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U.S. Tax Reform – Border Adjustment Proposal: Current Status, and How Your Company May Be Affected

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On 24 June, 2016, the Republican Speaker of the U.S. House of Representatives, Paul Ryan, and House Ways and Means Chairman Kevin Brady released a sweeping "Blueprint" proposal to reform the U.S. tax code. The Blueprint proposed to change the U.S. corporate tax system to a consumption-based, territorial tax system with the following elements:

(1) a flat corporate income tax rate of 20 percent
(2) immediate expensing of capital business investments
(3) no deductibility of interest expense that exceeds interest income; and
(4) a border adjustment tax, presumably allowing U.S. companies to exclude all export sales from taxable income, and denying a deduction for the cost of imports (exports and imports both would include materials, products, services, and intangibles).

The border tax adjustability (border adjustment tax, or BAT), is a critical part of the Blueprint because it raises tax revenue to allow the U.S. to lower the corporate tax rate. It also addresses a fundamental concern of many U.S. policymakers, in particular Ryan and Brady-their view that companies have too much incentive, under current tax laws, to locate business operations and assets outside of the U.S., in low-tax foreign jurisdictions. By applying the border adjustment, say the authors, the U.S. corporate tax would apply to U.S. sales, regardless of the location of production or ownership.

With the election of President Donald Trump, the Blueprint and the BAT, has transformed from a theoretical, political document to a viable policy proposal. While the BAT has strong support in the Republican-led U.S. House, it is not yet clear, however, whether President Trump will endorse the idea. In addition, the prospects for

Key Points

- A border adjustment mechanism (border adjustment tax, or BAT), is a critical component of the Tax Reform Blueprint being promoted in the U.S. Congress by Speaker of the House Paul Ryan and House Ways and Means Chairman Kevin Brady
- The provision, if enacted, will have profound implications for multinationals with U.S. operations, and any businesses with imports or exports to or from the U.S. It could also result in huge currency revaluations.
- It is not yet clear whether President Trump will endorse the Ryan/Brady BAT proposal, or whether the proposal could pass the U.S. Congress.
- Many believe that the BAT as currently proposed would not withstand World Trade Organization (WTO) scrutiny, and would likely result in retaliatory tariffs imposed by U.S. trading partners, and ultimately, a global trade war. But some in the U.S. Congress as well as the President may be willing to take on that battle.
- Whether or not a BAT provision is included in a U.S. tax reform bill, we think it's more likely than not that U.S. tax reform will be enacted by late 2017 or early 2018, and that the legislation will include provisions to encourage businesses to locate business operations in the U.S., and discourage tax-motivated decisions to locate operations or assets in low-tax jurisdictions outside the U.S.

the BAT in the U.S. Senate are uncertain at best. There is growing skepticism of the proposal, including some outright opposition, among Republicans and Democrats alike in the U.S. Senate. Also, in recent weeks, there has been an intensifying lobbying effort in opposition to the BAT in particular by retail business interests that sell mostly imported goods, as well as among oil refiners and other U.S. businesses that rely on imported goods, services, and intangibles.

Although full details on the Blueprint BAT proposal have not yet been released by its authors, reports suggest a structure that may not withstand WTO scrutiny, since the BAT would adjust a direct, rather than indirect, tax, and the resulting structure could not be said to be economically equivalent to European style value-added taxes that are allowed by the WTO. If the BAT is included in the U.S. tax reform bill that is ultimately enacted, it is a near certainty that it would be challenged before the WTO, which could very likely result in retaliatory tariffs and, possibly, a full trade war among many WTO members and the U.S.

President Trump has announced plans to issue his own tax reform plan in the coming weeks, and it is not yet clear whether this plan will include a BAT provision. Whether or not Trump proposes a BAT in similar form, however, we do expect him to propose some kind of structure that would impose taxes on at least some imported goods, which itself would be likely to face intense WTO scrutiny.

How Will This Affect Your Company?

The BAT proposal would represent a profound change in the U.S. tax code as virtually no business with imports or exports to or from the U.S. would be unaffected. Economists project that the change could increase the value of the dollar against other currencies by as much as 25 percent. Businesses with U.S. sales that rely heavily on imports would have significantly higher U.S. tax liability; the opposite would be true for U.S. businesses with significant net export income. U.S.-based multinationals that have established foreign subsidiaries and tax structures in low-tax jurisdictions to sell goods or services abroad might find greater tax savings by locating in the U.S., since export income would be free from U.S. tax. Any tax advantage of locating operations or assets abroad and importing goods or services into the U.S. could also disappear, since imports would not be deductible to U.S. business taxpayers. Finally, U.S. investors holding foreign investments denominated in local currencies could face a significant hit to the value of these foreign holdings if the dollar appreciates on the order of 20-25 percent as the result of the BAT proposal.

Outlook

U.S. tax reform, whether it includes a border adjustment mechanism or other provisions to encourage businesses to locate in the U.S., faces a long and politically difficult road to get from proposal form through the Congress to enactment. We expect legislative language to be released by House Republicans this Spring, and a separate proposal to be released in the Senate later this year, on top of the Trump proposal promised (presumably in outline form) in the coming weeks. House Republicans have announced their intention to get a bill passed through the House by the end of July, and we expect the U.S. Senate to move on their own bill later this year. Realistically, it is unlikely that U.S. tax reform could be enacted any earlier than late 2017 or early 2018.

As the legislation and process matures, U.S. lawmakers will have to make difficult decisions that will undoubtedly create winners and losers in U.S. tax reform. There will be transition rules to provide relief to those negatively impacted and special exceptions to mitigate harm to certain industries or sectors. All of these elements that will become well-defined down the road are being shaped today.

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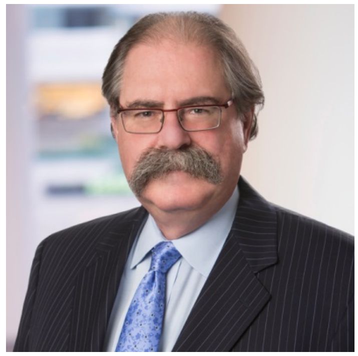

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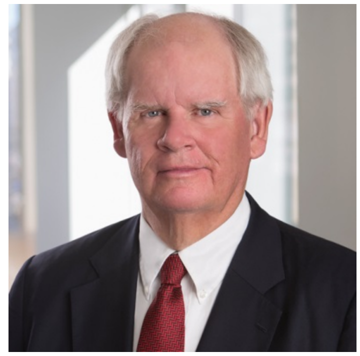

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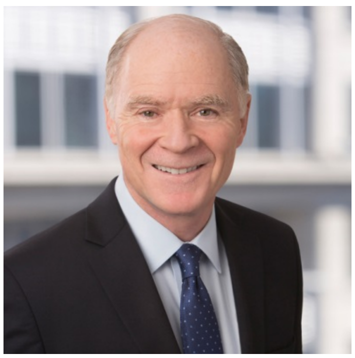

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