TAX PLANNING UNDER THE
DESTINATION BASED CASH FLOW
TAX: A GUIDE FOR POLICYMAKERS
AND PRACTITIONERS

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I. INTRODUCTION

This essay describes some basic tax-planning strategies under the destination based cash flow tax (DBCFT) proposed as part of the “Blueprint” published by the Committee on Ways & Means of the House of Representatives. 1 This article is designed first for policymakers so that they can either correct or confirm the strategies I describe, and second for the practitioners and taxpayers that will navigate the DBCFT if it is enacted.

A central theme of the discussion that follows is that the DBCFT contained in the Blueprint is not the “pure” DBCFT proposed by economists.2 Instead, it is a hybrid that incorporates aspects of the pure DBCFT, but also elements of our current income tax. Many of the planning opportunities under the DBCFT arise because of its hybrid nature.

II. TAX PLANNING UNDER THE DBCFT

A. Generating Deductions

Tax planning under an income tax system is based upon maximizing deductions and avoiding or deferring income. To illustrate, assume a U.S. pharmaceutical company (currently subject to a nominal U.S. corporate tax rate of 35%) has an Irish subsidiary (currently subject to a nominal rate of 12.5%). Under current income tax law, the U.S. parent would seek to transfer intellectual property to its Irish subsidiary at a low transfer price, develop the intellectual property substantially using personnel located in Ireland, and have the Irish subsidiary receive royalty payments from unrelated parties that would not be Subpart F income.3 The U.S. parent would report any gain on the initial sale, but could defer the subsequent profits of the Irish subsidiary indefinitely.

2 See Auerbach, et al., Destination Based Cash-Flow Taxation 17 (Oxford U. Ctr. for Bus. Tax’n, Working Paper No. 17/01, 2017). When I refer to the DBCFT, I mean the one in the Blueprint. I refer to the one proposed by economists as the “pure” DBCFT.
3 See Temp. Treas. Reg. § 1.954-2T(c)(3)(i) (exempting royalty income earned with respect to property to which the foreign subsidiary has “added substantial value” if “regularly engaged in the development, creation, or production of … property of such kind”).

All references to section numbers are to the Internal Revenue Code or its regulations.
Under a DBCFT, generating deductions onshore would remain an important tax planning strategy, but the tools to accomplish this strategy would change. For example, interest could no longer be used to strip earnings, but deductions could be generated by making capital investments that may be immediately expensed. For example, a taxpaying company operating under a DBCFT could generate deductions by buying business assets and leasing them (especially to companies (like exporters) that could not use the deductions that would be generated from purchasing the equipment). Likewise, a taxpaying company could buy a building, and lease it back to the seller. The purchase of the building would generate a deduction, which could shelter other income.

Returning to the example above, if the DBCFT is enacted, the U.S. pharmaceutical company’s strategy would be reversed. The U.S. parent would fully develop the intellectual property in the United States with its own employees. Their salaries would be deductible.

B. Excluding Income from Exports

Under a DBCFT, exporting products, services, and intangibles abroad is even more important than deferring income because the proceeds would be exempt under the tax’s border adjustment feature. Exporting may be accomplished by providing products, services, and intangibles to a foreign customer, but also to a foreign affiliate. The Blueprint appears to respect the residence of entities, and because the corporate residence of a client or affiliate is effectively elective, there are plenty of tax planning opportunities to create exports.  

C. Transforming an Onshore Brick and Mortar Importing Business into an Online Direct-Order Business Conducted by a Foreign Subsidiary

Next, consider a U.S. corporation that is in the domestic retail sales business. It buys all of its products domestically at wholesale prices and sells them at retail prices to U.S. customers. Now assume that this U.S. corporation organizes a wholly-owned Irish subsidiary that qualifies for the benefits of the U.S.-Irish tax treaty. The Irish subsidiary could buy the products from its U.S. parent, and then sell the products directly to the customers of its parent, with the assistance of an independent agent located in the United States. Under the

