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## President Trump's Tax Reform Proposal: Multistate Tax Considerations

### Overview

On April 26, 2017, the Trump administration released a one-page fact sheet outlining principles for tax reform (the "Proposal"), with the stated goals of:

1. Growing the economy;
2. Simplifying the tax code;
3. Providing tax relief to American families, and
4. Lowering the business tax rate.[1]

[1] 2017 Tax Reform for Economic Growth and American Jobs.

These goals and some additional context to the Proposal were provided by Treasury Secretary Steven Mnuchin and National Economic Council Director Gary Cohn at an April 26th press briefing. During this briefing, Mnuchin and Cohn announced that a formal proposal would be released this summer.

This tax alert highlights the various federal income tax elements of the Proposal and provides an overview of the associated multistate tax considerations.[2]

## Individual Tax Reform

As it relates to individuals, the Proposal provides tax relief by reducing the seven current income tax brackets which range from 10% to 39.6% to three brackets of 10%, 25% and 35%, doubling the standard deduction and providing tax relief for families with child and dependent care expenses. It also attempts to simplify the tax code by eliminating most, if not all, tax deductions with the exception of the deductions for mortgage interest and charitable gifts, as well as repealing the alternative minimum tax and the estate tax. Finally, the Proposal calls for the repeal of the 3.8% tax on net investment income that was enacted under the Patient Protection and Affordable Care Act of 2010 (a/k/a Obamacare).

## Business Tax Reform

Reduction in the Corporate Tax Rate: The Proposal lowers the federal corporate tax rate from 35% to 15% and makes the 15% rate available to businesses organized as passthroughs. The implication of the presentation by Mnuchin and Cohn is that the 15% rate for passthrough entities would either be an entity-level tax (with no tax on subsequent distributions to the entity's owners) or a cap on the tax imposed on the income allocated to the passthrough entity owners as opposed to a 15% entity level tax on the passthrough entity.

**Territorial Tax System:** The Proposal seeks to transition to a territorial tax system, whereby only income earned from activity within the United States is taxable. Currently, US corporate taxpayers pay US income tax on their global profits, with a deferral of tax for most active business income earned overseas by foreign affiliates. The Proposal provides that the purpose of the territorial tax system is to "level the playing field for American companies."[3]

**Repatriation Tax:** The Proposal reiterates the position taken by the President during his campaign that a one-time tax will be imposed on all foreign accrued profits regardless of whether the profits are actually repatriated to the United States. Once this "deemed repatriation" occurs and the tax is paid, the taxpayer can repatriate the profits to the United States without paying additional federal income tax.

**Elimination of Tax Breaks:** The Proposal does not provide specifics, but simply states that the Proposal will: "Eliminate tax breaks for special interests."[4]

**Other Considerations:** The Proposal does not address whether the Trump administration supports the border adjustment tax – a tax on all goods imported into the United States and an exclusion from taxable income for revenue from exports – or the immediate expensing of all business investment costs paired with a limitation on the deductibility of net interest expense, as set forth in the House Republican tax reform blueprint. The Proposal also does not stipulate the tax rate that would be applied to the deemed repatriations of foreign source income (during the campaign, candidate Trump suggested levying a 10 percent rate on such amounts). Additional consideration and discussion is likely to occur around both topics.

## Multistate Tax Considerations

The potential implications of tax reform go beyond federal taxation. Below is a summary of some key considerations from a multistate perspective:

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[2] Note that the Proposal is relatively vague and the prospects for its passage by Congress are unclear at this time; these multistate tax considerations are described in the context of the Proposal concepts being ultimately enacted.
[3] 2017 Tax Reform for Economic Growth and American Jobs.
[4] *Id.*

