CLEARY GOTTLIEB

Business tax reform: a beginner's guide
Where are we headed? What can we do to prepare?

January 25, 2017

Introduction

The inauguration of a new President and Congress controlled by the same party has increased the likelihood of comprehensive tax reform. Legislation could be enacted as soon as the second half of this year. Neither the timetable nor the outcome is predictable. The range of possibilities includes:

Radical changes in the corporate tax system of the kind contemplated by the House Republican Blueprint for Tax Reform (described below).

Tax reform legislation that is **more conventional**, possibly on a **slower timetable**.

— Major tax reform isn't simply a matter of making big-picture policy judgments. *Any* reform—even a real simplification—will require the resolution of a large number of granular (but important) details.

— Even with a running start, and no distractions, the process can take a long time.

No action. The fact that the institutional decisionmakers—the House, the Senate and the Administration—are controlled by members of the same party doesn't guarantee that they will be able to reach a consensus.

Whatever the outcome, the process will involve conflicting signals, reversals of field, plausible rumors that prove to be unfounded, and implausible rumors that turn out to be true. The pendulum swung in the direction of less ambitious changes last week, when the President-elect said the House Blueprint was too complicated. It swung back again two days later, when he said it's still on the table.

What to do now

A reader might ask "If the crystal ball is as cloudy as you say it is, why do we need to pay attention to tax reform now?" Possible reasons to do so include:

1. The proposals that Congress is considering aren't set in stone. **Now is the time for taxpayers and industry groups to make their views known to policymakers.**

2. The prospect of sweeping changes will create **opportunities and risks**. Beginning to think about the implications of the proposals will help put businesses in a position to capture opportunities, and minimize risks, as more information becomes available.

3. Tax reform could have significant **macroeconomic consequences**, including changes in exchange rates. Market participants should consider whether there are risks that should be hedged, or trading strategies that should be pursued.

4. Tax reform could have disproportionately momentous consequences for some businesses. There will be **winners and losers**. *See* slides 17-19.

   — Potentially affected companies don't need to spring into action immediately.

   — It wouldn't make sense to embark on a restructuring every time a storm cloud appears on the horizon. Many legislative proposals never become law.

   — But corporate actions can have **a long lead time**. If tax reform would have significant implications for a company's business model or structure, it may be prudent to consider how the company would adapt to the changes if they become law.

Key features of the Blueprint

Businesses would pay a destination-based cash flow tax ("**DBCFT**"). The new system would apply to businesses conducted through partnerships as well as corporations. The tax would differ from current law in significant respects:

Capital expenditures (including domestic plant and equipment) would be deductible immediately.

Net interest expense would *not* be deductible.

Business income derived by foreign subsidiaries would be exempt from tax. It would no longer be necessary to retain the related earnings overseas.

Border adjustment:

— Export revenues would be exempt from tax. Domestically incurred costs to generate those revenues would be deductible in full.

— No deduction would be allowed for the cost of imported goods and services.

The mechanics of the border adjustment system are counterintuitive. Before going any further, it may be helpful to provide an example of how the system would work.

Example

Importco buys goods manufactured in the U.K. and sells them to U.S. customers. **Exportco** buys goods manufactured in the United States and sells them to U.K. customers. Each company earns a 25% margin on its sales: it buys goods for $80 (or its sterling equivalent) and sells them for $100 (or its sterling equivalent). The current $:£ exchange rate is $1:£0.8.

Case A illustrates the consequences of border adjustment assuming no change in exchange rates. **Case B** shows what would happen if the border-adjusted tax triggers a 25% increase in the value of the dollar (as predicted by economic theory), so that the $:£ exchange rate moves to parity.

Current law.
Importco and Exportco each would have taxable income of $20 ($100 receipts minus $80 cost of goods sold), and would pay U.S. tax of $7 (35% of $20).

The Blueprint.
The corporate tax rate would be reduced to 20%. No deduction would be allowed for the cost of imported goods and services. Revenues from sales to foreign customers would be exempt from tax.

Case A

(border adjustment, no change in exchange rates)

Importco would have taxable income of $100 (gross domestic receipts of $100; no deduction allowed for the cost of imported goods), tax liability of $20, and after-tax cash of zero.

Exportco would have a loss of $80 ($80 deduction for the cost of domestic goods; $100 proceeds of sales to foreign customers not includible in income), no tax liability, and after-tax cash of $20. If Exportco can use the loss to shelter unrelated income, it would realize tax savings of $16 (20% of $80), for after-tax cash of $36.

