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Federal VAT Could Be Harmful For U.S. Retirees

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Letters to the Editor

Federal VAT Could Be Harmful for U.S. Retirees

To the Editor:

I am both delighted and honored by Leif Mutén's letter regarding my FTC-for-VAT article: delighted that he has chosen to take issue with my proposal and honored to be in Gary Hufbauer's distinguished company when Mutén chooses to paint both of us with the same brush. (See *Tax Notes Int'l*, July 24, 2006, p. 303; see also *Tax Notes Int'l,* July 3, 2006, p. 41.)

Mutén raises several issues that warrant a response. In his third paragraph, he agrees with me that FTC for VAT would blur the distinction between direct and indirect taxes, and then he segues into statements about VAT not being an export subsidy. In my article, I mention the current WTO/GATT export subsidy rules, but I don't care whether the content of those rules is accurate or not. What interests me is that there is no bar, WTO or otherwise, to the U.S. allowing a capped FTC for VAT against U.S. income tax. To the extent that VAT credit helps simulate territorialism while allowing the rest of the U.S. tax system to remain as it is, it is a "good thing," regardless of the export subsidy status of VATs.

Next, Mutén says that while traditional views on the nonshiftability of income taxes and the shiftability of VATs are not absolute, they are "sufficiently clear to form the base of our WTO system." I agree that the current WTO rules reflect those views. However, far from being "sufficiently clear," the traditional direct-indirect distinction is outmoded, and the WTO rules based on it need to be changed. Today VATs and income taxes are just different ways to allocate the same tax burden. For that reason, I agree with Ways and Means Committee Chair Bill Thomas and others that this antique distinction in the WTO should be eliminated. If VAT credit helps achieve this result while performing its main function of emulating territorialism, so much the better.

In the middle of his letter, Mutén identifies three types of U.S. or U.S.-related firms that he says would not benefit from VAT credit: (1) firms like pharmaceutical companies that sell zero-rated goods (i.e., goods on which the VAT rate is zero); (2) firms based in one EU state that sell to a firm in another EU state;[1] and (3) financial services firms, which are usually exempt and therefore are not required to pay VAT.

I will address each of these three situations separately, but before I do, I have two general observations. First, as I note in the opening paragraphs of my article, VAT credit is an alteration to the U.S. worldwide system that can help that system emulate territorial results. If there are benefits of territorialism that it does not replicate in full, the

[1]In this case, the "reserve charge" procedure applies. The seller is not required to pay any VAT, and the purchaser self-assesses VAT at its home country rate. Reverse charge mimics what would usually happen if an EU merchant sold to a buyer in a country outside the EU: There would be no VAT due on the export sale, and, if the buyer's home country had a VAT and the buyer were a VAT-registered business, it would self-assess the appropriate VAT at the time of importation.

value of those benefits, and the possibility and cost of achieving them in parallel with VAT credit, need to be weighed against the costs of a total switch to full-fledged territorialism. Second, as the hypothetical on page 46 of my article illustrates, it may be necessary for firms to change some of the ways they do business to take full advantage of VAT credit.

Turning now to the three types of firms Mutén identified: In the case of firms that sell only zero-rated goods, Mutén's hypothetical could be correct. If those firms continue to sell nothing but zero-rated goods, they would not benefit from VAT credit because no VAT would be due on their sales. One of the tragedies of foreign tax credit systems has always been that if a firm pays no foreign tax, it gets no foreign tax credit.

The notion that those firms would continue to sell only zero-rated goods, however, is far-fetched. The reason is that the benefit of VAT credit vis-à-vis income tax would frequently be leveraged. A $100 sale with a 10 percent margin of profit will create only $3.50 of U.S. income tax liability if the tax rate is 35 percent, but that same sale would generate $20 of VAT at a VAT rate of 20 percent. Even if the cost of VAT-able inputs on the sale were $70, and therefore would generate input credit of $14 (20% x $70), there would still be $6 of net VAT liability due to the foreign government. That would be enough to zero out the U.S. tax and provide a cross-credit against the income tax due on other active, offshore income if the taxpayer were not already in an excess-VAT-credit position.

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In the case of firms in EU countries that buy from or sell to firms in other EU countries, and therefore are affected by the reverse-charge mechanism, Mutén's challenges are valid only in the narrow confines of his specifics. A sale subject to reverse charge creates no VAT liability for the seller, and for this one sale, the tragedy of FTC would apply: No tax paid equals no tax credit. As with the sale of zero-rated goods, however, it seems unlikely that this state of affairs would continue in a VAT-credit world.

For the reverse-charge purchaser, Mutén correctly states that, immediately after the purchase, there would be no creditable VAT because the reverse-charge VAT would be offset by the equal input credit that it generates. This zero-sum situation, however, lasts only until the purchaser incorporates the reverse-charge items in a future sale. At that point, the VAT that is due on the sale creates a positive VAT liability, and that VAT would potentially be creditable if the taxpayer were not already in an excess-VAT-credit position. This situation is analogous to the export-import hypothetical on page 46 of my article.

In the case of financial firms, Mutén seems to suggest that there would be a dispute over VAT credit between those firms and the suppliers who sell them VAT-able goods and services. Financial firms are frequently VAT-exempt, which means that they pay no VAT on the services they provide and, unlike firms selling zero-rated goods and services, cannot get a credit or refund of the input VAT they pay their suppliers. This situation causes them to build the cost of their input VAT into the services they provide, and that in turn creates a cascading problem if their services are used by other businesses that must pay VAT on their output.

Mutén says a financial firm "would in principle maintain that it is the real taxpayer," but my proposed standard that creditable VAT must be paid directly to a foreign government would negate this claim. Therefore, unless the firm changed its product mix, as it well might in light of VAT credit, it would not be able to claim VAT credit. The supplier to the financial firm, however, should be able to get credit for any net VAT it paid directly to the foreign government.

Mutén concludes his letter by saying that, rather than dismantling the WTO distinction between direct and indirect taxes, the better route would be for the U.S. to "join the club and introduce a proper VAT." One reason a VAT has not been enacted in the United States may be the harmful effect it would likely have on the current after-tax savings of U.S. retirees, including the amounts in their Roth IRA accounts.

The social safety net in the United States is markedly smaller than the social safety net in many other developed countries; if current political thought continues, it will become even smaller in the future. The solution for this regression is supposed to be the savings that individuals set aside during their working years.

If a federal VAT were enacted, people who have decades to go before they retire would have time to adjust to the new system and make the trade-offs between consumption and saving that could allow a comfortable retirement.

For current retirees and those very near retirement, however, there would be no opportunity to adjust. The purchasing power of their existing after-tax savings would be permanently diminished by the VAT, and the potentially offsetting effect of any income-related benefits could be limited or nil, depending on individual levels of income.

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To avoid that result, a transition regime would be needed. That regime might include a system of capital reporting that establishes the level of pre-VAT capital for each taxpayer and then allows refunds for payments of VAT that are properly allocated to preenactment capital. Implementation of that or any transition system is unlikely because it would necessarily make the tax system more complex, and without a budget surplus to fund transition refunds, it would also require a higher VAT rate. However, without some form of transition relief, the negative impact of a federal VAT on the buying power of retirees' after-tax savings might be too high a political price to pay for the advantages the VAT would offer. ◆

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