10 January 2017

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Waking Up from a Long Winter's Nap … the Border Adjustment Tax is the Sleeper Issue in the House Republican Tax Reform Blueprint

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Thanks to the Republican sweep of the White House and the Congress, all the talk in recent years about tax reform is on the verge of turning into action. What many dismissed as idle chatter before Election Day suddenly became very real as the prospect of passing tax reform by using the budget reconciliation mechanism requiring only 51 votes in the Senate turned from a pipedream into reality. But, with so many tax reform options on the table, how do you know what to focus on? What ideas are worth explaining to the C Suite, running diagnostics, and spending resources to support or oppose?

The House Republicans' "A Better Way," more frequently referred to as the "Blueprint," is getting most of the attention. Released in June of 2016, it is more fully developed than President-elect Trump's tax reform plan. The two have many synergies, however, including lower business tax rates, some version of full expensing for capital expenditures and limitations on interest expense deductions, and special rates for repatriating offshore earnings. As a result, the Blueprint is expected to be the launch pad as the countdown to tax reform begins.

The Sleeper Issue … Border Adjustment Tax

A key policy and revenue provision, the border adjustment tax, or "BAT," has emerged as the "sleeper" issue in the Blueprint. It has the potential to affect virtually every business in the United States. For many — particularly companies that rely on global supply chains — the impact could be significant. If your business directly exports or imports products, services, or intangibles, the BAT will impact you. If your business indirectly exports or imports products, services, or intangibles, i.e., you buy from an importer/distributor, the BAT will impact you. You need to know what it is and how it will affect you.

What is the Border Adjustment Tax?

The BAT is a mechanism intended to encourage business activity and exports in the United States and discourage corporate inversions, certain cross-border manufacturing operations known as *maquiladoras*, and imports. It is designed to counter the border adjustments our trading partners apply in their value added tax (VAT) regimes. As described in the Blueprint, it operates by excluding the sales of exports from U.S. taxation and denying U.S. tax deductions for the costs of imports. In practice, it decreases the effective tax rate on exports and increases the effective tax rate on imports, which can be expected to affect their prices and costs, respectively. The BAT applies to products (e.g., raw materials, parts, items for resale), services (e.g., financial, legal, accounting, medical, engineering, architectural, management), and intangibles (e.g., royalties).

Winners and Losers … Battle Lines Being Drawn

The BAT has the potential to affect most American businesses since many rely either directly or indirectly on exports or imports. As companies start to crunch the numbers, it appears there could be stark winners and losers, at least as the BAT is currently described in the Blueprint. Net exporters of products and services would benefit from an effective tax rate of zero on exported sales. Net importers, and businesses that pay royalties on intellectual property held outside the U.S. or interest on non-U.S. loans, could see their effective tax rates soar. The battle lines have been drawn, with supporters and opponents coalescing with like-minded stakeholders.

Other Important Things to Know About the BAT

While President-elect Trump's tax reform plan does not include a BAT, Mr. Trump and his advisors have spoken favorably about a border tax to discourage maquiladoras and imports. Since the policies between Mr. Trump's border tax and the Blueprint's BAT seem aimed at the same circumstances and the same result, and given the significant synergies between the Trump and House Republican tax reform plans, melding the two concepts as tax reform progresses seems likely.

Trade experts warn that the BAT could be viewed as a discriminatory tax or a prohibited export subsidy not compatible with the United States' World Trade Organization ("WTO") commitments. A successful challenge at the WTO by U.S. trading partners likely would take several years to resolve, but could result in punitive tariffs on U.S. exports and leave U.S. businesses in limbo, calibrating risks while awaiting clarity. Although House Republicans acknowledge this possibility, they consider the BAT an indirect tax, like the European VAT, which would not run afoul of WTO rules.

Economists are split on the impact of the BAT. For example, some say that the value of the dollar will increase as a result, reducing the effective cost of imports over the longer term. Others are more concerned about the effective short-term increase in the cost of imports.

House Republican Response

House Republicans are frustrated that hard lines are being drawn even before they release a formal plan. They are aware of the concerns about the BAT and are working to design a response that would mitigate those concerns, including possible transition rules for raw materials and certain commodities, while keeping the overarching policy in place. They want stakeholders to run the numbers in the context of the overall Blueprint, including lower rates, full expensing, a territorial international system, and repatriation, to see how they come out in the big picture. Then they want to hear from stakeholders so they can understand their business flows and practices.

One thing seems certain — House Republicans plan to stick with the BAT. Speaker Ryan and Ways and Means Committee Chairman Brady continually reiterate their support for the BAT in the face of criticism. With estimates that the BAT could raise as much at $1.3 trillion and pay for almost one-third of tax reform — and stem the tide of businesses leaving the

United States — it seems far more likely that House Republicans will tinker with it rather than abandon it altogether.

What Will You Tell the C-Suite?

Don't be caught napping. Time is short. Work on the BAT has been underway for months, and Chairman Brady plans to have his tax reform plan ready when then-President Trump and Speaker Ryan say it's time. You need to be ready, as well. Know whether the BAT affects you. Run the numbers to see how it affects your business. And have a plan to respond. This is a time when you may not be able to rely on your trade association, since many will have members on both sides of the issue and will not be able to take a position. How will you explain to the C Suite what you are doing to protect the interests of your company?

The K&L Gates tax and trade teams have decades of policy and technical experience to help you understand the BAT, determine its impact, and develop a position and strategy for your business. If you would like to discuss providing input or how best to position your business on this fast-moving issue, we would be happy to assist.

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