- **Rate Reduction:** With the potential reduction of the federal tax rate from 35% to a rate that may be as low as 15%, state corporate income taxes will become a more significant factor in corporate taxation. States are not required to reduce their tax rates, and many states are facing budgetary pressures that may weigh against a corporate income tax rate cut.
- **Expansion of the state tax base:** Under the Proposal, the federal tax base could become much broader as most tax deductions may be eliminated. This would ultimately lead to an expansion of the state tax base because many states conform (to varying degrees) to the federal definition of taxable income. As stated above, while the federal changes include rate cuts to offset the broader base, it is uncertain whether states would take a similar approach; due to budget pressures, it is possible that many states would not cut their rates.
- **State Non-Conformity of the Internal Revenue Code ("IRC"):** Generally, states conform to the IRC as of a specific date (i.e. "static" conformity). When tax reform occurs, a situation could arise where states that have static conformity require that federal taxable income be determined under the pre-tax reform IRC. Even in states that conform to the IRC, the states may de-couple from key provisions that have the potential to erode the state tax base.
- **Repatriation:** If repatriation is not included in federal taxable income, but rather is treated as a separate taxable item, questions arise as to how it will be taxed by the states. Which entity in the federal affiliated group will be the "deemed recipient" of the "deemed repatriation"? Will the repatriation of income be treated as a dividend, as a new category of miscellaneous income reported on a new subsection of Line 29 of the federal Form 1120, or a line 1 gross receipt? What will be the apportionment factor implications (i.e., will it be apportionable, allocable or potentially distortive)?
- **Negotiating credits & incentives on reinvestments:** Initiating discussions with state economic development agencies should be considered to assess incentives packages related to re-investment of funds into the United States. Given the potential magnitude of the repatriation of foreign profits (untaxed foreign profits held overseas by US corporate taxpayers are estimated to exceed $2 trillion), many taxpayers may use these funds on capital expenditures and/or increase labor force and states are proactively competing to attract businesses.
- **Territorial System:** While it is still unknown how states would respond in a territorial system, companies should re-assess their filing methodologies for state tax purposes, and determine whether it is advantageous to file a "water's-edge" election or file on a worldwide basis. Additionally, companies that have had historical international planning structures, may assess the state impact of such structures, in any analysis related to "unwinding" such structures. This would be of particular relevance in states that have worldwide reporting or if states propose legislation to mandate worldwide reporting.
- **Settling audits resulting in liabilities:** To the extent there is a reduction in the federal tax rate, the resolution of state tax audits prior to the reduction which result in payments may yield a permanent tax rate benefit. Because negotiating a resolution can be a time-consuming process, consideration should be given to initiating discussions with the applicable taxing authorities as soon as practical.
- **State reporting of federal RAR changes:** For similar reasons as the last (and prior to the reduction of the federal tax rate), consideration should also be given to accelerating the reporting/payment of federal RAR changes in those states where a liability may result.

If you have questions regarding President Trump's tax reform proposal or other tax reform matters, please contact any of the following Deloitte Tax professionals:


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## IRS enters into initial country-by- country reporting exchange agreements

The IRS has started signing its initial bilateral country-by- country (CbC) reporting competent authority arrangements (CAAs), the government-to-government agreements under which CbC reporting information will be exchanged. CAAs have been signed with the Netherlands, Norway, and other yet-to-be-named countries.[5] The text of the CAA between the United States and the Netherlands has been posted on the IRS's website.

Typically, CAAs like these are published in full by the IRS and the treaty or tax information exchange agreement (TIEA) partner, as long as both competent authorities agree to do so. It is expected that all CbC CAAs, including the ones already signed, will contain language similar to that in section 3(2) of the model CAAs that the IRS released on April 18, 2017. That section of the model CAAs appears to address potential concerns regarding whether voluntary filings with the IRS for 2016 tax years that begin before the effective date of Treas. Reg. §1.6038-4 (the 2016 gap year) will be respected by the other country. As long as that language has been included in a CAA, voluntary filing for the 2016 gap year should be respected.

### US-Netherlands CAA observations

The text of the CAA between the United States and the Netherlands is very similar to the text of the US model CAA (on the basis of a double tax convention). There are a few differences, however, as well as an expected clarification regarding voluntary filing for the 2016 gap year. Each of these issues is discussed below.

**Definition of "constituent entity": Same in substance as US Model CAA but different for US MNE groups and Dutch MNE groups:** One difference between the US model CAA and the US- Netherlands CAA is the definition of "constituent entity." For US MNE groups, both the US model and the US-Netherlands CAA refer to the definition in the US Treasury regulations.

With respect to MNE groups in the other jurisdiction, the US model duplicates the definition found in the OECD Model Legislation and Model Multilateral Competent Authority Agreement.[6] The US-Netherlands CAA, in contrast, refers directly to the "relevant Netherlands tax law." Given that the relevant Netherlands tax law is based on the OECD definition, there is no substantive difference between the two formulations.

However, there appears to be a different definition of constituent entity when comparing the definition in US Treasury regulations compared to the definition used in the OECD and Dutch rules. Specifically, the definition of "constituent entity" in the Dutch rules is based on accounting consolidation rules, consistent with the BEPS Action 13 final report. In contrast, the definition of "constituent entity" under the US Treasury regulations excludes foreign corporations or foreign partnerships for which there is insufficient control under I.R.C. §6038(a).