Example

Case B

(border adjustment with change in exchange rates)

Importco and Exportco would have the same income or loss as in Case A: $100 income (and $20 of tax) for Importco; an $80 loss (and zero of tax, with potential tax savings of $16 if the loss can be used to shelter unrelated income) for Exportco. The change in exchange rates would have dramatic consequences for their after-tax results.

Importco's after-tax cash would be increased to $16. This improvement is attributable to a reduction in the dollar cost of goods purchased from U.K. suppliers. (Importco pays its suppliers £64; the U.S. dollar equivalent of £64 was $80, and now is $64). As a result, Importco would have after-tax cash of $16 ($36 pre-tax proceeds minus $20 tax). This exceeds the amount that Importco would have received under current law; the increase is attributable to the reduction in the tax rate from 35% to 20%.

Exportco's situation is more complicated. If Exportco has U.K. competitors, it may not be able to increase its sterling prices without losing market share. If Exportco wished to maintain the same level of dollar revenues, it would need to increase the prices that it charges U.K. customers from £80 to £100. If Exportco keeps its sterling price at £80, it will have pre-tax cash flow of zero ($80 revenue minus $80 costs). As in Case A, if Exportco can use the loss to shelter unrelated income, it will realize tax savings of $16 (20% of $80), and would have after-tax cash of $16. This exceeds the amount that Exportco would have received under current law; the increase is attributable to the reduction in the tax rate.

What’s the timetable?

1. Congress’s first priority is the repeal and replacement of Obamacare. Formal action on tax reform is unlikely until health care has been addressed.

2. The repeal and replacement of Obamacare may prove to be challenging, from a technical or political standpoint. The legislation is being advanced through the budget reconciliation process (a parliamentary mechanism that restricts the use of filibusters).

3. The prospects for tax reform legislation this year will depend in large part on how long it takes Congress to deal with health care.

4. Unless tax reform can be configured to attract significant bipartisan support in the Senate, it will also need to be advanced through reconciliation. Congress has adopted a reconciliation resolution with respect to health care; it would need to adopt a separate reconciliation resolution with respect to tax reform.

When will we see a proposal? When will we know what to take seriously?

Details concerning the House proposal may become available before too long. But we won't know which features of the proposal are likely to become law for a long time: **six months or more**.

In order to become law, a bill must be passed by the House and Senate, and signed by the President. The House and Senate can have sharply different views regarding the shape of tax reform.

— The Speaker of the House and the Chairman of the House Ways and Means Committee are strongly committed to tax reform. Ways and Means Committee staffers are working actively to develop a legislative proposal.

— The reconciliation process will give the Senate, and individual Senators, significant influence over the final product.

  - If the House bill includes border adjustment or other novel features, some observers expect the Senate to scale them back.
  - But it would be a mistake to take the Blueprint lightly: it represents a very serious proposal.

The President has given mixed signals concerning his receptiveness to the Blueprint. It is uncertain how the Administration's policy preferences will affect the end result.

Background

When the House Blueprint was published in June of 2016, it was seen as an interesting but largely academic exercise. In their own words, the authors decided to "go long". Perhaps to their surprise, the election has put the Blueprint front and center.

The system contemplated by the Blueprint isn't inherently liberal or conservative. The key point is that it would be ***different***, in far-reaching and potentially unpredictable ways. The transition to the new system could have dramatic consequences not only for particular corporations and industry groups, but for the broader U.S. economy.

— The Blueprint would convert the corporate income tax into a destination-based tax. This represents an attempt to combine the characteristics of a value-added tax system with an immediate deduction for domestic labor and other inputs (but not interest expense).

— No other country has done this.

— There are serious questions regarding whether the proposal in its current form would be WTO-compliant: some commentators think it would not be.

Rates

House Republicans, and the President, have called for significant reductions in corporate and individual tax rates. If comprehensive tax reform is enacted, it almost certainly will include rate reductions. But focusing on rates can be misleading:

Tax rates are a dependent variable. They are determined by other policy judgments. How much revenue does the government need? What spending cuts (or increases) are contemplated? Is it important that tax reform be revenue-neutral? What is the distribution of the tax burden among income groups?

Campaign proposals are marketing documents: promised rate reductions may prove to be unattainable when the technicians try to work out the details.

The scoring of a tax reform bill by the Joint Committee on Taxation can have a powerful effect on the end result. These revenue estimates will use dynamic scoring that takes into account macro changes to the economy.

