The outlook for global tax policy in 2017

United States tax reform
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The outlook for US tax reform and its potential effects on global tax policy

The US tax reform picture is more dynamic and fluid than it has been for some time. In this piece, we provide an overview of the current state of the US tax reform debate. This article has been prepared for general informational purposes only. It is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.

There has been a general desire for some time to reform the US tax system to increase US tax competitiveness and grow the economy.

Many reform ideas have been under development for years, but the political dynamics have made action on tax reform challenging. With Republicans in control of both chambers of Congress and a Republican president in power, the prospect of achieving significant tax reform has become much more likely, with some speculating that tax reform legislation could be enacted in the 2017-2018 timeframe. Should that happen, it is expected that the changes would be effective for 2018 forward; however, it is possible – though somewhat less likely – that changes could affect earlier tax years.

Of course, whatever the outcome, multiple parties will be impacted by the changes, with some groups potentially benefitting from reform while others could face a more challenging tax picture. And, of course, tax reform by a major trading nation like the United States will likely prompt other countries to adopt measures in response, as they adjust to the revised business and economic landscapes.
Where exactly the corporate income tax rate ends up will depend partly on revenue considerations, and what other provisions are included in tax reform to offset the revenue loss of lowering the rate.

What is the US striving for?

For Republican lawmakers controlling the legislative agenda, economic growth remains a key issue. While US economic growth is strong and unemployment is down, it is expected that reform plans will include provisions intended to increase demand for US goods and services as well as a return to capital investment in US companies. Generally, the tax reform plans under consideration share the broad goals of stimulating US economic growth by encouraging companies to invest and create jobs in the United States and to reduce their reliance on imports. The leading plans would generally lower income tax rates, broaden the US tax base by eliminating many targeted tax preferences and make changes to the international tax system that are aimed at bringing the United States more in line with other countries’ territorial tax systems.

There have also been calls from the Trump Administration and members of both political parties for legislation to increase investment in US infrastructure. As such, it is possible that some provisions designed to fund infrastructure investment could be included in tax reform legislation.

The process and timing

While Republicans control both chambers of Congress, their majority in the Senate is shy of the 60 votes needed to overcome a Democratic filibuster that could tie up a reform bill. Therefore, Republicans plan to pursue tax reform legislation through “reconciliation.” Reconciliation allows certain legislation to pass with a simple 51-vote majority, but places limits on what can be included in the legislation. House Republicans had intended to use the reconciliation process to repeal and replace the Affordable Care Act (and its associated taxes). That plan, however, is now off the table, leaving a number of issues, both political and economic, that may get folded into tax reform.

Potential tax reform elements

President Trump and congressional Republicans agree on many elements of tax reform – such as lowering tax rates and eliminating many business tax preferences. However, statements made by President Trump before the election suggested some key differences, such as the international tax regimes they propose. Trump, during his campaign, supported repealing deferral and maintaining the worldwide taxation system, while congressional Republicans have sought to move the United States more towards a territorial system of taxation.

Corporate income tax rates are likely to drop as part of the comprehensive tax reform effort in Congress, although when and by how much is uncertain. The rates being considered range from 15% – the rate President Trump proposed during his campaign (with the same rate on the business income of pass-through entities) – to 20% for corporations (and 25% for pass-through business income), which House Republicans proposed in their June 2016 tax reform “Blueprint.”

Where exactly the corporate income tax rate ends up will depend partly on revenue considerations, and what other provisions are included in tax reform to offset the revenue loss of lowering the rate. Congressional Republicans have pledged to make their tax reform effort revenue-neutral, using dynamic scoring (that factors in the economic effects of their tax cuts). While Trump’s campaign plan had been estimated to cost trillions of dollars, the president is expected to try to develop a plan that is closer to revenue-neutral. Trump has indicated he would release a comprehensive tax plan in early 2017.