Therefore, the definition of "constituent entity" for Dutch MNE groups is potentially broader than the definition of "constituent entity" for US MNE groups. This could make a difference in the types of entities that would have to be reported on the CbC report for each country. For example, under the US Treasury regulations, certain variable investment entities (VIEs) need not be reported on the US MNE group's CbC report if the group's ownership of such VIEs was 50 percent or less.

**Definition of "fiscal year": Same in substance as US Model CAA and same for US MNE groups and Dutch MNE groups:** The definition of the term "fiscal year" in the US-Netherlands CAA is slightly different from that in the US model CAA, but the substance appears to be the same. In addition, the substance of the definition for both US and Dutch MNE groups appears to be the same, as discussed below.

Under the US model CAA, the term "fiscal year" is defined as "the annual accounting period with respect to which the Reporting Entity prepares its financial statements." Under the US-Netherlands CAA, the definition of the term "fiscal

[5] At the time of writing, other CbC CAAs were being released; however, this alert examines only the US-Netherlands CAA. The CAA with Norway follows the US model CAA even more closely than the US-Netherlands CAA.
[6] http://www.oecd.org/ctp/transfer-pricing/beps-action-13-country-by-country-reporting-implementation-package.pdf

year" defers to the relevant Netherlands tax law. These definitions are in substance the same, because they both base the relevant reporting period on the ultimate parent entity's fiscal year end.

With respect to US MNE groups, the definitions of "fiscal year" in the US model CAA and the US-Netherlands CAA are the same. Both defer to the definition of the "reporting period" as defined in the relevant US Treasury regulations. Furthermore, because the US CbC regulations are generally based on the ultimate parent entity's fiscal year end, as well, the definition of "fiscal year" under the US CbC regulations, the OECD model legislation, and Dutch tax law are all generally the same.

As a result, even though the definition of "fiscal year" in these different sections appears to be different, the substantive definition is still the same both for US MNE groups and Dutch MNE groups. As noted above, this is in contrast to the definition of the term "Constituent Entity," which is potentially narrower for US MNE groups than for Dutch MNE groups.

**Voluntary filing for 2016 gap year: Should be respected:** As noted above, the US-Netherlands CAA addresses potential concerns regarding voluntary filings with the IRS for the 2016 gap year. Section 3(2) of the US-Netherlands CAA mirrors the language in the corresponding section of the US model CAA, and provides that the United States and the Netherlands intend to exchange CbC reports with respect to fiscal years beginning on or after January 1, 2016. This would include reports filed voluntarily with the IRS for the "gap years" beginning on or after January 1, 2016, but before the effective date of the final US regulations on June 30, 2016.

The US-Netherlands CAA states that it becomes operative on the date when the second competent authority signs the CAA. This suggests that the Netherlands does not need to submit the CAA to Parliament or undertake further ratification procedures for it to become operative.[7] Taken together with the language in section 3(2), this appears to support the expectation that 2016 gap year voluntary filings with the IRS will be respected under the US-Netherlands CAA.

**Conclusion**

These developments are promising news for US multinationals, as CAAs will permit taxpayers to file their 2016 CbC reports with the IRS rather than with foreign governments (via either local or surrogate filings). US multinationals whose tax year begins before June 30, 2016, and who file on extension, will generally be able to file their first CbC reports with the IRS when they file their 2016 tax return.[8] US multinationals whose tax year begins before June 30, 2016, and who do not file on extension, will generally need to file the CbC report using the amended return option described in Rev. Proc. 2017- 23.[9]

The IRS has stated that negotiating additional CbC CAAs is a top priority over the next few months. As agreements are concluded, the IRS will update the CbC page on irs.gov to provide a list of the jurisdictions with which it has entered into CAAs. We will continue to provide updates as more CAAs are entered into and as more details about individual CAAs are made public.