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4 The OECD’s International VAT/GST [goods and services tax] guidelines would also respect the sales of services and intangibles to the immediate buyer without looking through to subsequent users. See Chapter 3 of the International VAT/GST Guidelines, OECD (Nov. 2015), http://www.oecd.org/tax/consumption/international-vat-gst-guidelines.pdf [perma.cc/K53K-YZK3].
Blueprint, the U.S. corporation could exclude the gross proceeds from the export to its Irish subsidiary. The Irish subsidiary would avoid U.S. federal income tax because it would not have a permanent establishment in the United States by reason of all activities being conducted through an independent agent.\(^5\) In fact, because the Blueprint would repeal the foreign base company sales rules,\(^6\) the Irish subsidiary's profits would not be Subpart F income and could be repatriated tax-free to its U.S. parent. Thus, under the Blueprint, the U.S. parent could avoid all U.S. federal income tax.

To prevent this outcome, the United States would first have to dramatically expand its extra-territorial taxing powers to impose a 20% excise tax on the price of goods, services and intangibles sold by any foreign entity directly to a U.S. consumer, regardless of whether that entity has a physical presence in the United States. Additionally, the United States would have to modify tax treaties to permit the United States to impose tax on a resident of a treaty jurisdiction that sells into the United States, even if the resident does not have a permanent establishment in the United States.\(^7\) Enforcing these powers would be very difficult. Convincing our treaty partners to agree to these changes will be equally difficult.\(^8\)

D. Earnings and Profits Under the DBCFT

Assume that a U.S. corporation, in its first year of operation, receives $100 from exports, and has total costs of $85 (but no imports). It earns economic income of $15, but has a tax loss of $85 (because it is able to exclude the $100 of export revenue). Now assume the corporation distributes all of its revenue. Under our current income

\(^5\) See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, U.S.-Ir., art. 5, July 28, 1997, S. TREATY DOC. NO. 105-31 (1997); Id. at art 6 (an enterprise does not have a permanent establishment merely by carrying on business through a broker or agent of independent status); Id. at art. 7 (profits of an enterprise are taxable by the other contracting state only if carrying on business through a permanent establishment situated in that state). Best Buy argues that China’s Alibaba would be able to avoid the tax by making sales online and shipping to U.S. consumers directly. Ginger Gibson & David Shepardson, *How Toyota, Target, Best Buy are Fighting Back Against Republican Border Tax Push*, REUTERS (Jan. 31, 2017), http://www.reuters.com/article/us-usa-trump-companies-tax-insight-idUSKBN15F0FK [perma.cc/7QDX-AC4G].

\(^6\) Supra note 1 at 29.


tax system, if a corporation has a tax loss in its first year of operation and makes a distribution, the distribution is treated as a return of capital (because generally a tax loss also means a deficit in earnings and profits). What result under the DBCFT?

The Blueprint is silent but my guess is that distributions, to the extent of earnings and profits (determined under current rules), would be treated as dividends. If the dollar appreciates to neutralize the effect of a DBCFT, and exporters can fully use their losses, then importers, exporters, and wholly domestic businesses should have the same amount of after-tax income after a border adjustment as they did before the enactment. In that case, the shareholders who receive equal distributions from equally profitable start-up companies should be taxable the same, regardless of whether the companies are importers, exporters, or wholly domestic. Shareholders would be taxable on an income tax basis with respect to their investment income under the DBCFT, and so dividends should be determined under the same rules as today.

However, to achieve this result under the DBCFT, corporations would have to keep two tax books. One set of books would be kept on a cash flow basis to determine corporate-level tax. The second would be on an income tax basis to determine earnings and profits. As explained in the next part, the retention of the earnings and profits concept permits tax planning opportunities that do not exist under a “pure” DBCFT.

