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VIEWPOINT

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In this article, the author examines how President Trump and the U.S. Congress might address tax reform.

The world is closely watching the United States with its Republican Congress and president. How will the new president change policy? Will the emphasis on immigration and healthcare overwhelm the agenda and prevent the government from focusing on creating jobs, streamlining regulation, and reducing taxes? How will President Trump prioritize his tax reform proposals that could reduce corporate taxes and affect global trade by implementing a border tax, tariffs, or a VAT?

In the world of taxes, one thing is clear: There will be corporate tax reform in 2017. Congress wants it. Trump wants it. And the U.S. economy needs it. No amount of controversy over immigration or healthcare will prevent it. The U.S. marginal corporate tax rate is the third highest in the world at 39.1 percent (35 percent federal rate plus a combined state rate) and is higher than those of most U.S. trade partners. U.S. corporate taxes apply to worldwide income of U.S.-based corporations. The high tax rate puts the United States at a substantial competitive disadvantage vis-à-vis the rest of the world for U.S.-produced goods and services.

A major reduction in U.S. corporate tax rates would drive companies to locate in the United States. Instead of being one of the highest-taxed countries, the United States would become one of the lowest-taxed countries. Combined with the benefits of access to the U.S. economy, a 15 or 20 percent tax rate would drive companies to locate facilities and jobs in the United States, which is what happened when Ireland lowered its tax rates. It began attracting large multinationals such as Google, Apple, and many pharmaceutical and technology companies. That location choice is pretty amazing, given the obvious disadvantages of being a small country with limited resources compared with the United States.

When U.S. corporate tax rates are reduced, look for industry-specific tax incentives to also be reduced to help pay for the rate reduction. The U.S. tax law, like tax laws in all other countries, functions primarily as a series of incentives for individuals and companies that do what the government wants them to do. Research and development tax benefits are a darling of many governments and will not be reduced by the Trump administration or the Congress led by House Speaker Paul D. Ryan, R-Wis. Other tax benefits will be eliminated, including the carried interest rule, which allows private equity companies to convert income from ordinary to capital gains.

One tool Congress and the administration will use to help offset the cost of the corporate rate reduction is a tax amnesty for income brought back to the United States from overseas. An estimated $2 trillion of income has been deferred by U.S. companies, and a 10 percent amnesty tax rate will have companies racing to repatriate income. That doesn't mean that $2 trillion of cash will flow back to the United States because much of that income is already being used in the United States by way of loans. Congress will include the full amount of the amnesty tax in its budget estimates. The tax amnesty will allow it to offset more of the cost of the corporate rate reduction and show less of an estimated deficit resulting from that reduction.

Both the corporate tax rate reduction and the amnesty will be taken up by Congress this summer and passed before the end of the year. One more tax change that is sure to occur is some type of border tax on goods imported into the United States from other countries, particularly Mexico. Trump has asked for a tariff, and Ryan has asked for a border tax imposed through changes to income tax deductions.

A tariff acts like an excise tax on the price of goods coming into the country. Similar to gross receipts or a sales tax, a tariff is a percentage of the value of the imported goods that serves to increase the price of those goods to U.S. consumers.

The border tax proposed by Ryan is different from a tariff. It would eliminate the deduction for purchases of materials produced outside the United States. Although the change to the income tax law seems simple on the surface, its application is actually fairly complex. Companies would have to determine where goods were produced and what value was added outside the United States. Because many goods are produced partly in the United States and partly outside the country, the determination of which portion of the goods was produced outside will not be easy. It comes down to yet another transfer pricing issue.

The tariff is the simpler proposal on its surface, because it's similar to a sales tax. Tax treaties present the greatest challenge to imposing tariffs. The income tax proposal is easier from a treaty perspective because it could be imposed only on companies that have a U.S. presence. It is also much more complex to administer and faces opposition from major U.S. companies, such as Wal-Mart, Target, and car manufacturers.

The tariff is the easier short-term solution for Congress and the administration to raise revenue and punish companies for outsourcing their manufacturing jobs. One way or another, you can count on some kind of border tax in 2017, which is how Congress will pay for building the wall between the United States and Mexico.

An even bigger challenge for U.S.-based multinationals is a VAT or general sales tax. Imposed by European and other countries, the VAT acts as a border tax for goods entering the country. Simply explained, a VAT exempts exports and taxes imports, resulting in a massive benefit for exports and significantly increasing the price of imports. Lacking a VAT has put the United States at a serious disadvantage relative to its trading partners.

The VAT, which is recognized worldwide, represents a more likely long-term solution to a border tax. Most countries would be unable to argue that a VAT violates international law or treaties, because many already have one. And a VAT would not face the equal protection challenges of a pure border tax or tariff because it would apply equally to companies whose products are produced either in or outside the United States. A VAT would also raise substantial revenue and would equalize the playing field for U.S. companies versus the rest of the world.

Consider a simple example of Boeing and Airbus. Suppose Boeing sells a 777 to Air France. Boeing pays U.S. corporate income tax of 35 percent on the net income from the sale plus a 22 percent VAT when the plane enters France. Suppose instead that Airbus sells an A380 to American Airlines. Airbus pays a corporate income tax of 33 percent and no VAT. The corporate tax rate difference is actually very small in this case. On $1 billion of sales, with a net profit of 20 percent, the additional 2 percent tax (the difference between the U.S. and the French corporate tax rate) is only $4 million. The VAT imposed by France on the imported planes represents an additional $200 million of taxes, which are passed on to the purchaser. So a similar product at the same price costs $200 million more to the French importer than the equivalent product costs to the U.S. importer.

The VAT is a complex tax system and would take time to implement, so Congress won't pass one in 2017 or even 2018. More likely is that a VAT will be included as part of individual income tax reform, which will not happen during the first four years of the Trump administration. If Trump brings large numbers of jobs back to the United States and is reelected in 2020, individual tax reform will happen in his second term of office.

Consider the last major tax reform by President Reagan. He passed three major tax bills during his first term in 1981, 1982, and 1984 — all intended to turn around the economy through various investment tax benefits (most notably, the massive increases in depreciation tax rates for equipment and real estate).

Reagan did not address individual tax reform until his second term, in 1986. Individual tax reform is too complex and too difficult to achieve in the first four years of a president's term of office. It is not as simple as just lowering rates. When tax rates are lowered, the tax base is always broadened, meaning that many of the tax benefits now enjoyed by various industries will disappear. Oil and gas, alternative energy, Wall Street, agriculture, and real estate could all see major reductions in tax benefits, and they will fight tooth and nail to retain their tax breaks.

The administration and Congress have to be 100 percent on board to achieve any significant individual income tax reform. And that is unlikely to happen when there are so many other policies that both the Trump administration and Congress want to tackle first, including immigration reform, healthcare, and jobs.

The world is watching the United States when it comes to taxes and immigration. In 2016 I spoke about taxes in 10 countries on six continents, and in every country, people were concerned about their own taxes and the consequences of taxes on the price of goods and services.

The rest of the world is well aware that the United States has high corporate tax rates, and that they enjoy the benefits of being able to ship goods to the United States without a VAT being tacked onto the price. Exporting countries want both a strong dollar and a weak local currency, as well as a low tax on goods imported into the United States. Those countries will continue to complain about unfair border taxes while they impose their own border taxes via a VAT or GST.

It is clear that both Trump and Ryan understand those competitive distortions and are committed to turning the tide through lower taxation on U.S. exports and higher taxation on imports. ◆