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HOW SHOULD EUROPE REACT TO US CORPORATE TAX REFORM PLANS?

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Abstract (english)

On April 26, President Trump presented a one page sketch of his long-heralded major tax reform, including some bare bones on corporate taxation. Besides slashing corporate income tax rates to a flat 15 percent and an even lower one-off rate for repatriating offshore funds, the plan remains quiet on the financing side. To balance some of the costs of a substantial tax cut, Congress Republicans have actively advanced a destination-based cash flow tax with border adjustment. This in mind, the EU should be aware of possible threats to its international competitive position. Any reaction should defy a tax race to the bottom and rather resort to early negotiations with US officials on a competition-friendly final version of the tax reform.

Abstract (deutsch)

Die von Präsident Trump am 26. April angekündigte umfassende Steuerreform enthält auch einige Hinweise zur neuen Form der Körperschaftssteuer. Allerdings sind bis jetzt nur einige plakative Maßnahmen zur Steuersenkung bekannt, insbesondere die Einführung einer flat tax von 15% und damit eine Ablöse des bisherigen maximalen Grenzsteuersatzes von 35%. Darüber hinaus soll es einen begünstigten Steuersatz von 10% für die einmalige Rückführung von derzeit in ausländischen Steueroasen geparkten Finanzvermögen geben. Dies betrifft vor allem große Multis (wie Apple, Pfizer, Microsoft, General Electric), die Headquarters z.B. in Irland oder Luxemburg halten. Keine Information gibt es über die laufende Finanzierung der Steuerreform, die für viele Congress-Abgeordnete der Republikaner unabdingbar ist, um die Staatsverschuldung nicht explodieren zu lassen. Mit dem Ryan-Brady-Plan liegt dazu auch schon ein weit gediehener Vorschlag vor. Er sieht die radikale Umstellung des Körperschaftssteuersystems von der bisherigen Produzentensteuer auf eine Konsumsteuer vor. Die „destination-based cash flow tax" (DBCFT) enthält einen Grenzsteuerausgleich, wie er ähnlich auch für die in Europa übliche Mehrwertsteuer gilt. Wegen des hohen Defizits in der US-Leistungsbilanz würde die DBCFT dafür sorgen, dass die Partnerländer mit Überschüssen (insbesondere Deutschland und China) zur Finanzierung der US-Steuerreform beitragen. Allerdings ist nicht geklärt, ob die DBCFT mit WTO-Regeln kompatibel ist. Die EU ist jedenfalls gut beraten, sich nicht auf einen Steuerwettbewerb einzulassen, der allen beteiligten Ländern schadet. Vielmehr sollte parallel zur Konkretisierung der Steuerreform mit den USA verhandelt werden, um Diskriminierungen im Außenhandel zu vermeiden. In der EU sollte gleichzeitig die schon lange diskutierte Harmonisierung der Steuerbasis für die Körperschaftsteuer vorangetrieben werden.

The US corporate tax system has over the years come under heavy criticism from companies as being complex and unfair. Income of corporations is taxed not only at the federal level, but in many states and in some municipalities too. Federal tax rates vary from 15 to 39 percent of taxable income, most companies being in the 35 percent bracket. In addition, state taxes amount to some 4 to 15 percent (no such taxes apply in South Dakota and Wyoming). Including local taxes, and subtracting all depreciations, deductions, credits and exemptions, this comes to an average effective rate of taxing corporate income of some 22.7 percent.[1] The resulting system represents a

[1] For more detail, see e.g. http://www.smbiz.com/sbrl001.html and GAO (2013)

pairing of high tax rates with a narrow tax base, which a number of analysts and politicians consider confusing and inefficient, and therefore call for a comprehensive reform of corporate taxation.

On April 26, President Trump issued a roadmap for an upcoming overall tax reform, including some bare bones on corporate taxation. The reform intentions remain quiet on the widely-discussed border tax adjustment which many Congress Republicans view as indispensable for financing any substantial cut in corporate tax rates. According to Senate rules, revenue neutrality is required for the tax reform in order to be permanent.

