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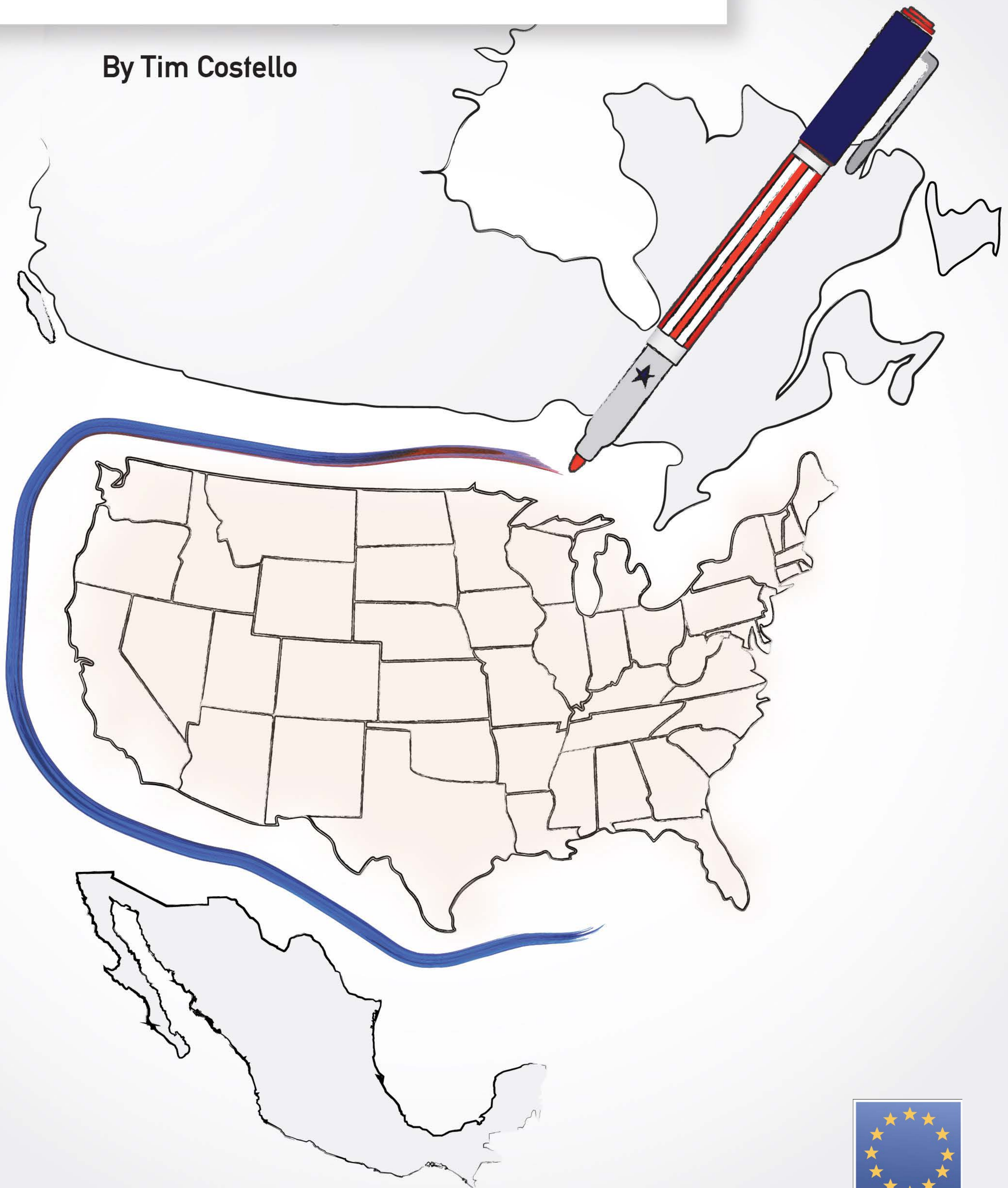

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Executive summary

This briefing examines the tax reform proposals made by the Republican Party in the United States, and in particular the border adjustment measures advocated by Paul Ryan, the Speaker of the House, and Kevin Brady, Chairman of the House of Representatives' Ways and Means Committee. It analyses the arguments for and against the tax plan, which aims to improve the business environment in the US, discourage aggressive corporate tax practices, and encourage companies to base their production in the US rather than overseas.