While the details remain to be seen, some key features that many think will be part of any final tax reform include:

- Lower corporate/business tax rates
- Lower individual tax rates
- Elimination of many deductions, exclusions and credits
- Possible limitations on interest deductions
- Move toward a territorial system and a mandatory transitional tax to encourage accumulated foreign earnings to be repatriated to the United States
- Some provision to encourage economic activity within the United States

Details to-date

Table 1 below summarizes the key features of the Trump plan (based on his tax proposals released during the campaign) and House Republicans’ Blueprint.
Table 1: High-level comparison of Trump’s campaign plan and House Republican Blueprint

<table>
<thead>
<tr>
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<th>Trump campaign plan</th>
<th>House Republican Blueprint</th>
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<tbody>
<tr>
<td>Top corporate tax rate (now 35%)</td>
<td>15%, corporate AMT eliminated</td>
<td>20%, corporate AMT eliminated</td>
</tr>
<tr>
<td>Top pass-through rate (now 39.6%)</td>
<td>15% rate within the personal income tax system for pass-through entities that want to retain profits within the business</td>
<td>25%</td>
</tr>
<tr>
<td>Taxation of future foreign earnings</td>
<td>In September 2015, proposed immediate worldwide taxation, repeal of deferral; unclear if he still supports</td>
<td>• Territorial, 100% exemption for dividends paid from foreign subsidiaries</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Border tax adjustment mechanism</td>
</tr>
<tr>
<td>Mandatory tax, untaxed accumulated foreign earnings</td>
<td>10%</td>
<td>8.75% for cash/cash equivalents, 3.5% otherwise, payable over 8 years</td>
</tr>
<tr>
<td>Cost recovery</td>
<td>Expensing for manufacturers</td>
<td>100% expensing of tangible, intangible assets except land</td>
</tr>
<tr>
<td>Interest</td>
<td>Manufacturers electing to expense capital investment lose the deductibility of corporate interest expense</td>
<td>No current deduction will be allowed for net interest expense</td>
</tr>
<tr>
<td>Other business provisions</td>
<td>Calls for them to generally be eliminated, except for research credit</td>
<td>Calls for them to generally be eliminated, except for research credit and LIFO</td>
</tr>
<tr>
<td>Individual rates (now 10%, 15%, 25%, 28%, 33%, 35%, 39.6%)</td>
<td>12%, 25%, 33%</td>
<td>12%, 25%, 33%</td>
</tr>
</tbody>
</table>

The details of Trump’s campaign tax plan and the House Republicans’ Blueprint are not identical, but directionally they are similar. Some of the elements of business tax reform proposed by Republicans could form the basis for discussions with Democrats. Democrats, however, have not supported the Republican’s proposed lower tax rates for high-income individuals. If the total burden on upper-income taxpayers were unchanged, however (for example through base-broadening), Democrats may be willing to accept the individual income tax rate reductions. The parties have also disagreed on revenue issues in the past, with Democrats arguing reform should be revenue-neutral on a macro-static (as opposed to macro-dynamic) basis. However, if reconciliation is used to advance tax reform, these differences become irrelevant, as Senate Democrats would have little opportunity to change or block the legislation.

It is not clear whether the Senate, the other party in this three-way negotiation, will propose a similar plan. Senate tax leaders have indicated they plan to follow their own tax reform process, however, it remains to be seen whether any Democrats will participate in drafting a Senate plan.
The outlook for global tax policy in 2017

The Blueprint contains another proposal that has generated controversy both inside and outside the United States - a border tax adjustment mechanism. A border adjustment is a way to tax imports and refund (or credit) taxes paid on business purchases used in the production of exports. Under the proposal in the Blueprint, revenue from export sales would not be taxable, and the cost of imported goods would be in the tax base (or taxed separately). If the Blueprint is enacted, the border adjustment mechanism, combined with other changes in the Blueprint, would shift the US income tax toward a consumption-based tax. Global policymakers are watching this proposal closely and are discussing what types of policy changes they may wish to make should this change become law.

Some supporters view border adjustments as a way to improve US competitiveness and the US balance of trade. For example, under current US tax law, a US exporter must pay an import tax on products sold in a foreign country where there are border adjustments (paid via the foreign country’s value-added tax, or VAT). A foreign exporter, in contrast, has no VAT liability; instead it receives a tax rebate under its border adjustment and pays no import tax to the United States.