The administration's rather vague reform plan and the likely adaptions to be expected from Congress raise a number of questions which have in part already been addressed in the heated debate, inside and outside the US, following the election campaign and the accession of Trump to the US presidency. Who will benefit and who will suffer from a change in the tax system? How will the reform impact on international trade relations? Will a border adjustment be compatible with the rules of the World Trade Organization (WTO)? Will European countries be among the losers and how might they react? Could any retaliatory measures end up in a trade war? These issues have provoked a series of ongoing analyses and comments centering on the border adjustment which, because of its revenue potential of some $1.2 trillion over ten years (Nunns et al., 2016), is likely to remain on the table, given the reluctance of Republicans in Congress to vote for steep rises in budget deficits. According to rough CRFB (2017) projections for the period up to 2027, the corporate part of the tax plan alone would result in an increase of federal debt by some US$3.7 trillion or 13 percent of GDP. These costs will be exacerbated by additional measures to relieve the tax burden of individuals (cutting tax rates, doubling the standard deduction while relinquishing most other deductions, repealing the estate tax and the alternative minimum tax), costing some $1.6 trillion over the coming decade. The following paragraphs summarize the discussion and provide an overview of possible answers from a European angle.

SLASHING THE CORPORATE TAX RATE

In international comparisons, US tax rates on corporate income are generally higher than on average in other industrialized countries. Depending on the sample and calculation method, the difference can be as high as 10 percentage points, in statutory as well as effective terms. The following Table 1 compares US corporate tax rates with equivalent rates in some major European countries. The data, though selective and collected from different sources, show the tax burden of US corporations at the upper end of the spectrum covered.

Table 1: International comparison of statutory and average corporate tax rates

	Top statutory tax rates in percent				Average tax rates in percent[1)]			
Year	USA[2)]	United Kingdom	Germany [3)]	France	USA	United Kingdom	Germany	France
2012	35.0	24.0	30.2	34.4	29.0	10.1	14.5	20.0
Current	35.0	19.0	29.8	33.3				

Sources: Congressional Budget Office (CBO); Deloitte, Corporate Tax Rates 2017; Bundeszentralamt für Steuern

Notes:
[1)] Average corporate tax rates are calculated as the total amount of corporate income taxes that a company would pay to that country relative to the income it earns there.
[2)] In selected brackets tax rates are higher than 35 percent to eliminate the benefits of lower tax rates in other brackets.
[3)] Including Solidarity Surcharge and Gewerbesteuer.

Pressure on US legislators has been high to vote on a substantial reduction of the tax rate. The last corporate tax reform with a noticeable reduction of federal tax rates was passed in 1986 under President Reagan, when the top rate was reduced from 50 to 35 percent of taxable income. The Trump administration now proposes a flat rate of 15 percent, while virtually eliminating the opaque system of deductions and exemptions. In particular, the possibility to deduct state and local income tax expenses from federal taxable income will be terminated.

Many analysts refer to the economic effects of this measure when they envision what the outcome of the current reform plans could be. However, a direct comparison with Reagan's tax reform is handicapped by the fact that current proposals are not confined to corporations, but also include pass-through entities (such as hedge funds and real estate developers) and large partnerships of lawyers, doctors and consultants.

REPATRIATING FOREIGN PROFITS

Apart from reducing the tax rate for companies, the new corporate tax policy will be shaped as a purely territorial tax system (exempting foreign profits of US companies from US taxation) and will grant a further reduced tax rate of 10 percent to attract those accumulated corporate profits of US companies parked abroad that will be transferred to the US for investment purposes. Such profits are currently not taxed when they remain outside the country, but are fully taxed (after accounting for foreign income taxes paid) when transferred to the US. This provides a big incentive for investing funds in foreign tax havens ("tax inversion"), often through establishing headquarters there or by creating mergers with existing foreign companies. Large multinationals (such as Apple, Pfizer, Microsoft or General Electric) have profited from this rule, e.g. by keeping earnings in the offshore headquarters and borrowing from them for investments in the US. Interest payments on such loans, accruing to the foreign subsidiary, are tax deductible in the US.

As a mirror image of US tax inversion, some foreign countries with relatively low corporate tax rates have gained superficially high tax incomes and GDP growth rates. Within the EU, Ireland and its "leprechaun economy" (Krugman, 2016) is an outstanding prominent example on the receiving side, followed closely by Luxembourg. Republicans in Congress have pondered a series of ideas, such as a one-off "transition tax" on the repatriation of all offshore earnings, permitting business to deduct all investment expenses from income in the year they were made, and terminating the possibility to deduct debt interest costs from taxable income (Jopson, 2016). President Trump now expects that the reduced repatriation tax rate will result in substantial investments and job creation in the US. However, previous evidence from the 2004 American Jobs Creation Act (which provided for a preferential 5.25 percent repatriation tax rate) suggests that the effects on additional employment might again be negligible.