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[7] Other countries that enter into future CAAs with the United States may adopt a different approach.
[8] For example, C corporations now have an extended due date of October 16, 2017, and Rev. Proc. 2017-23 states that the IRS will not start accepting CbC reports until September 1, 2017. As a result, calendar-year US multinational C corporations will be able to file their first CbC reports when they file their 2016 tax return in October 2017. For questions concerning due dates and tax returns for other types of entities or C corporations with a fiscal year, please contact a member of Deloitte Tax LLP's Washington National Tax.
[9] This will be the case, for example, for calendar-year C corporations and C corporations whose fiscal year ends on March 31, 2017. However, because of Rev. Proc. 2017-23's permissive rule for amending a taxpayer's 2016 income tax return, the IRS has effectively extended the deadline for Form 8975 to December 31, 2017, for calendar-year C corporations, at least for the first early reporting period. For more information on Rev. Proc. 2017-23 and the permissive rule for amending a taxpayer's 2016 income tax return for CbC purposes, see Global Transfer Pricing Alert 2017-005, March 21, 2017.

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## BEPS Action 15: 68 jurisdictions sign MLI to modify bilateral tax treaties

On 7 June 2017, representatives covering 68 jurisdictions gathered at the OECD's headquarters in Paris for the signing of the *Multilateral Convention to Implement Tax Treaty-Related Measures to Prevent Base Erosion and Profit Shifting* (MLI).

The MLI is designed to implement swiftly the tax treaty-related measures arising from the G20/OECD base erosion and profit shifting (BEPS) project. "Minimum standard" changes to the functioning of existing bilateral tax treaties in the areas of treaty abuse, mutual agreement procedures (MAPs) and treaty preambles will be implemented through the MLI. Further, depending on the reservations and notifications made by each party, optional changes to modify tax treaties in respect of permanent establishments (PEs), transparent entities, residency tiebreakers, double tax relief, minimum shareholding periods, capital gains derived from immovable property and a jurisdiction's right to tax its own residents will be facilitated.

A subgroup of 26 jurisdictions, including 16 EU member states, have opted into the mandatory binding arbitration provisions, based on the principles set out in the final report on BEPS action 14 on making dispute resolution mechanisms more effective.

### Signing jurisdictions and treaties covered

The 68 parties to the MLI are the following:

| | | |
|---|---|---|
| Andorra | Germany | Netherlands |
| Argentina | Greece | New Zealand |
| Armenia | Guernsey | Norway |
| Australia | Hong Kong | Pakistan |
| Austria | Hungary | Poland |
| Belgium | Iceland | Portugal |
| Bulgaria | India | Romania |
| Burkina Faso | Indonesia | Russia |
| Canada | Ireland | San Marino |
| Chile | Isle of Man | Senegal |
| China | Israel | Serbia |
| Colombia | Italy | Seychelles |
| Costa Rica | Japan | Singapore |
| Croatia | Jersey | Slovak Republic |
| Cyprus | Korea | Slovenia |
| Czech Republic | Kuwait | South Africa |
| Denmark | Latvia | Spain |
| Egypt | Liechtenstein | Sweden |
| Fiji | Lithuania | Switzerland |
| Finland | Luxembourg | Turkey |
| France | Malta | United Kingdom |
| Gabon | Mexico | Uruguay |
| Georgia | Monaco | |

Eight other jurisdictions have expressed their intent to sign the MLI, including Mauritius and Estonia, the only EU/EEA state remaining to sign.

The OECD, in its role as Depositary, has published provisional lists of the treaties they intend to bring within the scope of the MLI, along with their reservations and notifications ("MLI Positions"). A treaty will be modified only if the parties to it agree ("Covered Tax Agreement"). Signatories may amend their MLI Positions until ratification. After ratification, signatories can choose to opt in with respect to optional provisions (such as arbitration) or to withdraw reservations. They cannot add reservations.
URL: http://oe.cd/mli

**Mechanism for modifying Covered Tax Agreements**

The MLI does not function in the same way as an amending protocol to an existing bilateral treaty. The MLI does not directly change the underlying text, but will be applied alongside the existing treaty, modifying its application.

**Flexibility and transparency**

In some cases, the BEPS recommendations include multiple alternative ways to address an issue and, in other cases, provide for a main provision to be supplemented with optional additional provisions. The MLI is sufficiently flexible to support all previously agreed BEPS approaches by allowing jurisdictions to select from alternative options and by filing standardized technical reservations that identify their choices.

The extent to which the MLI modifies an existing tax treaty depends on the MLI Positions of the parties to the treaty and the corresponding application of the mechanical provisions of the MLI. The OECD has published a toolkit, including interactive flowcharts, to assist in the application of the MLI to existing tax treaties. A public online matching tool, to simulate the likely matching outcome based on MLI Positions, is under development and a beta version is expected to be available by October 2017.

In general, any reservations or choices made by a country will apply to all its Covered Tax Agreements, but can be restricted to a subset of its Covered Tax Agreements based on objective criteria.