E. Using Corporate Inversions

Corporate inversions will still have benefits under the Blueprint. For example, an Irish parent could raise debt financing (and deduct the interest) to fund its U.S. subsidiary’s deductible capital investments. The U.S. subsidiary could develop intellectual property and sell the foreign rights to the Irish parent on a tax-free basis, and the Irish parent would amortize the purchase price and deduct the interest to reduce its earnings and profits. For example, assume that the Irish parent borrows $1,000 to buy its U.S. subsidiary’s intellectual property. Assume the U.S. subsidiary has more than $100 of earnings and profits. In a taxable year, the Irish parent has $100 of original issue discount and the U.S. subsidiary pays a dividend of $100 to its Irish parent which, in turn, pays the amount to its U.S. shareholders. Had the Irish parent not existed, the dividend would have been taxable

9 Of course, this begs the questions about how earnings and profits would be determined under a DBCFT. Would today’s rules be used, would the rules measure earnings and profits based on an economic income basis, or would investments be expensed and interests denied?
to the U.S. subsidiary’s U.S. shareholders, or subject to U.S. withholding tax on payment to its foreign shareholders. However, in the year of the dividend, the Irish parent has no current or accumulated earnings and profits (the $100 dividend received is offset by the $100 of original issue discount expense) and so the dividend it pays its shareholders would be a nontaxable return of capital.

In fact, this strategy is equally available to a nonconsolidated U.S. parent company that receives a dividend from its U.S. subsidiary. The U.S. parent would have no net income by reasons of the dividends-received deduction, and the original issue discount deduction would offset its dividend income for earnings and profits purposes. The U.S. parent could distribute the dividend it receives to its U.S. shareholders without income tax or to its foreign shareholders without U.S. withholding tax.\(^\text{10}\)

F. Using Transfer Pricing to Import at a Low Cost

One of the principal benefits of a DBCFT would be to remove the incentive for U.S. multinationals to sell intellectual property at low-transfer pricing rates to affiliated Irish (or other low-taxed treaty-eligible) companies. However, for those U.S. multinationals that had previously transferred U.S. intellectual property to their offshore subsidiaries and would need to license it back, under the DBCFT, the royalty payments would be nondeductible import expense and, to add insult to injury, the income of the subsidiary would be Subpart F income. These U.S. multinationals would seek to pay a low transfer-pricing royalty rate. Therefore, the DBCFT does not avoid transfer pricing; it merely changes the situations where transfer pricing matters.

G. Generating and Using Export Losses

Under the DBCFT, exporters would generate losses that they will be unable to use. Exporters will therefore become acquisition targets for importers that are denied deductions for their imports (and vice versa).\(^\text{11}\) These would be acquisitions principally for tax reasons – the DBCFT’s version of an inversion. Also, the DBCFT would encourage exporters to buy importers’ goods directly from abroad, and

\(^{10}\) I thank Michael Schler for this example.

sell them to the importer.\textsuperscript{12} Because the exporter would not receive a deduction (or basis) for the imported goods, this strategy would allow the exporter to use its tax losses and effectively sell those losses to the importer.

H. Converting Carry from Foreign Investors into Tax-Exempt Export Income

A DBCFT would also provide a windfall for managers of Cayman Island funds. Currently, fund managers receive a relatively small fixed management fee (say 2\%) of assets under management and a larger carried interest (say 20\% of gains) that potentially benefit from long-term capital gains rates. Under a DBCFT, a U.S. hedge fund manager would seek to restructure its compensation entirely as contingent fees for services provided to foreign investors.\textsuperscript{13} All of these fees would be excludible exports (and not at all at taxed).\textsuperscript{14} Additionally, unlike consumer goods, this exported service would not reflect any dollar appreciation because both parties would be transacting in dollars.

The question then arises whether the Blueprint will treat services provided to a Cayman Islands fund that is entirely owned by U.S. pension plans as provided to a foreigner (so entirely exempt) or to the beneficial U.S. owners (so fully taxable).\textsuperscript{15} Compensation received from taxable domestic investors would remain structured as carried interests (unless the income would be exempt if restructured as fees received from a Cayman Islands corporation owned by these investors). All expenses from salaries and overhead (used to generate both excludable and taxable amounts) could be used to offset taxable amounts.

