The potential impact of a border adjustment tax

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There has been a great deal of excitement surrounding the prospects of comprehensive tax reform since the presidential election. Now, President Donald Trump is expected to outline his path to tax reform in an address tonight to a joint session of Congress. Few details have been given on what his plan may entail, but U.S. Treasury Secretary Steven Mnuchin has stated that the administration is taking a serious look at a border adjustment proposal that adopts a destination-based cash flow tax.

Creating a Modern Tax System

Considering 2016 marked the 30th anniversary of the country's last major tax overhaul (President Ronald Reagan's 1986 Tax Reform Act) the Internal Revenue Code is arguably due for a reboot.

A lot has changed in 30 years. The rise in globalization along with the internet age has eased the movement of goods and capital across borders. Many of the world's most profitable companies do not deal in tangible goods at all. Rather, the value in these companies resides in their intangible property – patents, licensing, and mobile capability. The current tax code was not built to properly account for such free movement of people, services and capital.

Even President Reagan's Tax Reform Act, which was innovative at the time, is now out of step with the rest of the Organisation for Economic Co-operation and Development signatory countries (OECD). In 1986, the United States was a trendsetter when it lowered its corporate income tax rate from 48 percent to 34 percent, making it the lowest statutory corporate income tax rate at the time. Now, the current U.S.

statutory rate of 35 percent is well above the OECD average. For example, both the U.K. and Ireland have much lower statutory tax rates today, at 20 percent and 12.5 percent, respectively.

The leading Republican proposal to modernize the U.S. tax system is the plan proposed by House Speaker Paul Ryan. At a mere 35 pages, the proposal – called “A Better Way,” or more commonly the House “Blueprint” – is more of a starting point than a full-fledged policy. And yet, it speaks volumes; the Blueprint’s vision for addressing the challenges of collecting revenue in a technologically advanced global economy has set off a contentious debate concerning how the tax system should be changed and who should pay for such changes.

The Destination Based Cash Flow Tax

The Blueprint attempts to resolve these issues by adopting a “destination based cash flow tax.” This involves modifying the income tax structure so that businesses are taxed on where their customers are rather than where they are incorporated. The destination cash flow tax incorporates two separate ideas: border adjustability and cash flow taxation. Border adjustability, as envisioned by the Blueprint, means that all imports would be subject to taxation and all exports would be exempt. Cash flow taxation, in turn, would make all capital expenditures immediately deductible, such that there would be no need to track depreciation because such investments could be expensed fully in the year of purchase. Additionally, the net interest deduction would be eliminated in order to remove the distortion favoring debt over equity-based purchases. By taxing only income earned strictly within the borders of the U.S. (border adjustability), and adopting cash flow taxation principles, the House Republicans hope to modernize the business income tax structure to minimize cross-border tax arbitrage (i.e., the use of aggressive tax planning techniques that allow multinational entities to take advantage of gaps between two different tax systems which result in little to no tax liability).

The Path to Reform

Both House Speaker Paul Ryan and Senate Majority Leader Mitch McConnell have indicated that tax reform will be passed as part of the 2018 budget reconciliation. The advantage of passing tax reform as a reconciliation bill is that only a Senate majority is required for passage (some may recall that the Affordable Care Act was enacted using the same mechanism). The downside to using budget reconciliation is that to keep the reforms in place, it must be revenue neutral, meaning that any reduction in the federal revenues (i.e., tax cuts) must be offset by reduction in credits or spending (i.e., eliminating deductions or loopholes). If the bill is not revenue neutral, it will sunset in 10 years, similar to the 2003 Bush Tax Cuts, which set off the fiscal cliff debate in 2012.

Revenue neutrality, by its very definition, creates winners and losers, which explains why the focus of the tax reform debate has *not* been “who gets their tax cut and when,” but rather who is going to end up paying for all of these promised tax cuts. Currently, the industry groups that have the most to lose under the Blueprint plan are retailers and companies that rely on cheap imports.

McDonald Hopkins’ Tax and Benefits team will continue to monitor the path to tax reform, and will keep you posted as the debate moves forward and tax plans solidify. If you have questions about President Trump’s February 28 address – or want to learn more about the proposal for a destination-based cash flow tax – contact one of the attorneys listed below.