IMPORTANT NEW BUSINESS TAX PROPOSALS FOR U.S. TAX SYSTEM

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During the past few months, there has been considerable speculation over potential changes to the U.S. tax system that could have an impact on international businesses. At this stage, the discussions are preliminary and the possibilities surrounding new business tax rules shift every day. Nevertheless, major points of agreement now appear to be materializing between the U.S. Congress and President Donald Trump, especially over the reduction in the U.S. corporate tax rate and potential enactment of a border-adjustment tax.

This alert provides an overview of Congress's tax proposals and President Trump's tax plan, and summarizes the proposed U.S. border-adjustment tax and its impact on international businesses.

Congress's Blueprint and President Trump's tax plan

In 2016, the Republican leadership and Republicans on the House Ways and Means Committee unveiled *A Better Way Forward on Tax Reform*, known as the "Blueprint," to guide future business tax reform efforts.[1] The Blueprint would:

- Lower the statutory corporate tax rate to 20%
- Create a new 25% tax rate for business income earned by pass-through entities
- Move the U.S. business tax regime toward a cash-flow, destination-based tax by:
  - Immediately expensing all capital expenditures (other than for land)
  - Eliminating deductibility of net interest expense
  - Implementing a border tax adjustment mechanism
  - Eliminating most business preferences (except the research and development tax credit and the last-in, first-out method of accounting)
  - Imposing a territorial international tax system (with a one-time tax on accumulated foreign earnings as a transition mechanism)

President Trump's original tax plan for businesses, announced during his campaign, differed from the Blueprint in several key ways. The President's plan would:

- Lower the corporate tax rate to 15%, with the same rate imposed on business income earned by pass-through entities

- Allow manufacturers to elect to expense capital investment; those manufacturers that make the expensing election would lose the ability to deduct corporate interest expense

A cut in the corporate tax rate would be a significant change. The current U.S. statutory corporate tax rate is 35 percent (the highest among G-8 countries) and has been at that level since 1992 (before that it was at 33 percent dating back to 1986 so there has not been much movement in the past 30 years). Both the congressional and administration plans propose much lower corporate tax rates – 20 percent and 15 percent, respectively.

U.S. border-adjustment tax

The “border tax” concept proposed by U.S. lawmakers is essentially a destination cash flow tax proposal, designed to correct the significant trade deficit that has existed in the United States for many years. The idea behind the border tax is that imports would be subject to a special tariff -- much like a value added tax -- and exports would not. The border tax is also designed to dis-incentivize U.S. businesses from earning profits offshore. That perceived problem has been the subject of many tax law changes and proposals during the last decade or more, including “inversion” and “interest stripping” rules designed to discourage U.S. tax deferral through the use of offshore entities.

As of March 2017, however, draft tax legislation has not surfaced, and the border-adjustment tax proposal will likely undergo significant changes. For example, President Trump has expressed reservations about the Blueprint’s border-adjustment proposal, calling it “too complicated.” In addition, Senate Finance Committee Chairman Orrin Hatch, a Republican from Utah, has indicated the Senate will develop its own version of tax reform. Once Congress drafts tax reform legislation, it may have to hammer out a compromise with President Trump. The Blueprint does not, after all, specify how the proposed changes would affect the country’s balance sheet.

The U.S. border-adjustment tax could have a significant impact on international businesses

By international standards, the United States imposes few taxes on consumption, while taxing producers more heavily. Many small manufacturers without overseas factories have long favored an overhaul of the United States tax code that would increase corporate taxes on importers. Powerful business groups like the American Chamber of Commerce, however, have said little about such proposals because of deep divisions in corporate America between those who would pay the import tax and those who might not.

The border-adjustment tax could hit large retailers the hardest if it takes full effect, with their heavy reliance on imported products as varied as microwave ovens from China and T-shirts from Bangladesh. If such a tax were imposed on imports from around the world, automakers could face hefty tax bills not only for cars imported from Mexico and elsewhere but also for the many auto parts they buy from overseas for their assembly lines in the United States. And energy companies could wind up paying more for imported oil. Even those seemingly safe from import taxes-exporters like Boeing, and American farmers-could lose sales if other countries retaliated against a U.S. border-adjustment tax.

Conclusion

International businesses should keep a close eye on legislative developments surrounding U.S. tax reform, the U.S. corporate tax rate, and the U.S. border-adjustment tax in particular, as these developments could create new tax planning considerations and opportunities.

It is important to note that before any tax reform proposal becomes law, the proposed legislation must pass each house of Congress – the Senate and the House of Representatives, and then go to the President to be signed into law (or vetoed). This could take considerable time, as there will likely be several iterations of the legislation. Stay tuned to see what proposals actually make it into new law.

[1] "A Better Way: Our Vision For A Confident America—Tax," Our Plan, A Better Way (available at http://templatelab.com/a-better-way-tax-policy-paper/.