The plan consists of the following elements:

- A reduction in the federal corporate tax rate
- Alterations to the tax code in order to incentivise investment
- Measures to address the unequal treatment of debt financing and equity financing
- The ending of federal taxation on the foreign earnings of US companies
- The introduction of a destination based tax system
- Changes to the treatment of export revenues and import costs

While the proposals remain just that, and have yet to be set out in draft legislation or definitively endorsed by President Trump, border adjustment, if enacted, would mark a radical departure from the existing arrangements and may be subject to a challenge at the World Trade Organisation by US trade partners.

A Destination-Based Cash Flow Tax (DBCFT)

Paul Ryan and Kevin Brady proposed the introduction of border adjustment in their 24 June 2016 blueprint for tax reform *A Better Way: Our Vision for a Confident America*[1]. The blueprint makes the case that the US tax code is "broken" because of its **length, complexity and**

1 *A Better Way: Our Vision for a Confident America*, Office of the Speaker of the House (24 June 2016) https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf

burdensome compliance costs. It argues that the current system "is littered with hundreds of preferences and subsidies that pick winners and losers", penalises savings and investment, and encourages US companies to move their operations overseas.

The current US corporate tax system has the following key characteristics: **the federal corporate tax rate is 35 per cent** - it rises to more than 39 per cent when state taxes are included; there are a large number of exemptions available to businesses – the effective corporate tax rate was 22 per cent between 2007 and 2011[2]; and, crucially, the system is income based. This means that the Internal Revenue Service (IRS) taxes businesses based on income earned. Another key characteristic of the current system is that it is origin based, meaning that tax applies to goods and services on the basis of where they are produced and regardless of where they are consumed.

Speaker Ryan and Chairman Brady have **proposed lowering the federal corporate tax rate to 20 per cent**; reducing the number of exemptions and special privileges available to businesses; applying corporate tax on a destination basis; moving towards territorial taxation of US companies with an international presence; and, taxing businesses based on their cash flow rather than their income. The new corporate tax system, dubbed a **destination-based cash flow tax (DBCFT)**, would also include border adjustments.

Incentivising investment

By taxing cash flow instead of income, the US would move towards an approach that is more in line with the consumption-based, value added approach to corporate taxation that is used by most other countries. The Republican blueprint states that such an approach would simplify companies' tax affairs and incentivise investment. Businesses would be allowed to "fully and immediately" write off the cost of investments in tangible property, such as buildings, and intangible assets, such as intellectual property. The measure would not apply to land. Businesses operating in capital-intensive industries would most welcome this proposed move to what is known as **full expensing,** as would those who argue that such a change would mark a pro-growth shift in the US tax code. Under full expensing, companies can deduct the entire cost of a capital investment investment up front rather distributing the costs over multiple years.

Equalising the treatment of equity financing and debt financing

This removal of depreciation would be accompanied by a change that would mean net interest costs are no longer deductible. The Tax Foundation estimated in July 2016 that, if implemented, the elimination of the interest deduction would raise $1.2 trillion over ten years[3]. This aspect of the Republican tax plan seeks to address the unequal tax treatment of equity financed investment and debt financed investment. It would negatively affect companies that are heavily reliant on debt financing, such as commercial real estate and private equity firms. While it does not go into specifics, the Republican blueprint says the Committee on Ways and Means would develop "special rules" to take into account the importance of interest income and interest expense in the business model of certain financial services companies.

Ending federal taxation on the foreign earnings of US companies

The Republican blueprint proposes to address the issue of US companies holding foreign earnings abroad by introducing a **100 per cent exemption for dividends from foreign subsidiaries**. US companies would be able to repatriate foreign earnings amassed under the current tax system at a one-off tax rate of 8.75 per cent, with the total amount due payable over an eight year period. This would be a welcome development for multinational US companies with large offshore cash holdings, such as certain high profile technology and pharmaceutical firms. Republicans and Democrats alike have highlighted their concerns over how the US currently taxes multinational corporations. An April 2016 report published jointly by the Obama White House and the US Department of the Treasury assessed that

2 *Average Effective Federal Corporate Tax Rates*, US Department of the Treasury (1 April 2016) https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/Average-Effective-Tax-Rates-2016.pdf