**Treaty abuse (minimum standard)**

The treaty abuse minimum standard addresses concerns that bilateral tax treaties could be used to make treaty benefits available in unintended circumstances. Options are given to support the different approaches permitted under the minimum standard: principal purpose tests (PPT) or simplified limitation on benefits rules (LOB), supplemented with a PPT. Alternatively, the use of detailed LOB rules (supplemented by a mechanism to deal with conduit arrangements) is permitted. A multitude of outcomes can arise where the approaches differ, and asymmetric results are possible if both jurisdictions approve.

All 68 signing jurisdictions have opted to include the PPT within their Covered Tax Agreements. The following 12 countries have chosen to opt for the supplementary LOB rules: Argentina, Armenia, Bulgaria, Chile, Colombia, India, Indonesia, Mexico, Russia, Senegal, Slovakia and Uruguay.

Where only one of the parties has opted for the simplified LOB rules, the specific notifications and reservations must be considered to determine the specific outcome.

**Permanent establishment (optional)**

The PE provision in the MLI lowers the threshold at which a PE (taxable presence) will arise by:

- Broadening the scope of a dependent agent PE (capturing the use of commissionaire arrangements and other matters);
- Narrowing the exemptions for a fixed place of business PE by requiring activities to be "preparatory or auxiliary" in nature and/or by introducing an anti-fragmentation rule; and
- Countering avoidance where long-duration construction contracts are split into a series of shorter contracts.

Within the EU, only eight countries have opted for the dependent agent/commissionaire changes: Croatia, France, Lithuania, Netherlands, Romania, Slovakia, Slovenia and Spain.

Fourteen EU member states have opted for the narrower preparatory or auxiliary provisions: Austria, Belgium, Croatia, France, Germany, Ireland, Italy, Lithuania, Luxembourg, Netherlands, Romania, Slovakia, Slovenia and Spain.

Thirteen member states have opted for the anti-fragmentation measures: Belgium, Croatia, France, Ireland, Italy, Lithuania, Netherlands, Portugal, Romania, Slovakia, Slovenia, Spain and the UK.

The splitting up of contracts anti-avoidance has only been fully adopted within the EU by France and Slovakia.

Eleven member states have reserved against all of the above changes to the PE threshold: Bulgaria, Cyprus, Czech Republic, Denmark, Finland, Greece, Hungary, Latvia, Malta, Poland and Sweden.

**Mandatory binding arbitration (optional)**

The mandatory binding arbitration rules will apply only if both parties to a treaty opt in. Unlike in most other areas of the MLI where reservations are standardized, parties are free to determine the scope of cases that will be eligible for arbitration (subject to acceptance by the other relevant parties).

Typically, a taxpayer can request arbitration where a case has been subject to a MAP for at least two years without resolution. Two different types of decision-making processes are facilitated by the MLI:

1. “Final offer” rules, whereby each competent authority presents its own proposed resolutions and the arbitrators choose their preferred outcome; and
2. The “independent opinion” approach, which results in a decision written by the arbitrators based on their analysis of the information provided to them.

The 25 jurisdictions that have opted into mandatory binding arbitration are: Andorra, Australia, Austria, Belgium, Canada, Fiji, Finland, France, Germany, Greece, Ireland, Italy, Japan, Liechtenstein, Luxembourg, Malta, Netherlands, New Zealand, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland and the UK. Most have opted for the default option of final offer arbitration.

The UK has reserved the right for existing arbitration provisions in 18 specified treaties not to be affected by the MLI, including those in the treaties with Belgium, Canada, France, Germany and the Netherlands. No reservations restricting the scope of matters acceptable for arbitration have been entered by the UK.

**Entry into force and into effect**

Individual signatories will need to ratify the MLI in line with their domestic constitutional arrangements. The MLI must be ratified by at least five jurisdictions before it first enters into force. Following a period of three months after the date of ratification by the fifth state, the MLI will enter into force for those first five jurisdictions at the start of the subsequent calendar month. A three-month period will apply for all other jurisdictions that subsequently ratify the MLI.

The MLI can enter into effect for a specific Covered Tax Agreement only after the three-month period has expired for all parties to the Covered Tax Agreement. The default timings are:

- Modified withholding tax provisions will have effect for payments made after the first day of the following calendar year; and
- Changes relating to taxes levied with respect to taxable periods will have effect for taxable periods beginning on or after a period of six calendar months has elapsed (or less if both parties agree).

