US Tax Reform: Prospects and Roadblocks

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Outline

- **US state of play**
- **Evaluation of alternatives that have been considered, including destination-based cash-flow tax (DBCFT)**
- **Outlook for reform**

State of Play

- **Republican-controlled government**
- **In US system, “President proposes and Congress disposes”**
  - – But Congress isn’t simply reactive – initiates proposals of its own
  - – Within Congress, tax legislation starts in the House of Representatives (Ways & Means Committee)

State of Play

- **Initial Congressional Agenda:**
  - Health care, then tax reform, both using <u>budget reconciliation</u> process
  - Allows passage by simple Senate majority (52-48)
- **Health care:**
  - Delays, failure to act
- **Tax Reform:**
  - House "Blueprint" plan

State of Play

- **House Blueprint (June 2016)**
  - Individual tax cuts (top rate of 33% vs. 39.6%)
  - Business tax shifts from current worldwide income tax at 35% (corp.) or 39.6% (non-corp.) to a Destination-Based Cash-Flow Tax (DBCFT) at 20% (corp.) or 25% (non-corp.)

State of Play

- **“New” Trump plan (≈ old Trump plan)**
  - One page document released in April
  - Top individual rate = 35% (from 39.6%)
  - Business tax rate = 15% (from 35%/39.6%)
  - <u>Territorial</u> tax system (instead of worldwide)
  - Eliminate estate tax
  - Eliminate many personal deductions

State of Play

- **"New" Trump plan (≈ old Trump plan)**
- **Previous estimate (Tax Policy Center):**
  – Revenue loss over 10 years = $6.2 trillion – 2.6% of GDP over the period, or about 14% of federal tax revenues
- **Plan did not include DBCFT**
  – DBCFT had <u>border adjustment</u>, key component <u>and</u> a large source of tax revenue (TPC: $1.2 trillion/10yrs.)

DBCFT – What is It?

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Starting from current US tax system…

- **Income tax for corporate and non-corporate businesses**
- **Worldwide approach to international activities**
  - Tax US-source income of all businesses
  - Tax foreign-source income of US resident businesses, with a foreign tax credit

DBCFT – What is It?

Adopt big domestic and international changes

- **Cash flow tax:**
  1. Replace depreciation with immediate expensing
  2. Eliminate net interest deductions (for NFCs)
- **Destination based:**
  3. Ignore foreign activities, as under a territorial tax
  4. But also effectively ignore cross-border activities, by having border adjustments offset business export revenues and import expense deductions

Relation to Other Policies

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- **Equivalent to a "subtraction-method" VAT plus a wage deduction (or an equal-rate payroll tax credit)**
  - Border adjustment as under a VAT
- **For the US, more compelling given the past political difficulty of adopting a VAT**

Motivation

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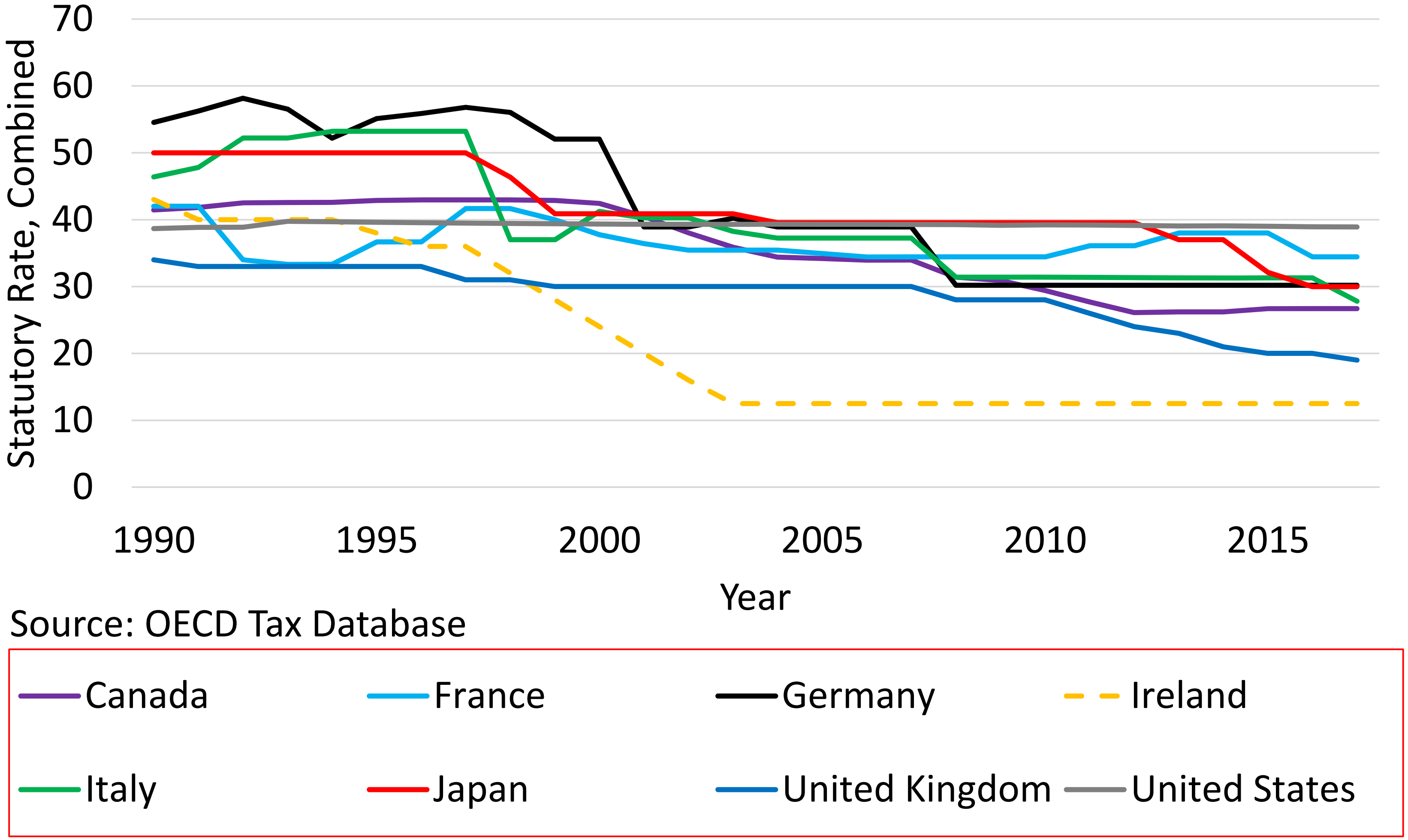
G-7 Corporate Tax Rates Since 1990



