US Tax Reform

What to expect for Swiss groups and foreign headquarters?
Since President Trump took office in January, there has been a lot of discussion around reforming the US tax code, with the new President announcing that this would be a top priority for his administration and both the House and the Senate controlled by the Republicans. However, despite early indications that this would be a fast-paced and fundamental reform, developments in the last few months seem to indicate that there is still plenty up for negotiation. To date, the Trump administration has prioritized repealing the Affordable Care Act (ACA), and this continues to consume resources and political capital in Washington. Meanwhile, the timeline for US tax reform stretches further into the future and its content remains unclear. Both US groups and foreign groups with US operations are preparing for some possible major changes, which would affect not only their bottom lines but also how they do business.

Although the detailed content remains uncertain, the goal of a possible reform is widely-accepted to be the strengthening of US economic growth, with a focus on job creation and simplifying the US tax system. To achieve this, a number of principles have been proposed:

- Reduction of tax rates on businesses and individuals
- Reduction of income tax rates on corporations cut from 35 percent to 20 percent (or even 15 percent in accordance with the original Trump campaign plan)
- Removal of many deductions
- Denial of interest deductions, except to the extent it offsets interest income
- Move from a worldwide taxation system to a territorial regime with a consumption-based focus (commonly referred to in the press as a “Border Adjustment Tax”).

The most recent indicator of possible content is the statement released by the “Big Six” congressional and administration leaders in late July titled “Principles for US Tax Reform.” Although significantly less specific than other documents already released, such as the House Blueprint released by the House of Representatives Republican Tax Reform Task Force back in June 2016, it is an important update on what is happening behind the scenes. What we do know is that the principles of the reform continue to be subject to active debate in both the House and Senate, although it is uncertain to what extent the White House supports key aspects of the House Blueprint.

Controversial Border Adjustment Tax (“BAT”) seems to be off the table

A key part of the Republicans’ tax proposal has been a move towards a destination-based cash flow tax, with a focus on where goods and services are consumed rather than where they are made. This would be a marked departure from the current worldwide taxation system, where businesses and people are taxed on their total income, regardless of source.

A border adjustment tax would work by denying US tax deductions to US buyers on imported goods and services, whilst exempting exported goods and services from US tax for US suppliers. Thus, in terms of deductible expenses, a US taxpayer may deduct its domestic cost of goods sold (COGS) but not its foreign COGS.

The introduction of a BAT would therefore have a significant impact for foreign groups with business activities in the US and, in particular, for foreign groups that produce goods outside the US and import them to the US. Under a BAT situation, the foreign group would pay tax at the US corporate rate on its US-based sales with no deduction for its costs of import. The impact would therefore be very significant for traditional Swiss export industries, such as the Swiss watch-making industry (relying on the Swiss made label), and the precision or pharma industries.

However, the latest political discussions suggest that this controversial BAT will not be included in the reform proposals. This is very positive news for exporting economies, like Switzerland, but any further developments in this area should still be carefully monitored.

Awaiting clarity on tax rate reductions

With a federal tax rate of 35 percent on corporate tax profits, the US is one of the few countries that has not reduced its corporate tax rate over the last few years. According to Republican plans, this could soon change with the rate reduced to either 15 percent (President Trump’s campaign proposal) or 20 percent (House Blueprint). We are currently awaiting clarity on this point. It is worth noting that without the BAT – which was expected to raise about $1 trillion in tax revenues – lawmakers and the White House will need to find other ways to help offset tax cuts if they want to stick to their revenue-neutral plans and prevent tax reform from increasing the budget deficit.

Denial of deductions

To simplify the US tax system, Republican leaders have proposed various limitations to tax deductions and other incentives. The most significant would be the denial of
interest deductions, except to the extent that these offset interest income. Although the latest statements have not addressed this topic, there is no indication that this is off the table. Foreign groups with highly-leveraged US operations, or that rely on specific tax incentives in the US, may be significantly hit by these possible limitations.

**What to expect next?**

How can we expect tax reform to play out? In chronological order, here are the likely steps ahead before a tax reform bill is signed:

- **Congress approves a budget**, along with budget reconciliation instructions for tax reform
- **The House acts**: it releases and assesses a tax bill, converting some version of the House Blueprint into fully-operational legislation.
- **The Administration acts**: it completes its other priorities, including addressing healthcare reform and releasing a more detailed tax budget.
- **The Senate acts**: if the bill passes the House by a convincing margin, the Senate will likely follow a similar approach to tax reform. If it passes with only a minimum number of votes, the Senate may pursue its own plans, possibly not based on the Blueprint.
- **The bills are reconciled**: Congress reconciles differences and develops a compromise bill, which must pass both the House and Senate.

**Conclusion**

Considering the latest developments, it seems unlikely that a US tax reform bill will be passed in the near future. However, notwithstanding the uncertainty, businesses should not wait to take action. With the BAT off the table, the greatest concern may have subsided, but Swiss groups and foreign headquarters located in Switzerland could still be worse-off under the new tax rules if they rely heavily on debt to finance their US operations and/or on specific incentives or credits in the US. As an immediate measure, impacted groups should closely monitor developments over the coming weeks and months. In parallel, with the help of modeling tools, they should start to take a view on the potential impact on their structure and operations, and consider how they might restructure their supply chain to mitigate the impact of a potentially unfavorable US tax reform.

Sébastien Maury
International Corporate Tax
smaury@kpmg.com