied on VATs and other consumption taxes on specific goods to finance their governments – collecting about a third of all revenue through these forms of taxation. The United States collects some federal revenue through consumption taxes – excise taxes – but otherwise relies on various levels of income tax to finance federal expenditures. Replacing the U.S. tax system with a new consumption tax regime would offer many growth incentives, but would also introduce some implementation challenges. One of the most important is how a consumption tax would interact with imports and exports.

The application of a consumption tax generally can be applied on an origin basis or a destination basis. The key distinction is whether the tax jurisdiction is asserted over production or consumption. An on origin-based tax applies to domestic production, whereby the tax is levied on domestically produced goods, including exports, but not imports. A destination-based tax applies to domestic consumption, with the tax levied on goods consumed domestically, with the levy applied to imports but not exports. The key feature of the latter principle is trade neutrality – goods compete in a given market on an even footing with the same level of tax applied equally.

A practical consideration animating this discussion is that the VATs of U.S. trading partners are also levied on a destination basis – U.S. goods are already subject to foreign VATs abroad. A move to a consumption tax in the United States should avoid the double-taxation of U.S. goods, which would occur if the U.S. imposed a consumption tax on its exports to countries with destination-based VATs, and move to a destination-based tax. Another attractive feature of a destination-based consumption tax is the avoidance of transfer pricing issues that animate U.S. international tax policy challenges under the current corporate income tax system. To achieve this reform, the tax would need to be applied to imports, while exempting exports, a process known as border adjustment.

TRADE-NEUTRALITY

Importantly, the goal of a destination-based tax system is *not* to subsidize exports or to raise the costs of imports like a tariff. A destination-based tax system imposes equal tax treatment on imports and domestically produced goods in its jurisdiction. with the same principal applying to exports consumed abroad where they face VATs imposed by other countries.

In a practical example, consider a U.S. consumer choosing between machines made in the U.S. and abroad. In the case of a pro-growth consumption-based tax reform, both would be exposed to a U.S. tax, and consumers would decide to purchase the machine for non-tax factors. The same principle would apply to U.S. goods abroad, where a destination-based U.S. tax would not be applied. The U.S. exports would face VAT taxes abroad, where it would compete on price and other non-tax factors. The tax is thus trade-neutral.

Importantly, tax is not the only, and is hardly the controlling influence on trade flows. While the implementation of a new destination-based tax system may introduce some short-term changes import and export flows – currency markets would offset any short-term restraint on imports or undue boost to exports.

Transfer Price Issues

Transfer pricing challenges animate much of the international tax debate, where large multinational firms must price interfirm transactions. A U.S. destination-based consumption tax would obviate this challenge.[2] Under the current income tax system, particularly exacerbated by the high U.S. corporate tax rate, U.S. firms have an incentive to shift income abroad. This can be accomplished through complicated, and legal, tax avoidance regimes that are costly to administer for firms, and reduce revenue in tax jurisdictions that might otherwise be reported. A destination-based tax system obviates the need to "locate" income abroad. Tax is levied on consumption in the domestic market, rather than reported income – such as that arising from intellectual property located offshore.

[1] http://www.oecd.org/tax/consumption-tax-trends-19990979.htm

[2] https://www.americanprogress.org/wp-content/uploads/issues/2010/12/pdf/auerbachpaper.pdf