In addition, under the DBCFT, lawyers who set up funds for U.S. money managers would no longer be paid by the managers but instead would be paid by the foreign funds to avoid tax on their fees (or at least the portion attributable to the foreign investors). Likewise,

\textsuperscript{12} Michael Schler originally suggested this strategy.

\textsuperscript{13} If the DBCFT does not look through entities, then this strategy would be equally effective for tax-exempt or taxable investors that invest through a Cayman corporation.


\textsuperscript{15} For more examples, see Hariton, \textit{supra} note 8.
if a foreign parent purchases a U.S. corporation, the law firm will prefer to be paid by the foreign parent, rather than the target.


Because the DBCFT applies a cash-flow tax to physical and intangible assets but an income tax to financial assets, taxpayers would be able to expense their purchase of capital assets (like equipment) but not financial assets. Therefore, a financial investor might be expected to shift his investments from financial assets to physical and intangible assets (at least until the difference in potential return offsets the tax savings).

Likewise, a U.S. corporation considering the purchase of a domestic target will have an even greater incentive than under current law to structure the acquisition as an asset purchase rather than a stock purchase because of the immediate deduction for equipment and improvements.

J. Using Affiliate Sales to Achieve a Tax-Free Step-Up

The entirety of the U.S. international income tax system is based on taxing outbound transactions and exempting inbound ones. That system would be upended by the Blueprint. If a DBCFT is enacted, most outbound transactions would become exempt (as exports), but the rules would have to be changed to tax what are now tax-free inbound contributions (as imports). Otherwise, a U.S. subsidiary could sell inventory to its foreign parent, and the foreign parent could contribute the inventory to another U.S. subsidiary in a section 351 transaction. If the second U.S. subsidiary received the parent’s fair market value basis in the inventory, the second subsidiary could then sell the inventory in the United States and pay no tax. A similar opportunity may exist for land, which is not subject to the DBCFT. Conversely, an inbound section 351 transaction would have to be treated as an import for which the subsidiary could not receive basis or claim a deduction. Under a pure DBCFT, these changes would not be necessary because basis does not exist under a pure DBCFT. But the Blueprint’s DBCFT does retain the LIFO method of accounting for inventory, and excludes land.

K. Using Partnerships to Sell Export Losses to Importers

Assume that a domestic partnership has two businesses: A domestic sales business and an exporting business. Each business earns revenues of $100, pays wages of $20, and purchases domestic inventory of $30.
Each business has pre-tax profits of $50. However, the export business generates a tax loss of $50, which is worth $10 based on a 20% tax rate. The domestic business has taxable income of $50 and pays tax of $10. On a combined basis, the partnership earns after-tax profit of $100. However, the domestic business pays tax of $10 and the exports business generates a loss of $50 (worth $10), so the combined business pays no tax.

<table>
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<th></th>
<th>Revenues</th>
<th>Wages</th>
<th>Inventory</th>
<th>Pre-Tax Profit</th>
<th>Tax</th>
<th>After-Tax Profit</th>
</tr>
</thead>
<tbody>
<tr>
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<td>-20</td>
<td>-30</td>
<td>50</td>
<td>10</td>
<td>40</td>
</tr>
<tr>
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<td>-20</td>
<td>-30</td>
<td>50</td>
<td>-10</td>
<td>60</td>
</tr>
</tbody>
</table>

Let’s assume that one partner is allocated all of the pre-tax economic income from the domestic business and the other is allocated all of the pre-tax economic income from the export business, and they agree to share the tax in accordance with relative profits. Since each business had the same pretax profit and, as a whole, the business paid no tax, they distribute 50 to each partner.

Although this allocation would appear to have substantial economic effect under current law, I suspect that it wouldn’t be allowable under the Blueprint. This partnership is a “splitter”. The tax benefit (exclusion of export income) is intended for exporters. Exporters are not entitled to refunds of their tax losses, and they must have income under the DBCFT in future years to use then. Presumably, the drafters of the Blueprint didn’t intend for exporters to be able to sell their losses.\(^\text{16}\) In this case, only the partner who is allocated the economic income from exporting should be entitled to the tax benefits from that activity. The domestic partner should be distributed $40 and the exporting partner $60. It also becomes clear from this example that tax does not follow book under the DBCFT. Capital accounts are an economic income concept; the DBCFT is not. Likewise, the allocation of an exporting tax loss to a partner should not reduce that partner’s basis. Otherwise the exclusion would become a mere deferral.