Rate reductions can be accompanied by revenue-generating changes from base-broadening or loophole closing. The House Blueprint calls for a reduction in the corporate tax rate from 35 to 20% (and from 39.6 to 25% for pass-thrus). Even if rates are reduced to this extent, some companies may pay more taxes under a new system.

Macroeconomic consequences

Most economists believe that the adoption of a border-adjusted tax could trigger a correlative increase in the value of the dollar relative to foreign currencies. In theory, a 20% border-adjusted rate could result in a 25% change in exchange rates.

Some commentators have characterized this effect as a multi-trillion dollar transfer of wealth from the United States to foreign countries (or, more precisely, from U.S. investors with foreign currency-denominated assets to foreign investors with U.S. dollar-denominated assets).

The magnitude and timing of this effect, and the overall costs and benefits of a border-adjusted tax, are the subject of active debate.

Some market participants (including economists at major investment banks) take the view that exchange rate changes are unlikely to be as immediate, or as closely correlated to the border-adjusted tax rate, as economic theory would suggest. They say that:

— The world is more complicated than economists' models;

— The consequences of a border-adjusted tax are likely to be spread unevenly across industries and commodities; and

— It may be distortive to express those consequences in terms of a onetime exchange rate adjustment.

Other big-picture consequences

The disallowance of deductions for net interest expense could affect the capital structure of U.S. corporations, the demand for new loans, and the credit quality of existing borrowers. Transition rules regarding the treatment of existing borrowings will be very important.

The introduction of a territorial system (active foreign income exempt from U.S. tax) would eliminate significant inefficiencies by enabling U.S. multinationals to obtain unrestricted access to foreign earnings.

Under the current system, a foreign subsidiary's active earnings are not subject to U.S. taxation for so long as those earnings are retained outside the United States and not returned to the U.S. parent company in the form of dividends.

The resulting incentives have led to the creation of an enormous logjam of foreign earnings—more than two trillion dollars—that cannot be brought home without triggering U.S. tax costs.

The Blueprint, like most recent tax reform proposals, would impose a onetime tax at a reduced rate on this pool. Thereafter, foreign earnings in the pool could be brought home without further U.S. tax costs. This transition measure is a structural necessity: it will be part of any version of a territorial system.

Why is there such a wide range of views regarding costs and benefits?

Everyone agrees that a border-adjusted tax would have very significant behavioral and macroeconomic consequences. That's the idea.

Why is there so little agreement regarding whether those consequences would be good or bad?

— This is new stuff: no other country has tried to replace its corporate income tax with a hybrid system that includes border adjustments (like the DBCFT).

— There aren't many good analogies. Experience with value-added taxes doesn't provide much guidance.

— Even in the VAT world, a subtraction-based tax of the kind contemplated by the Blueprint would be a very rare beast. 150 countries impose a value-added tax in addition to a corporate income tax. 149 of them use a credit-invoice VAT. The 150th country, Japan, applies a subtraction-based method that operates in practice like a credit-invoice VAT.

Preparing for tax reform

Each company's situation is different. If a company doesn't have any characteristics that make it particularly vulnerable to tax reform, it may take the view that it is too early to begin thinking about it.

- It is, after all, impossible to predict whether tax reform will be enacted, or what shape it will take.
- Blue-sky strategic thinking may be called for primarily in respect of the Blueprint's most novel features—the border-adjusted tax, the disallowance of net interest, and the immediate write-off of domestic investments. Their very novelty may make it more likely that they will fall by the wayside during the course of the legislative process.

Depending on the ultimate shape of tax reform, some companies may need to consider intragroup restructurings and recapitalizations; refinancings of external debt; changes to distribution or supply chain arrangements; and the renegotiation of long-term contracts.

Tax reform could affect the costs and benefits of proposed business combinations, and could create incentives for acquisitions and divestitures.

Signposts of a need for strategic planning

Big Plans

Businesses that are considering a major project—a leveraged acquisition; a significant investment in plant and equipment; a long-term supply or output contract—should consider the costs and benefits of the project both under current law and under possible tax reform scenarios.

Financings

Businesses that could be affected by the disallowance of net interest expense should consider the implications of the proposal for new borrowings, including rollovers of existing debt.

— Should they seek to lengthen maturities in the hope that existing debt will be grandfathered? Should they shorten maturities (or to negotiate change-of-law redemption triggers) to provide maximum flexibility when the rules change?

— If a multinational group conducts significant operations in other countries, would it derive more durable benefits by situating new borrowings outside the United States?

Foreign currency

Most economists believe that the Blueprint's proposed border-adjusted tax would increase the value of the U.S. dollar relative to foreign currencies. Borrowers and investors should identify potential mismatches (for example, foreign currency-denominated assets funded with dollar-denominated liabilities) and consider hedging strategies to address them.