While in the near term a country that adopts border adjustments could see a temporary increase in exports and decrease in imports (and a corresponding increase in revenue), the longer-term effects of border adjustments are likely to be different. Most economists think that the real price level would adjust to offset the effect that border adjustments might have on trade, with changes in currency values (e.g., exchange rates) the primary mechanisms for the adjustment.

How would the Blueprint’s border adjustment work?

Countries with VATs typically include border adjustments, which refund (or credit) taxes paid on business purchases used in the production of exports, and they tax imports. Border adjustments are included in VATs to transform the tax into a destination-based system that taxes domestic consumption. The provision in the Blueprint is a 20% border-adjusted cash flow tax. Under the provision, revenue from export sales would not be taxable, and the cost of imported goods would be in the tax base (or taxed separately) as it would not be deductible. The provision would apply to all domestic consumption and would exclude any goods or services that are produced domestically, but consumed elsewhere.

Do multilateral trade agreements place any restrictions on border adjustments?

There is uncertainty over whether the border adjustments as proposed in the Blueprint would be allowed under the multilateral trade rules negotiated as part of the General Agreement on Tariffs and Trade under the World Trade Organization (WTO). WTO rules allow for border adjustments under indirect taxes (e.g., VATs), but not for direct taxes, such as income taxes. The border adjustments as proposed in the Blueprint would, in effect, be administered as an income tax. The case for the Blueprint’s border adjustments being permitted is that they move the US income tax system considerably toward being a consumption tax (vs. a direct tax).

At the time this report went to press, it was unclear whether President Trump would support the border adjustment provision outlined in the Blueprint. US Treasury Secretary Mnuchin said in February, "We're looking at it seriously - there are certain aspects of it that we're concerned about, [and] there are certain aspects that we like."

What might other governments be thinking about?

Tax policy never operates in a vacuum, and policy formation today is more reliant upon consideration of impacts – or “spillover” – effects than it has ever been. So with some key components of US reform on the table – but certainly not agreed upon – what are the considerations that other governments may be making while they continue to watch US policy unfold from afar?

While it is hard to predict precisely what the impact of the US tax reforms will be, the following sets out some of the issues that policymakers outside of the United States may be thinking about:

• The President has said that his tax reforms will be designed to boost the US domestic economy by supporting growth and jobs. The lower tax rates should, at least in the short- to medium-term, work to advance this goal.

• If it is part of the final tax reform bill, a border adjustment tax regime could (at least initially) favor US domestic businesses.

In addition, US reforms, if achieved, may potentially lead to responses by businesses and individuals, such as:

• Mobile businesses might consider relocating to the United States – for example, in the technology, pharmaceuticals, services and financial sectors.

• Businesses might shift their expansion and investment decisions to the United States.

• Internationally-oriented businesses currently headquartered outside the United States could consider moving their headquarters to the United States.

• Individuals might decide to relocate to or from the United States.

The medium- to long-term impacts of the tax reform proposals are difficult to predict. Some commentators have predicted that the increased stimulus to the US economy stemming from tax reform would lead to domestic inflation, which in turn could cause US interest rates to rise. This monetary effect could dampen the longer-term stimulatory effects of the tax changes.

Others have pondered the longer-term effects that the US tax reform proposals could have on the trade policies of the United States and its major trading partners. Will the border adjustment tax, if enacted, lead to “retaliatory” law changes by the United States’ major trading partners? Will this in turn lead to greater protectionist policies that could impact the global economy?
In effect, any base erosion and profit shifting actions by either the OECD or European Commission may be impacted by US tax law changes, and consequently rethought in the future.

US tax changes create challenges for the United States’ trading partners, placing even greater importance on those countries’ reform agendas. Governments are aware of this, and many are reinvigorating their efforts in this area. This is evidenced by the data reported in this publication, including the ongoing focus on reducing corporate income tax rates and driving greater levels of economic activity via enhanced or entirely new business incentives.