L. Tax-Exempt Entities

Under our current income tax system, tax-exempt entities avoid tax on income from the activities that are related to their tax-exempt status. However, under the DBCFT, exporters would pay no

\(^{16}\) This is another example where a “pure” DBCFT varies from the Blueprint’s version. A pure DBCFT would allow exporters a refund or, at the very least, allow the loss to offset payroll taxes.
tax and would receive deductions for their costs. For tax-exempt organizations that are also exporters, under a DBCFT, it would be better to be taxable than tax-exempt.

Assume that a U.S. university develops a video-based degree for which it receives tuition and fees from foreign students. Because under current law the tuition and fees are exempt from tax, it makes more sense for the university to operate the video-based degree business as tax-exempt and neither pay tax nor generate deductions.

Under the DBCFT, the university would have an incentive to contribute the business to a taxable subsidiary. The taxable subsidiary would not pay any tax and would generate tax losses from the export business, even if the business were profitable. The university could also contribute to the taxable subsidiary assets that generate unrelated business taxable income and the subsidiary’s losses could be used to help to shelter what would otherwise be taxable to the university.

M. Using U.S. Corporations as Tax Shelters

Under a DBCFT, U.S. corporations would become a tax shelter for wealthy shareholders. First, under the rates proposed by the Blueprint, there would be an increase in the disparity between the corporate rate and the top individual rate (13 percentage points as compared to under 9 percentage points today). Second, exporters would be in perennial loss positions. Shareholders could contribute their investment assets to their export companies and use the export losses to reduce the tax rate on their investment earnings to zero. The personal holding company rules and accumulated earnings tax attempted to prevent this practice, but were notoriously unsuccessful.

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17 See I.R.C. § 512 (2015) (excluding royalties from definition of “unrelated business taxable income” on which an otherwise exempt organization may be subject to tax).
18 I thank Richard Upton for his comments on this section.
19 The top marginal rates under the Blueprint for individuals and corporations, respectively, are 33% and 20%. See supra note 1, at 17, 25.
N. Preserving Interest Deductions

Under the DBCFT, net interest deductions are denied. However, if the DBCFT were simply incorporated into our existing income tax system, taxpayers would be able to achieve the functional equivalent of a deduction for interest.

Assume that an individual investor holds an interest in a domestic feeder fund that is treated as a partnership for U.S. federal tax purposes. The domestic feeder fund, in turn, invests in a leveraged hedge fund that is also treated as a partnership. Under the DBCFT, interest deductions would be denied for the hedge fund’s interest expense. However, if the taxpayer were instead to invest in a foreign feeder fund that is a controlled foreign corporation (“CFC”) or a passive foreign investment corporation (“PFIC”) that has made a qualified electing fund (“QEF”) election, and the foreign feeder fund invests in the hedge fund partnership, then the interest expense of the hedge fund partnership would reduce the earnings and profits of the foreign feeder fund, which could include interest, dividend income, and capital gains. Through this mechanism, interest expense, which is only supposed to offset interest income, could offset other income as well.

Alternatively, the taxpayer could use any of a number of financial instruments that are not characterized as indebtedness (and therefore do not generate interest expense) but contain time value components. For example, a contract that provides an up-front payment for the obligation to deliver commodities or publicly-traded security in the future contains a significant time value component, which would offset income on the delivery but would not be treated as interest. If interest deductions are denied, these and similar arrangements could be used to achieve the effect of an interest deduction.21

On the other hand, for a taxpayer that does incur interest expense, interest income would be desirable because interest expense could be deducted only against interest income. Under current income

21 It is possible that the Blueprint intends to deny interest expense only for borrowings that are used to buy property that is expensed. This would be consistent with the purpose behind the denial – to treat the marginal effective rate of new investment to be zero. The Blueprint retains an income tax for financial assets, and so it would be consistent to allow interest deductions for debt used to purchase financial assets. Then interest would be entirely disallowed on debt used to purchase expensed property (and not allowable to the extent of interest income), and entirely allowable with respect to other debt (and not limited to the extent of interest income). However, because money is fungible, tracing rules would be easy to avoid.
tax law, taxpayers have quite a lot of flexibility to combine various financial instruments with debt, and create a single debt instrument that generates only interest income.