Signposts of a need for strategic planning

Tax attributes

Taxpayers with foreign tax credit carryovers and other favorable tax attributes should consider whether steps can be taken at a reasonable cost to make those attributes usable prior to tax reform.

Timing opportunities

As the shape of tax reform becomes clearer, taxpayers should consider whether there are transactions that should be completed before the new rules enter into force, or deferred until after their effective date.

— If a company has a business unit that it expects to sell at a loss, it may derive more significant tax savings by selling that business unit, and recognizing the loss, before tax reform enters into force.

— Similar considerations could apply to appreciated assets. If there are strategic or market-related reasons for selling an asset now, a company may be willing to pay tax at a 35% rate even if a post-effective date sale would have been taxed at a lower rate, or could even have been exempt from tax. If there's no hurry, a company might prefer to wait and see.

Policymakers normally seek to minimize "cliff effect" consequences (unfairness, arbitrage opportunities or inappropriate behavioral incentives resulting from the application of different rules before and after the effective date of tax reform), but there inevitably will be cases in which the timing of a transaction will make a material difference.

Winners and losers

Border adjustment is likely to have disparate consequences for particular businesses and industries. Trying to identify winners and losers is complicated by the absence of a consensus concerning what to expect.

The Blueprint says that the new system will create American jobs by spurring exports and encouraging manufacturers to rely on domestic suppliers. Most economists believe that, in theory, border adjustment won't affect the level of exports and imports over the long term, because the tax costs and benefits will be offset by the change in exchange rates.

An increase in the relative value of the dollar could adversely affect:

Sovereign and private borrowers that use foreign currency-denominated cash flows to support dollar-denominated liabilities; and

Pension funds and other U.S. institutional investors whose portfolios include significant unhedged positions in foreign currency-denominated financial assets.

U.S. multinationals may need to consider hedging their foreign currency-denominated assets

Winners and losers

If border adjustment does not result in a significant reduction in the cost of a particular imported good or commodity, then the disallowance of deductions for imports could adversely affect:

Natural resources companies whose raw materials, and refined products, are priced in U.S. dollars.

Businesses that rely on imported raw materials. A chocolate manufacturer doesn't have a choice: there aren't any cacao plantations in the United States.

Retailers that source products from China and sell them to U.S. consumers.

Domestic as well as foreign **automobile manufacturers**. Without regard to where their assembly plants are located, every automobile manufacturer makes use of components and materials sourced from outside the United States.

For some enterprises, the disallowance for net interest expense will be offset by the ability to write off capital expenditures immediately instead of amortizing them over time. Allowing businesses to claim an immediate deduction for the cost of a domestic long-term investment in plant and equipment effectively is a substitute for allowing them to deduct interest expense incurred to finance such an investment. The interest deduction and the immediate write-off are different ways of granting the same benefit: it would be duplicative to allow taxpayers to benefit from both of them.

Winners and losers

The disallowance of net interest expense could have more momentous consequences in cases where borrowing proceeds are ***not*** used to buy a turbine or build a factory:

Leveraged acquisitions.

In considering how to structure and finance the acquisition of a U.S. company (or a foreign company with significant U.S. operations), prospective acquirors should take account of the possibility that net interest expense won't produce U.S. tax benefits

Funding foreign operations.

The disallowance of *all* deductions for net interest expense would eliminate the need for interest allocation rules targeted at borrowings by U.S. companies to fund activities carried on through foreign subsidiaries.

Limitations on net interest deductions could survive as part of tax reform even if border adjustment is eliminated.

The devil is in the details

The Blueprint is a brief summary of what inevitably will be complex and far-reaching legislation. Many important details will need to be worked out.

Committee staff charged with preparing draft legislation can be expected to draw on models including the most significant recent tax reform proposal, then-chairman Camp's 2014 bill. The text of that bill, which was much more limited in scope than the Blueprint, is 979 pages long.

The transition from current law to the new system will raise important questions:

— Will rates (or other features of the new system) be phased in over time?

— Will grandfather rules be provided for pre-enactment indebtedness, investments that have not been fully depreciated, and supply or output contracts?

— In general, a phase-in of benefits would reduce, and a grandfather rule would increase, the cost of tax reform legislation.

— Policymakers will need to provide a workable mechanism for the utilization of loss and credit carryovers from pre-enactment years. Similar issues arise in connection with every significant change in the tax rules, and policymakers typically are attentive to the relevant fairness issues.