Source: OECD Tax Database

Top Five US Companies

1966:

1. AT&T
2. IBM
3. GENERAL MOTORS
4. EXXON MOBIL
5. EASTMAN-KODAK

2016:

1. APPLE
2. ALPHABET
3. MICROSOFT
4. EXXON MOBIL
5. AMAZON

A Changing Economic Setting

In last half century,

- Share of IP in nonresidential assets <u>doubled</u> (BEA, Fed FOF)
- Share of before-tax corporate profits of US resident companies coming from overseas operations <u>quadrupled</u> (BEA)

Implications

Increased pressure on systems that tax corporate income in traditional ways, based on where companies <u>have residence</u>

- With greater multinational activity, easier to engage in "inversion"
  - Incentive for US firms to do so since other countries (even with high tax rates) don't tax foreign source income
- Also, incentive for US firms to keep profits offshore ("lock-out" effect)

Implications

Increased pressure on systems that tax corporate income in traditional ways, based on where companies <u>produce</u>

- Location of production easier to change because of multinational activity and lower costs of transportation (e.g., chips vs. steel)
  - Incentive for firms (US and foreign) to do so because US tax rate is higher

Implications

Increased pressure on systems that tax corporate income in traditional ways, based on where companies <u>report profits</u>

- Profit-shifting easier (via related-party transactions) when have foreign operations and are locating and valuing IP

DBCFT as an Alternative

- Eliminates ability to shift profits out of US, since affects only (and increases) foreign tax liability
- Eliminates incentive to shift production out of US, since zero tax on US-source profits
- Eliminates incentive for corporate inversions, since no distinction in the treatment of US and foreign companies
- Eliminates lock-out effect, since no tax on profit repatriations
- **But controversial, because of domestic and international implications**

Domestic Winners & Losers

- **In theory, fiscal devaluation should be largely offset by real exchange rate appreciation**
  - But import-intensive industries have been skeptical
- **Also, elimination of interest deduction would more than offset benefits for some industries**

Foreign Impacts

- **A big US step in the tax competition game, as companies would be encouraged to**
  – Shift borrowing to other countries from the US
  – Shift profits from other countries to the US
  – Shift production from other countries to the US
- **EU, in particular, has reacted negatively**
  – In support of an alternative approach attempting coordination, via the OECD's BEPS project
  – A likely WTO challenge, increasing uncertainty
- **Also, credit market impacts via FX reaction**

Outlook for Reform

- **July 27**: Joint Statement on Tax Reform from Ryan/McConnell/Mnuchin/Cohn/Hatch/Brady
  - Lower tax rates for small and large business
  - Investment expensing
  - <u>No</u> border adjustment
  - Silent on interest deduction
  - "Bring back jobs and profits trapped overseas"
  - "Level playing field between American and foreign companies and workers"
  - "Protecting American jobs and the U.S. tax base"

Outlook for Reform

What does this mean?

- Without border adjustment, need <u>much</u> lower tax rate to accomplish stated objectives
  - No border adjustment, no reduction of interest deductions, expensing and much lower tax rate would imply huge loss of tax revenue
  - Giving up on budgetary responsibility would necessitate 10-year sunset (as in 2001)
- **Does "protecting jobs" mean tariffs?**

Outlook for Reform

What does this mean?

- Possible that little will be accomplished in short term (i.e., in 2017)
- But 2018 will be an important Congressional election year