Jurisdictions can unilaterally replace the term “calendar year” with “taxable period,” and vice versa (potentially leading to asymmetry).

Different provisions apply for dispute resolution and cases could be eligible even where the dispute relates to a period before the MLI was in force.

**Comments**

The MLI is an important milestone in global agreement on international corporate taxation. It sends a signal that countries are determined to cooperate on corporate taxation to minimize base erosion while working to avoid economically damaging double taxation.

The participation of 68 jurisdictions in the signing ceremony is expected to result in the amendment of over 1,100 treaties in line with BEPS recommendations – about one-third of the global total. The MLI remains open to interested parties, and the OECD Secretariat hopes that 90 jurisdictions will have signed by the end of 2017.

Many countries have listed significant numbers of treaties in their provisional notification: UK (119); China (102); Belgium (98); France (88); India (93); Luxembourg (81); and Netherlands (82). Widespread adoption should help to ensure consistency in the implementation of the BEPS project, resulting in more certainty for businesses and tax authorities. The next step is for the signatories to complete their domestic ratification procedures; this will determine when the changes have effect for each tax treaty – likely to be from 2019.

All members of the BEPS Inclusive Framework are committed to endeavoring that treaties will comply with the minimum standard requirements. The US did not participate in the signing ceremony, but does have robust LOB provisions in its existing treaties. The Inclusive Framework on BEPS will undertake a peer review and monitor whether its members' treaties satisfy the BEPS minimum standards.

The PPT will be introduced in all 1,100 treaties covered by the MLI although 12 signatories, including India and Russia, have chosen to supplement this with a simplified LOB clause. Japan has opted for the PPT.

The proposed changes in respect of PEs have not been adopted as widely. Within the EU, only France and the Netherlands will broadly adopt all of the PE changes and the UK will only adopt the anti- fragmentation rule. These provisions may need to be revisited by the Inclusive Framework to increase consistency.

The effective resolution of disputes that could lead to double taxation remains an essential objective of double tax treaties and key to removing one of the barriers to international trade. The number of disputes between tax authorities globally continues to rise, and the adoption of the optional mandatory binding arbitration rules by 26 jurisdictions, will be welcomed by business.

The OECD, in its capacity as Depositary, has published on its website a number of useful tools along with provisional lists of treaties, options and reservations for each of the signatories. Businesses that currently benefit from double tax treaties between the initial signatories can now begin to analyze the impact of the changes published. Careful analysis will be needed since the information available is long and complex (the UK's positions alone amount to 66 pages+. The public online matching tool expected to be launched in October 2017 will be welcomed.

Although there is no requirement to do so, many governments may produce some form of consolidated treaties once the positions are finalized on ratification.

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## Border-adjustment tax gets mixed reviews from US House Ways and Means Republicans

House Ways and Means Committee Chairman Kevin Brady, R-Texas, stuck by his argument that a proposed border-adjustment tax would make US businesses more competitive internationally and remove current-law incentives for companies to relocate offshore in comments at a 23 May 2017 committee hearing. But even though most Republicans on the panel aligned themselves with Brady's position, other GOP tax writers joined their Democratic colleagues in raising concerns about the proposal.

### Border-tax overview

The "Better Way" tax reform blueprint that Brady and House Speaker Paul Ryan, R-Wis., released in June 2017 proposes a new destination-based cash flow tax that provides for "border adjustments" through a not-yet-specified mechanism that would serve to eliminate US tax on products, services, and intangibles exported abroad (regardless of their production location) and impose a 20% US tax on products, services, and intangibles imported into the US (also regardless of production location).

This border-adjustment tax – which has not yet been released as a discussion draft or an introduced bill and is described only in general terms in the House GOP blueprint – has divided congressional Republicans and become the focus of an intensive lobbying battle within the business community, with retailers, oil refiners, and other import-dependent industry sectors on one side and export-heavy businesses on the other.

Brady acknowledged the objections that have arisen in recent months, noting in his opening statement that "[w]e know there are legitimate concerns, including from some of our witnesses here today and our colleagues on the other side of the aisle about how it will affect American workers, businesses, and consumers. And we are committed to working with all of you to address these concerns. We have to get it right."

### Impact on consumers

Several Republicans contended at the hearing that the proposal could have a detrimental impact – in the form of higher prices – on US consumers. Rep. Erik Paulsen of Minnesota, whose district is home to many Target Inc. employees – the retailer is headquartered in a neighboring district in downtown Minneapolis – said he "cannot support the border adjustability provisions as introduced last year in the blueprint."