Corporate tax rates

It is likely that many countries will be reassessing whether their headline corporate tax rate positions them as an attractive place to work, invest and save. The average OECD corporate income tax rate in 2016 was 24.7%, higher than the rate proposed by the House Republicans and by Trump during the campaign. Indeed, data in this publication shows that jurisdictions continue to desire having a competitive, “low-rate, broad-based” business tax environment, extending a trend that we have seen for some years now. Headline corporate income tax rates continue to fall – albeit in slightly fewer countries and with lower overall rate reductions than in the last few years. At the same time, the number of countries forecasting an increased overall business tax burden continues to outstrip those forecasting a reduced burden, cementing the “broad-base” component of the trend.

Many countries continue to believe that competitive tax rates can enhance growth. A number of reports and studies have supported this view, including, for example, Australia’s Henry Review which reported that “Australia’s company income tax rate, which currently stands at 30%, is high relative to other comparably sized OECD countries. The average rate for small to medium OECD economies is currently around 25%.” Reducing taxes on investment would increase Australia’s attractiveness as a place to invest, particularly for foreign direct investment. Reducing taxes on investment, particularly company income tax, would also encourage innovation and entrepreneurial activity. Such reforms would boost national income by building a larger and more productive capital stock and by generating technology and knowledge spillovers that would improve the productivity of Australian businesses and employees.

It’s not just the rate

Business tax reform for any country is not just about delivering lower tax rates. Governments must also consider their tax incentives and more general business tax settings as well – especially for innovation, R&D and capital investment, as we move through what the World Economic Forum has described as the “Fourth Industrial Revolution.” This will be particularly pertinent if the United States reshapes its tax incentives in favor of new capital invested in the United States, and if immediate expensing of capital expenditures (as proposed in the House Republicans’ Blueprint) is enacted.

We are already seeing a refreshed focus by governments in the incentives area. As set out in this publication, there has been a strong uptick in the number and scope of incentives offered by countries – from innovation and patent “boxes,” to R&D incentives and broader business incentives such as depreciation and capital investment allowances. Whether this is to counter ongoing weak economic growth, to provide a more competitive tax environment in the context of the BEPS project or is a precursor to further action in response to US reform remains unclear. But it is fair to assume that, should US reforms spur greater Foreign Direct Investment and capital spending via lower tax costs, other countries will form a response.

A new phase of anti-base erosion measures?

Both the House Republicans’ Blueprint and Trump’s campaign plan included options to limit the interest expense deduction, although the details of the proposals differ. And while many countries are indeed already moving to limit interest expenses (with India being the latest country to adopt the OECD’s BEPS Action 4 recommendations; in its recently announced Union Budget for tax year 2017-18, the Indian Government proposed imposing a limit of 30% of earnings before interest, taxes, depreciation and amortization), such a move by the United States would likely have spillover effects elsewhere. Much the same can be said if the United States makes changes to the way it taxes foreign-earned income of its multinational corporations – such as the rules governing controlled foreign companies, transfer pricing and hybrid mismatch arrangements. Should changes in these areas be enacted, the OECD and others may also want to change their approach to these rules. In effect, any base erosion and profit shifting actions by either the OECD or European Commission may be impacted by US tax law changes, and consequently rethought in the future.

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3 The effective rate paid by companies, which includes National/Federal rates plus any state or regional taxes. Source: OECD Tax Database, accessed 28 February 2017.
5 Ibid, page 163.
6 Ibid, page 149.
7 https://www.weforum.org/about/the-fourth-industrial-revolution-by-klaus-schwab.
Concluding thoughts

Many governments are already modeling the potential impacts of US tax reform and assessing how they might shape their tax policies in response. Companies should be carrying out a similar exercise, as any change in US tax law will affect aspects of their tax strategy. To a certain degree, companies can use a similar approach to the one they used when assessing the impact of the OECD’s BEPS recommendations – monitor, model and engage; the process, protocols and knowledge-sharing activities should already be in place. And as always, monitoring and assessment must be linked to (and embedded in) overall business and tax strategies.
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