3 *Details and Analysis of the 2016 House Republican Tax Reform Plan*, Kyle Pomerleau, Tax Foundation (5 July 2016) https://taxfoundation.org/details-and-analysis-2016-house-republican-tax-reform-plan/

the existing system "rewards US companies that shift their reported profits abroad to lower-tax jurisdictions and encourages inversions"[4]. Under the current system, US companies are taxed on the earnings of their foreign subsidiaries, minus a credit for tax paid in other jurisdictions, but only when the income is repatriated. This process of **deferral** can result in US companies retaining overseas income abroad for an indefinite period and, along with other complexities of the US system, "create greater incentives to manipulate the location of foreign income" than exists under tax systems used by other countries.

Introducing destination based taxation

By moving to a **destination based** system of corporate tax under a cash flow approach, US tax authorities would focus exclusively on transactions that occur in the United States. Destination based systems tax goods and services where they are consumed, and do not take into account where such goods and services are produced.

Changing the treatment of export revenues and import costs

This leads to the most contentious aspect of the GOP congressional leaders plan - the proposed introduction of a **border adjustment tax**. In essence, the proposal would mean that products, services and intangibles exported from the US would not be subject to US tax, while products, services and intangibles imported into the US would be subject to US tax "regardless of where they are produced". Companies would be able to exclude export revenues from their tax calculations, while they would no longer be able to deduct import costs. Under DBCFT, border adjustment would create a significant tax advantage for companies who are exporting from the US over those who are importing into the US. Additionally, some estimates say border adjustment under a DBCFT of 20 per cent could raise up to $1.1 trillion over ten years – which advocates of the measure say could be used to cover some of the cost of the reduced federal tax rate for companies. The Tax Foundation estimates that cutting the federal corporate tax rate to 20 per cent would cost $1.8 trillion in revenue in the first decade of implementation[5].

Speaker Ryan and Chairman Brady claim that a border adjustment would increase the competitiveness of US products and services in the global economy, and specifically in countries that apply VAT to imports. In an interview with the New York Times on 12 December 2016, Chairman Brady said a destination based system would "level the playing field for made in America products" and would remove "all the niceties to move jobs, research and headquarters overseas"[6]. Unlike most advanced economies, there is **no federal VAT imposed on imports to the US**. In contrast, US companies exporting to countries such as Ireland from the US are subject to both US corporation tax and Irish VAT. However, in the context of WTO rules it is important to note that VAT makes no distinction between domestically produced goods and imported goods.

In practice, a border adjustment system that does not apply tax to exports could result in large US exporters receiving **tax rebates** from the Federal Government. A company with a majority portion of its total revenue derived from sales outside of the US may find that, when other deductions are taken into account (asset, wage and inventory costs) they end up with a negative tax bill. As noted by William G. Gale of the Brookings Institution in January 2017[7], the optics of large corporations receiving a rebate from the Federal Government would probably not play well among a public whose awareness of aggressive tax practices by multinational corporations has heightened in recent years.

4 *The President's Framework for Business Tax Reform: An Update*, The White House and the US Department of the Treasury (4 April 2016) https://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-An-Update-04-04-2016.pdf

5 *Details and Analysis of the 2016 House Republican Tax Reform Plan*, Kyle Pomerleau, Tax Foundation (5 July 2016) https://taxfoundation.org/details-and-analysis-2016-house-republican-tax-reform-plan/

6 *New Approach to Corporate Tax Law Has House G.O.P. Support*, The New York Times (12 December 2016) https://www.nytimes.com/2016/12/12/business/economy/new-approach-to-corporate-tax-reform.html?_r=0

7 *Understanding the Republicans' corporate tax reform*, William G. Gale, Brookings Institute (10 January 2017) https://www.brookings.edu/opinions/understanding-the-republicans-corporate-tax-reform/

Offsetting the initial impact of border adjustment

In practice, the **strengthened dollar** should offset the benefit accruing to exporters from border adjustment as the cost of their products and services would become more expensive on the international market. In turn, importers should benefit from cheaper import prices. However, it would take time for the dollar to appreciate to a level that would offset the initial impact of border adjustment – leading to short-term adverse effects for some producers and consumers. Should they proceed with border adjustment, policymakers may decide to address these short-term effects by putting in place certain transitional arrangements to alleviate some of the impacts[8].