DEVELOPMENT OF THE DISCUSSION ON BORDER ADJUSTMENT

Although the financing side of the substantial corporate tax cut has not been specified yet, it can be expected that Congress will insist on some form of balancing tax revenues. When in February 2012 then-President Barack Obama proposed to slash the corporate tax rate from 35 to 28 percent, he concurrently planned to broaden the tax base. However, his plan was not consentingly entertained by Congress. One of the more lasting ideas has been to replace the current origin-based corporate income tax (CIT) with a "destination-based cash flow tax" (DBCFT). Such a tax would incorporate a "border adjustment" with the effect of taxing imports and excluding exports from taxation. While the CIT is levied on corporate profits (sales revenues less deductible expenses), the DBCFT is virtually a national sales tax resembling a subtraction-method value added tax (VAT), but would provide for a deduction of the costs of domestic production factors (mostly compensation of

employees). Comparing the CIT with a DBCFT and the VAT, the main differences between these concepts are depicted in the following Table 2, which is taken from Toder (2017).

The basic difference between an origin-based and a destination-based corporate tax system may be visualized by the following Figure 1. In the former case, domestically produced goods, whether consumed at home or exported, are taxed. In the latter case, domestically consumed goods, whether produced at home or imported, are taxed.

As stated in Auerbach et al. (2017), existing corporate tax systems are usually neither destination-based nor resorting on the cash flow as tax base. A notable exception was the IETU[2] flat tax in Mexico from the beginning of 2008 through the end of 2013. However, the IETU was applied in parallel to the ordinary CIT and functioned as an alternative minimum tax (a secondary tax to secure revenues also from experienced tax-avoiders). Main virtues of a system taxing consumption instead of production are simplicity, minimal distortions on location choices, providing incentives for investments, unbiased treatment of debt and equity, and robustness against tax-avoidance. The economic effects of a DBDFT are often compared with value-added taxation (which is common in many US partner countries, including the EU) and a complementary reduction of taxes on labor.[3]

Table 2: The difference between CIT, DBCFT and VAT

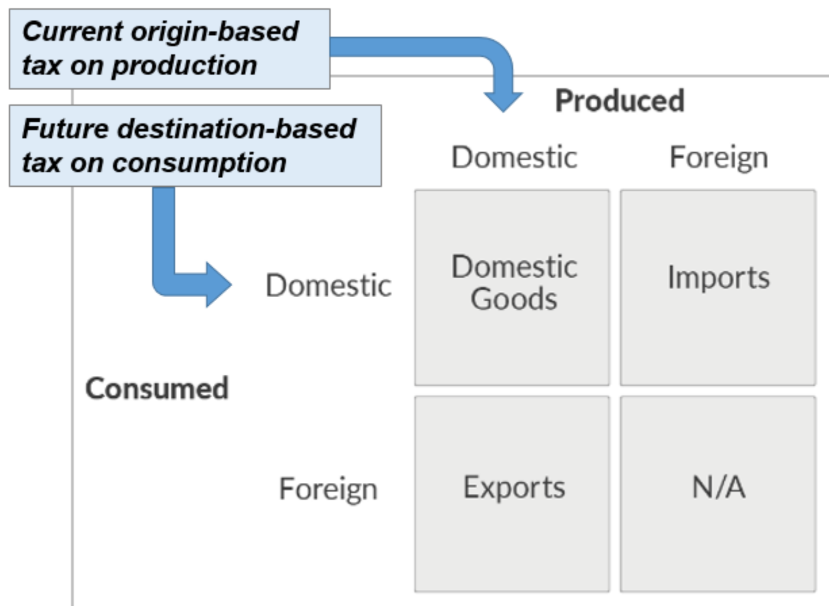
	Corporate income tax (CIT)	**Destination-based cash flow tax (DBCFT)**	**Subtraction-method value added tax (VAT)**
Investments	Capitalized and deductible over time as asset value declines	Immediately deductible	Immediately deductible
Current purchases from other firms	Deductible	Deductible	Deductible
Interest expenses	Deductible	Not deductible	Not deductible
Dividends	Not deductible	Not deductible	Not deductible
Employee compensation	Deductible	Deductible	Not deductible
Foreign trade	Export sales taxable, import purchases deductible	Export sales exempt, import purchases not deductible	Export sales exempt, import purchases not deductible

Source: Toder (2017)

[2] Impuesto Empresarial a Tasa Unica.

[3] Gale – Harris (2013) have forcefully argued in favor of switching the US tax system to a VAT, though without border adjustment. Jones (2017) advocates the DBCFT to minimize the disadvantages of US companies stemming from the consumption taxes in competitor countries.