Paulsen asked Target CEO Brian Cornell, who testified at the hearing, to elaborate on what he thought should be the key elements of any tax reform plan. Cornell replied that his top priorities were a lower rate as well as simplicity, clarity, and certainty – things that he said the border-adjustment tax would not guarantee.

"As I've listened this morning to the discussion, there's one word I continue to hear repeated again and again, and that's 'if.' *If* currencies appreciate, and *if* the GDP grows, and *if* manufacturing comes back, and *if* we can avoid trade wars. We certainly need to be sitting here working on something that's going to provide greater certainty to…the families we serve at Target, my 320,000 employees, [and] those small businesses that are in the back of the room," he said.

Rep. Jim Renacci, R-Ohio, said he is skeptical of the border adjustment but was trying not to be. He expressed his concerns as three questions: whether border adjustability picks winners and losers, who bears the ultimate burden of the tax, and whether it complies with our current international treaty obligations.

He said the first two questions can only be answered with economic theory at the moment. As to the third question, Renacci said that "at best, border adjustment is a case of first impression, and at worst it's a flagrant violation of our obligations."

Another GOP taxwriter seen as uncertain about the proposal was Mike Kelly, R-Pa., who asked witnesses how it would affect "the price on the shelf" and how it would affect consumers going forward.

Cornell replied that the supply chains for many consumer goods currently do not exist in the US and cautioned that "unintended implications" of the border-adjustment tax could lead to higher prices on "essential" consumer items such as apparel and produce. He contended that lawmakers need to ensure they understand the impact of their proposals on consumers as they move forward with tax reform.

Also among the unconvinced is Ways and Means Committee Republican Pat Tiberi of Ohio, who did not attend this hearing but weighed in with reservations about the proposal's impact on consumers at a 24 May committee hearing to examine President Trump's budget and tax reform proposals.

Democrats on the panel argued that the tax benefits in the House GOP blueprint are generally skewed toward wealthier taxpayers and that an additional increase in consumer prices resulting from a border-adjustment tax would further squeeze low- and middle-income taxpayers.

"When you have shocks to an economy like trade disruption, technological change, and other things, you want the tax system to sort of insulate people from shocks so that everyone's after-tax income can go up," said Rep. Loretta Sanchez, D- Calif. "A rising tide should raise all boats."

**Currency adjustment**

One leading defense of the border adjustment has been an economic argument that currency will adjust to mitigate the effects of a tax on imports. Cheaper exports will lead to increased demand for US products and thus US dollars, which will drive up the currency enough that US businesses that purchase imported goods will have increased buying power that will offset increased purchase prices.

But not all lawmakers were sold on the idea that currency would adjust completely (that is, enough to cover the full burden of the tax on imports), let alone fast enough to mitigate the increased cost of imports. Renacci, for example, commented that "market analysts and currency experts have been skeptical; Wall Street firms believe there is a large potential for disruption and could cause volatility in the market."

Rep. Kenny Marchant, R-Texas, asked several witnesses how companies have fared in recent months with the dollar and euro fluctuating against the pound. Cornell of Target said that contracts for imports are often dollar-denominated, which negates a currency adjustment.

Another witness, Lawrence Lindsey, a former advisor to President Reagan, countered that the market power of large retailers and their ability to hedge for currency risk would allow them to adjust to a border tax.

"All the…countries that have border adjustability still have retail sectors…that haven't been wiped out by the imposition of border adjustability," he said.

**WTO compliant?**

Members on both sides and several witnesses expressed concern that a border-adjustable tax could run afoul of World Trade Organization (WTO) rules and potentially lead to the imposition of retaliatory tariffs. The general principle is that border adjustments are allowed in indirect taxes, such as a value-added tax (VAT), but not in direct taxes, such as an income tax. While many members compared the proposed border-adjustment tax to a VAT, others noted it is still technically an income tax levied on corporations based on where sales occur and not a consumption tax levied on consumers.

On the other hand, some members and witnesses advocated for a wait-and-see approach. In response to concerns expressed by Rep. Renacci, Lawrence Lindsey asserted that "no one will know until [the case] is brought [to the WTO]."

Ways and Means Tax Policy Subcommittee Chairman Peter Roskam, R-Ill., who supports the proposal, commented that "[i]t's important to recognize that [WTO] Director General Roberto Azevêdo has noted that there's lots of gray areas in the WTO rules and he has declined to speculate."

