
Appendix D

Details of the Corporate Activity Tax

In this appendix, we outline features of CAT designed to avoid arbitrage on imports, handle taxation of capital assets with long lives, and deal with financial payments and receipts by nonfinancial firms. We also outline special rules for financial firms and rules for international financial transactions. Finally we underscore the basic parallel between CAT and VAT systems with respect to border tax adjustments.

In-Lieu-of Tax on Imports

To prevent arbitrage, import declarations must state whether or not the importer is subject to CAT. If the importer is not, an in-lieu-of tax, at the CAT rate, would be imposed. The WTO legality of the in-lieu-of tax is assessed in appendix C.

Capital Assets with Long Lives

No deduction, depreciation, or amortization would be permitted for the purchase of structures, patents, trademarks, copyrights, business goodwill, shares, or other assets with long or indefinite lives. Capital gains on the sale of such assets would be subject to CAT, and capital losses would be a deduction. In other words, only gains and losses in transactions involving defined capital assets would be subject to CAT, not the entire amount of receipts or expenses.

Financial Payments and Receipts by Nonfinancial Firms

Dividend, interest, lease, royalty, and insurance payments could not be deducted from the CAT base for nonfinancial firms. These are factor costs for using capital and technology, or the assumption of risk. Like wages and profits, they belong in the tax base. Moreover, allowing deductions for such payments would open the door for all manner of tax avoidance schemes. Conversely, nonfinancial firms would exclude such receipts from their CAT base, but only to the extent of similar payments to taxable US firms and households.

Special Rules for Financial Firms

Special rules would apply to financial firms, such as banks, leasing firms, and insurance companies. The IRS would vet the designation of a firm as a “financial firm.” Unlike nonfinancial firms, the rules on dividend, interest, lease, royalty, and insurance premiums would be reversed for financial firms. They would include receipts from US firms and households in the CAT base, and deduct payments to US firms and households. By this method, value added through financial intermediation and risk pooling in purely domestic transactions would be subject to CAT. However, receipts from and payments to foreign parties would be treated the same for nonfinancial and financial firms to prevent tax arbitrage between them—as the next paragraph explains.

International Financial Transactions

The rules on international capital, technology, and risk payments would be designed to ensure that the US Treasury collects CAT on all payments to foreign recipients. Payments by US firms to foreign firms for the use of capital (dividends, interest, and rents), technology (royalties), and the assumption of risk (insurance premiums) would not be deducted from the CAT base. Conversely, the same territorial principle would apply to capital, technology, and insurance receipts from abroad. These receipts would be treated just like receipts from the export of goods and other business services: When received by US firms, they would not be included in the CAT base.¹ Special rules would prevent tax shelter firms

1. While financial receipts from abroad would not be included in the CAT base, financial payments to US households (directly or through pass-through entities) would be taxed as individual income. Our proposed rules mean that any US value added from balanced financial receipts from and payments to foreign parties would not be subject to CAT. Such financial transactions are classically footloose, and the rules simply acknowledge the reality that if the United States tried to tax such business income, the activity would quickly move abroad.

based abroad from accumulating or distributing foreign dividend, interest, and royalty income to US individuals on a tax-free basis.²

Parallel with VAT Border Tax Adjustments

Just as with VAT taxes imposed by other countries, exports of goods and business services to foreign buyers are excluded from the tax base, and imports purchased from foreign suppliers are not deductible. These rules build border tax adjustments into the tax base for cross-border transactions in goods and business services. They ensure that firms have no tax motivation to locate production abroad, or engage in offshore outsourcing, to service the US market.

2. The special antiavoidance rules would be patterned after the Personal Holding Company rules currently in the Internal Revenue Code. To deter tax evasion, particularly by individuals, the United States should extend the scope of its information sharing with foreign tax authorities.