For example, assume that a taxpayer has excess interest expense. The taxpayer wishes to purchase both a $1,000 bond from a financial institution and a $100 at-the-money option with respect to the stock of a publicly-traded company. The taxpayer could combine the two instruments into a single contingent payment debt instrument (“CPDI”): The taxpayer would advance $1,100 to the financial institution and receive back at maturity $1,000 plus the increase in the value of the publicly-traded company. Although the taxpayer’s economics would have not changed, the taxpayer’s entire return on its combined investment would be interest income, which could be offset by the taxpayer’s excess interest expense. Had the taxpayer instead kept the two investments separate, gain on the option would not be treated as interest income.

O. Foreign Companies Could Move to the United States to Receive a Subsidy

Foreign companies that make goods and sell them abroad and whose employees are in the 15% tax bracket could receive a U.S. subsidy by moving their operations to the United States, claiming a deduction for wages taxable at a 20% rate, and paying workers taxable at 15%.

P. Low-Cost Insurance in the Event of Repeal

Proponents of the DBCFT argue that under the DBCFT, there would be no reason for a U.S. parent to transfer intellectual property to its offshore subsidiary because foreign royalties received directly by the U.S. parent would be exempt. However, the drafters of the DBCFT assume that the DBCFT will remain in effect forever. They are correct that if that were the case, there would be no reason for U.S. multinationals to transfer intellectual property to treaty-eligible, lower-taxed affiliates. However, if a DBCFT is enacted, there would remain a meaningful risk that it will be repealed or modified the next time that Democrats control the government, or when the United States has a trade surplus.22 Even if there would be no immediate benefit to transferring intellectual property to low-taxed foreign affiliates under a DBCFT, doing so would provide low-cost insurance against a future reversal of U.S. tax policy. Therefore, it is no stretch to predict that

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22 This would be more likely if the DBCFT sunsets after ten years in order to pass through reconciliation.
enactment of a DBCFT will lead to the largest tax-free exodus of U.S. intellectual property ever.

Because a sale by a U.S. multinational to its Irish subsidiary would be exempt from U.S. tax, the U.S. multinational would seek to maximize the transfer sales price. This would allow the Irish subsidiary to amortize a high purchase price and use the amortization to generate deductions for Irish tax purposes. (Ireland does not have a DBCFT, so the Irish subsidiary could amortize the “import”.) The U.S. multinational might also have the Irish subsidiary borrow to finance the initial purchase of the IP to generate interest deduction. This would also generate deductions for Irish tax purposes. Although the Blueprint would deny a U.S. parent net interest expense deductions, it does not appear to prevent the U.S. parent’s Irish subsidiary from using interest deductions to reduce its own earnings and profits and shelter any Subpart F income.

III. CONCLUSION

The Blueprint promises a simpler tax code. This will be a broken promise. A DBCFT won’t be simpler than our income tax, but the complexity will change. The new tax planning strategies will include (i) generating deductions by making capital investments, (ii) exporting goods, services and intangibles to related parties, (iii) selling excess losses, (iv) using the earnings and profits rules to effectively deduct interest expense, (v) using aggressive transfer prices to minimize imports, (vi) converting carry to tax-exempt foreign services income, (vii) using partnerships to sell losses, (viii) using the for-profit the subsidiaries of tax-exempt entities to generate losses, (ix) using a U.S. corporation as a tax shelter, and (x) transferring intangibles abroad in anticipation of the eventual repeal of the DBCFT.

23 Blueprint, supra note 1, at 6, 15, 16, 26, 30, 31, 32, 34.