Another witness, Kimberly Clausing, a professor of economics at Reed College, said she was confident, based on conversations with trade lawyers that the WTO would find against a border-adjustment tax. She also noted in her answer to a question about WTO retaliation from Rep. Mike Thompson, D-Calif., however, that the dispute resolution provisions which could be triggered by a border tax are provisions the US negotiated and often protect US products in disputes.

**Transition rules**

Even those in support of border-adjustment tax agreed that transition rules will be necessary to avoid market shocks. Roskam said “a smooth transition is key,” and in his closing remarks, Ways and Means Chairman Brady called for a “thoughtful, deliberate transition.”

California Republican Rep. Devin Nunes asked former Reagan advisor Lawrence Lindsey for recommendations on phasing in the tax. Lindsey suggested that one approach would be to apply the tax initially to a percentage of imports and then gradually increase that percentage over time until the tax is fully phased in.

**Better ways than the Better Way?**

For their part, most Democrats on the panel argued that increased spending on infrastructure and education would do more to build the middle class and create jobs than transitioning the corporate income tax towards a consumption tax.

Ranking member Richard Neal, D-Mass., stated in his opening remarks that meaningful investments in infrastructure “can be done through the tax code and would also jump-start economic growth and create thousands of jobs.” Neal added that “to remain competitive, we must invest in workforce development” to close the education and skills gap. He also expressed support for “using repatriation dollars to pay for infrastructure and/or other productive purposes for the middle class.”

Rep. Mike Thompson of California argued that a lack of skilled workers – not a lack of capital formation – was the main impediment to economic growth in many states.

Several members also made the argument that it was disparities among labor markets and regulations rather than issues with the US tax code that has caused production of many goods to move overseas. Citing examples of industries leaving the US for China and Mexico, Rep. Sander Levin, D-Mich., argued “it wasn’t because of our tax systems; it was because of the huge differential in the cost of labor.”

The Trump administration, meanwhile, has yet to fully embrace or reject the notion of a border tax. Treasury Secretary Steven Mnuchin has stated that the proposal “does not work in its current form” although the administration likes “some parts” of it. But in comments at a 23 May forum sponsored by the Peter G. Peterson Foundation, Mnuchin appeared to criticize the proposal more directly, saying that it “doesn’t create a level playing field for all US businesses” and that “it has very different impacts on different companies, …the potential to pass on significant costs to the consumer, [and]…the potential of moving the currencies.”

**White House budget prompts more border tax discussion**

The border-adjustment tax was also one of several topics addressed at a House Ways and Means Committee hearing on the president’s budget and tax reform proposals on 24 May 2017 and a Senate Finance Committee hearing covering the same ground on 25 May 25 2017. Treasury Secretary Mnuchin was the sole witness at both hearings.

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## Calendars to watch

Each edition, be sure to mark your calendars for some of the more important events (recent and upcoming) as well as tax developments making in impact on businesses investing into the United States.

**Recent and Upcoming Activities**

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| May 3 | **Dbriefs archive:** Post-merger integration tax strategies – Capturing synergies in a rapidly changing world<br>Watch<br>**URL:** https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/may/2017/dbriefs-post-merger-integration-tax-strategies-capturing-synergies-in-rapidly-changing-world.html?id=us:2em:3na:usic:awa:tax:061917 |
| June 13 | **Dbriefs archive:** JUS federal tax reform: State tax implications<br>Watch<br>**URL:** https://www2.deloitte.com/content/www/us/en/pages/dbriefs-webcasts/events/june/2017/dbriefs-us-federal-tax-reform-state-tax-implications.html?id=us:2em:3na:usic:awa:tax:061917 |
| June 14 | **Dbriefs webcast:** Transfer pricing spotlight: Italy, Spain, and other global hot topics<br>Register<br>**URL:** https://www2.deloitte.com/content/www/us/en/pages/dbriefs-webcasts/events/june/2017/dbriefs-transfer-pricing-spotlight-italy-spain-and-other-global-hot-topics.html?id=us:2em:3na:usic:awa:tax:061917 |
| June 28 | **Dbriefs webcast:** Global indirect tax automation: A breakthrough, centralized approach<br>Register<br>**URL:** https://www2.deloitte.com/content/www/us/en/pages/dbriefs-webcasts/events/june/2017/dbriefs-global-indirect-tax-automation-a-breakthrough-centralized-approach.html?id=us:2em:3na:usic:awa:tax:061917 |