Nonetheless, speaking at an event on 17 January 2017, William Dudley, President of the Federal Reserve Bank of New York, said he was doubtful that a rise in import prices would be offset by an equivalent rise in the dollar. He warned against assuming there would be such a "pass through" in the dollar and said a border adjustment could lead to numerous unintended consequences. David Perdue, the Republican US Senator for Georgia, cautioned in a letter to his Senate colleagues on 8 February 2017 that even if there was a successful revaluation of the dollar, there would be "multi-trillion dollar" reduction in the value of foreign investments held by US investors[9]. "American seniors will see their retirement savings evaporate", Senator Perdue wrote.

Speaker Ryan and Chairman Brady believe a destination-based system with a lower headline rate, border adjustment and less complex procedures would incentivise more companies to maintain their presence and operations in the US rather than moving overseas (be it through **inversion, outsourcing or transfer pricing**) to jurisdictions with lower tax rates. However, their tax reform blueprint has faced domestic opposition and, if implemented, may face further challenges on the international level.

International compliance

A border adjustment tax in the form outlined in the GOP blueprint **would likely violate the rules of the World Trade Organisation** (WTO), and could potentially lead to retaliatory actions by the EU and other prominent US trading partners. In their blueprint, the GOP claim that a border adjustment tax under their package of reforms would not violate WTO rules because the adjustments would take place under a cash flow system based on the consumption tax approach. WTO rules permit border adjustments in the case of indirect taxes, which it defines as "sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges"[10].

However, even Alan Auerbach, the academic who has worked extensively on the destination-based approach and whose work is relied upon throughout the GOP blueprint, has expressed scepticism that the DBCFT would be found compliant with WTO rules. In a paper published in November 2016[11], he said it was "not clear" that DBCFT would be considered an indirect tax by the WTO "even though the distinction between direct and indirect taxes has little meaning and no bearing on any economic outcomes". Professor Auerbach also highlighted what most see as the biggest obstacle to the plan being deemed WTO compliant, namely the fact that it **includes a tax deduction for wages** paid by companies based in the US. Such a deduction distinguishes the Republican proposal from the VAT approaches adopted by other countries. The inclusion of a wage deduction has the benefit of making the new cash flow based system less regressive; however, it would potentially violate WTO rules if it only applied to companies that produced their goods domestically. Removing the wage deduction element from the DBCFT would make it less progressive, but may make it more compatible with existing WTO rules.

8 *Fed's Dudley Q&A: US Economy In Good Shape; Eye On Brexit*, BTA,MNI (17 January 2017) https://www.marketnews.com/content/feds-dudley-qa-us-economy-good-shape-eye-brexit-bta

9 Letter by Senator David Perdue, United States Senate (8 February 2017) http://www.perdue.senate.gov/imo/media/doc/BAT.pdf

10 *Agreement on subsidies and countervailing measures*, World Trade Organisation https://www.wto.org/english/docs_e/legal_e/24-scm.pdf

11 *The Role of Border Adjustments in International Taxation*, Alan J. Auerbach and Douglas Holtz-Eakin, American Action Forum (30 November 2016) https://www.americanactionforum.org/research/14344/

Border adjustment taxes in the US could lead to **protectionist reactions** from US trading partners. Pierre Moscovici, the European Commissioner for Jobs, Growth, Investment and Competitiveness, told the Financial Times on 14 February 2017 that the EU would react "if somebody is behaving against our interests or against international rules in trade"[12]. However, as the law firm White & Case noted in a January 2017 brief[13], policy measures enacted by WTO members are considered to be compliant with WTO rules until found otherwise in a ruling adopted by the WTO Dispute Settlement Body. This means that countries may adopt policies that they are aware could fall foul of WTO rules because such policies may not be challenged by other WTO members for political or economic reasons. Should the US enact border adjustment, the process by which it may or may not be found compliant with WTO rules could take years.