Figure 1: Origin-based versus destination-based corporate taxation



Source: Adapted from Pomerleau (2017)

The DBCFT with border adjustment has been propagated for some time by Republicans in the House of Representatives and Speaker Paul Ryan (House GOP, 2016) in cooperation with the House Ways and Means Committee and Chair Kevin Brady (Ryan-Brady Plan). However, the idea was much earlier already suggested by renowned academics as a cure for the "broken corporate tax system" (Auerbach – Devereux, 2017), viewed as dragging production and profits offshore and benefitting debt over equity financing. The consequences of border adjustment were already considered by Auerbach (2006), Auerbach – Devereux (2013) and Devereux – de la Feria (2014).

President Trump, as part of his isolationist policy, during his election campaign has uttered various proposals on corporate tax reform, among them the introduction of high import tariffs to help reduce the deficit in the current account and to discourage offshore production by US companies. Although the DBCFT is currently not part of the administration's reform plans, it is expected that financing requirements will bring it back to the surface soon (see e.g. Jacobs – Kapur, 2017). The following paragraphs are therefore devoted to some possible effects of introducing a DBCFT.

EFFECTS OF SWITCHING FROM ORIGIN-BASED TO DESTINATION-BASED TAXATION

A change from origin-based to destination-based taxation could be designed to mitigate the impact on the competitive positions of trading partners, if the change could be internationally coordinated, be it bilaterally or on a multilateral level. Problems would certainly arise if the change happened unilaterally in the US, yielding temporary advantages for US companies at the expense of companies in partner countries. Even then, the effects are ambiguous, depending on the price setting behavior of companies, the choice of invoicing currencies, the exchange-rate pass-through to domestic prices, and the demand and supply elasticities of exports and imports.

With respect to the trade balance, an origin-based tax burdens exports but not imports, while a destination-based tax is levied on imports and exempts exports. To some proponents of a border adjustment (e.g. Auerbach – Holtz-Eakin, 2016; Auerbach – Devereux, 2017), this means just a shift of taxation from where products are made to where they are sold (as with a value-added tax) with no effect on long-run trade flows (border adjustment neutrality). Pomerleau (2017) argues more cautiously that in a competitive world both taxes would in the long run be trade neutral, i.e.

after exchange rates and prices have adjusted, but this may take quite some time. Some improvement in the US trade balance may occur, if US multinationals abstain from overpricing their imports from their foreign subsidiaries and underpricing their intra-company exports, which is current practice to keep high-taxed domestic profits low.[4]

Even if the overall trade balance would not change much, individual companies engaged in foreign trade would in the short run be affected asymmetrically: exporters would enjoy tax reductions and importers face an increase in their tax liabilities; the latter could to some extent be pushed to increase their resale prices. Therefore, US firms depending much on imports, such as oil companies and retailers, have fiercely opposed the DBCFT.

Any imminent decrease in the trade deficit would partly or fully be compensated by price adjustments, be it as an appreciation of the dollar and/or as a rise in US import prices, which could have negative distributional effects on US consumers. Even if the corporate tax rate is drastically reduced, the parallel increase in import prices would appreciate the dollar, thus compensating the effect of the import tax. It appears as if such a plan may end up in temporary tax revenues combined with permanent tax cuts.

A dollar appreciation also entails that non-dollar assets of US companies abroad would lose, while dollar-assets of foreign companies in the US would gain in their respective home currencies. Dollar-denominated debts would rise in foreign currencies which could in particular hurt debt-ridden emerging countries. However, as Buiter (2017) and Blanchard – Furman (2017) show, dollar appreciation is not an inevitable fate. Under special circumstances (in particular concerning the price setting behavior of companies) the new tax could even result in a depreciating dollar.

Pomerleau (2017) summarizes some of the positive side effects (as seen from the US perspective) of a DBCFT as compared with the CIT: (1) the DBCFT would deter US companies from shifting production and profits offshore; (2) companies would have less incentives to minimize their tax burden via transfer pricing; (3) given the large US current account deficits (some $500 billion annually), the DBCFT would raise tax revenues which could be used, e.g., for lowering income tax rates; (4) it would remove current tax advantages for financing investments through debt as compared with equity; and (5) some of the legal provisions to avoid tax-base erosion could be abandoned, significantly simplifying the tax system. Mirroring these effects, there would be some erosion of tax bases in partner countries, which of course is not of much consideration to the Trump administration.

In an attempt to empirically evaluate the potential effects of a DBCFT with border adjustment, Patel – McClelland (2017) employ a historical panel (for the years from 2004 to 2013) of tax returns on a firm-by-firm basis for comparison of an income tax base and a cash flow tax base. The simulations indicate that a border-adjusted cash flow tax base would have been significantly larger than the existing income tax base. The authors therefore conclude that it is politically worthwhile to pursue a change in the corporate tax system.

