Forewarned is Forearmed: Taking Note of US Tax Reform

By Graham Green

Both US and non-US companies should take note of the growing consensus for tax reform, which is gaining steam this year. Current tax reform proposals would move the United States away from a worldwide approach to international taxation and towards a destination-based system. Under a destination-based system, the taxing jurisdiction for business income would be based on the place of consumption (i.e., where goods, services, or intangibles are consumed), rather than the place of production.

These proposed changes include border adjustments that would eliminate deductions with respect to imported goods, services, and intangibles and create a tax exemption for the export of goods, services, and intangibles. In effect, US corporations would exclude their non-US sales from taxable income while deducting wages and costs incurred in the United States. However, imports would be subject to tax on a gross basis with no corresponding deduction for wages or costs incurred outside the United States.

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What Goes Around Comes Around

The emerging proposal for US border adjustments should be understood in the broader context of tax reform proposals that have been considered in recent years. Most notably, in 2014, the international tax proposal circulated by then Ways & Means Committee Chairman Dave Camp sought to encourage the repatriation of previously untaxed foreign earnings and profits and to move the United States closer to a territorial system of international taxation. As far back as 2005, the President’s Advisory Panel on Federal Tax Reform recommended a proposal similar to the destination-based system that included border adjustments.

The June 2016 Republican Blueprint similarly advocated for moving to a more territorial system, in part, through a destination-based system of taxation. As part of the move to a destination-based system, the Blueprint proposed border adjustments. The significance of the border adjustments to the Blueprint should not be underestimated. Even though enactment of border adjustments may seem far-fetched, the border adjustments represent a significant portion of the revenue generated by the Blueprint to offset decreases in corporate tax rates, which is a central aspect of the Blueprint. Meanwhile, inversions have developed as a primary concern for lawmakers as reflected in both the Camp proposal and the Blueprint. Lawmakers see reducing corporate rates as a means of reducing incentives for US companies to move offshore.

Timing Is Everything

Although the Trump Administration has stated a goal of enacting tax reform by August, there are hurdles that make that ambitious timeframe unlikely. Even in light of Republican control of both houses of Congress and the White House, tax reform will inevitably take time given the enormity of the undertaking. Creating a destination-based system that will include border adjustments would only increase the amount of time needed for Congress to pass tax reform. The Republican leadership also has committed to repealing and replacing the Affordable Care Act before enacting tax reform. This dynamic gives US and non-US companies more time to consider the implications of US tax reform and, in particular, how a destination-based system featuring border adjustments would impact their operations.

The Blueprint does not indicate the timeframe for implementing border adjustments, but transition rules would be needed to phase in such a significant series of changes. The 2005 Advisory Panel recommended a four-year transition period under which importers would be able to deduct 90%, 60% and 30% of their import-related expenses for the first three years, respectively. Meanwhile, exporters would pay tax on 90%, 60% and 30% of export sales, respectively. In the fourth year, the border adjustments would be fully phased in. The 2005 Advisory Panel’s proposal provides the best indication available of how Congress would implement border adjustments.

Parting Perspectives

Although the current environment in Washington is focused on partisan divides, it is important to note that when it comes to tax reform, there is much on which both parties agree. Both parties would favor simplifying the Internal Revenue Code (Code), increasing the efficiency of the Code so that rational decision-making—and not tax incentives—drives economic activity, and ensuring that the Code preserves horizontal equity, that is, treating similarly situated taxpayers similarly. Although the parties will disagree on other tax policy matters, these widely shared perspectives on tax policy increase the likelihood of the enactment of tax reform in the near term and the likelihood that many elements of tax reform will receive bipartisan support. Meanwhile, the pressure to generate revenue to offset the desired reduction of corporate rates adds to the likelihood that border adjustments will be featured in the final product of tax reform.

About the Author: Graham Green advises multinational clients, primarily insurance companies, banks and regulated investment companies, on the taxation of financial institutions and financial products. Graham also counsels on tax planning, compliance and transactional matters including mergers, acquisitions, reorganizations and demutualizations. Prior to joining Eversheds Sutherland (US), Graham was a tax attorney with the IRS Office of Chief Counsel in Washington DC. There, he was the principal author of the proposed and final regulations under IRC section 833(c)(5) applying a medical loss ratio qualification test to Blue Cross and Blue Shield companies. He can be reached at grahamgreen@eversheds-sutherland.com.