US reaction

The tax proposals of Speaker Ryan and Chairman Brady have generated significant opposition in the US. The White House, which has yet to outline its own tax reform measures in any great detail, has sent out **mixed signals** on the border adjustment plan. In an interview with the Wall Street Journal on 16 January 2017[14], President Trump said it was "too complicated". "Anytime I hear border adjustment, I don't love it", he remarked. Meanwhile in his confirmation hearing on 19 January 2017, Steven Mnuchin, the Secretary of the Treasury, said that President Trump was not contemplating a broad border tax but was instead suggesting "repercussions" for a small number of companies who have shifted production from the US[15]. In a meeting with American CEOs on 23 January 2017, the President said the US would impose "a very major border tax" on companies that shift production from the US overseas.[16] Until the White House publishes its tax plan, which it is expected to do so in March 2017, and definitively clarifies the President's position, it is challenging to assess its stance on the issue of border adjustment.

Opponents and proponents of border adjustment have lobbied President Trump on the Ryan/Brady blueprint since his inauguration in January. The plan has **divided corporate America**, with leading exporters including General Electric, Boeing, Pfizer and Oracle forming the "American Made Coalition" in support of border adjustment. A spokesperson for the coalition said it was committed to advancing legislation that "levels the playing field for American businesses and workers"[17]. Other companies that are more reliant on imports have spoken out against the GOP plan. GAP, Nike, Walmart and Best Buy were among the companies who formed the "Americans for Affordable Products" coalition to oppose any border adjustment measures. Retailers, who rely heavily on imported goods, believe any border adjustment measure would **increase costs for consumers and put jobs in the retail industry at risk**. The CEOs of seven major retailers met with President Trump and Chairman Brady in Washington DC on 15 February 2017 to express their opposition to border adjustment. The Retail Industry Leaders Association, which has launched a national campaign to oppose border adjustment, claims the measure would "force higher prices on consumer staples" such as food, medicine and clothing[18].

Conclusion

Policymakers, businesses and citizens on both sides of the aisle have long argued that the US tax code is in need of an overhaul. The

12 *EU and others gear up for WTO challenge to US border tax*, The Financial Times (14 February 2017) https://www.ft.com/content/cdaa0b76-f20d-11e6-8758-6876151821a6

13 *Border-Adjustable Taxes under the WTO Agreements*, Scott Lincicome and Richard Elgin, White & Case (19 January 2017) https://www.whitecase.com/sites/whitecase/files/files/download/publications/border-adjustable-taxes-under-the-wto-agreements.pdf

14 *Donald Trump Warns on House Republican Tax Plan,* ***The*** Wall Street Journal (16 January 2017) https://www.wsj.com/articles/trump-warns-on-house-republican-tax-plan-1484613766

15 *Trump's treasury pick: 'No across-the-board border tax'*, CNN Money (19 January 2017) http://money.cnn.com/2017/01/19/news/economy/mnuchin-trump-border-tax/

16 T*rump: US to impose border tax on groups that shift production from America*, The Financial Times (23 January 2017) https://www.ft.com/content/21b357e6-1719-3557-91ab-491cec6b112c

17 *More than 25 American Businesses Launch Coalition to Support Tax Reform*, American Made Coalition (1 February 2017) http://www.americanmadecoalition.org/coalition_launches_in_support_of_tax_reform_that_incentivizes_american_products_and_american_jobs

18 *Retailers Unite to Stop Harmful Border Adjustable Tax*, Retail Industry Leaders Association (1 February 2017) https://www.rila.org/news/topnews/Pages/Retailers-Unite-to-Stop-Harmful-Border-Adjustable-Tax.aspx

Republican proposal to replace the current corporate tax rate of 35% with a destination-based cash flow tax of 20% is worthy of consideration. It would simplify the US corporate tax system and contribute to efforts to dissuade multinational companies from engaging in aggressive tax practices such as profit shifting.

However, the imposition of border adjustment in the US as part of a move to a destination-based cash flow tax would represent a radical departure from the existing set-up. It would deny importers the ability to deduct the cost of imported goods from their taxable profits and exempt export revenue from company tax bases.

The potential for clashes between major trading partners looms large should the White House choose to move forward with border adjustment as set out by Speaker Ryan and Chairman Brady last summer. Assessing the compliance of border adjustment as envisaged in the GOP blueprint with international trade norms is challenging without further details, although, as outlined above, the wage deductibility measure included in the proposal may violate WTO rules.

The talks, negotiations and lobbying efforts in the weeks ahead will determine the exact make-up of any tax reform measures and should provide greater clarity to businesses and to America's trading partners.

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