POSSIBLE CLASH WITH INTERNATIONAL TRADE RULES

US legislators must also consider some negative side effects, as transition costs may be significant, and the DBCFT may be incompatible with the multilateral trade rules of the World Trade Organization. The overarching goal of the WTO lies in the stepwise elimination of impediments to cross-border trade, be it in form of tariffs or non-tariff barriers. According to WTO rules, border

[4] Popular examples of such "transfer pricing" are Microsoft, recording profits partly in tax havens such as Bermuda and Puerto Rico, or Amazon's cost-sharing agreement with its Luxembourg subsidiary.

adjustment is typically permitted in case of indirect taxes (taxes borne by the product), such as the VAT. In case of direct taxes like a corporate income tax, border adjustment could violate Art. XVI GATT and Art. 3.1(a) of the Agreement on Subsidies and Countervailing Measures (ASCM). The DBCFT with border adjustment (exempting production for exports from any US profit tax) may thus be qualified by the WTO Panel or the Appellate Body as an illicit export subsidy. This principle was first formulated by the 1970 GATT Working Party on Border Tax Adjustments (Lincicome – Eglin, 2017). Further, when imports are taxed according to their gross value (including foreign production costs), this means in the short run (before price adjustment occurs) a discrimination in favor of US domestic products (where the net value is subject to taxation) and may thus violate the provisions on national treatment of Art. III(2) and III(4) GATT (Becker – Englisch, 2017). Freund (2017) quotes as an example the difference between a sweat-shirt produced in Maryland (taxed on total value added, less the wage bill) versus one produced in China (taxed on total value added). In addition, the discrimination would not be uniform, but vary according to deviating wage bills across US states and sectors.

In case the House Republicans pursue their tax plans, the European Union seems determined to take the issue to the WTO. The US may accept the challenge, because any WTO lawsuit concerning import restrictions would run through the Dispute Settlement procedure with a number of stages, and a final decision may take years before becoming effective. From here one could also infer that Trump's threat to completely withdraw the US from WTO membership (actively subscribed by company executives like Jones, 2017) may be classified as a tactical maneuver, or just as one of his hasty utterings. Pending further details on the US tax reform, the WTO could eventually rule in favor of US plans or reject them. Apart from an extended WTO procedure, US trading partners could anyway stiffen their provisions to counter tax base erosion and name the US as a tax haven which, however, would be an obvious step towards an open trade war. It could be argued, though, that cross-ownership of US and European stakes reduces the probability of such a warlike conflict (Kooths – Potjagailo, 2017).

According to the calculations of Bown (2017), the WTO could face its largest case to date. Based on the WTO trade effects formula, the WTO might authorize trading partners to retaliate against import restrictions by an estimated $220 billion annually and against export subsidies by an additional $165 billion annually. Considering only US import restrictions, annual retaliatory measures by the European Union could amount to some $42 billion, surpassed only by China with some $46 billion. Export subsidies are likely to be countered almost immediately by the importing country by means of countervailing duties. Only in case of competition in third markets – Bown quotes as example the exports to China of (subsidized) US Boeing airplanes versus European Airbus airplanes – countervailing duties would not apply, and the case would have to go through dispute settlement.

As Bown also emphasizes, a DBCFT need not be designed to violate WTO rules. It is the deductability of wage bills that discriminates imports against US domestic production. If the US granted importers the same wage cost deduction from their US tax liability as it grants competing US goods, no discrimination would occur (see also Hufbauer – Lu, 2017).

How should the EU react?

Sooner or later, EU countries will have to decide how to react to the US corporate tax reform. A passive attitude would be to wait and see what kind of reform will actually evolve from the one-page sketch hastily presented at the occasion of "100 days" of Trump's presidency. A more sophisticated approach would take up some of the more elaborated ideas from the Republicans in Congress. It is to be expected that the further shape of the tax reform will incorporate the already available expertise of the governing party.

As long as the US corporate tax reform remains confined to reducing tax rates without changing the system, this will "only" touch the relative competitive position vis-à-vis companies of other countries. The question is, whether or not other countries will react by following the US in also cutting tax rates, which could end up in some kind of a "race to the bottom". As final result of such a process, competitive advantages due to differences in tax rates would be eradicated, but budgetary stability in all countries participating in the race would also be threatened. National governments will therefore not be keen to follow such a strategy, but rather recommend that companies adjust to the new competitive environment and compensate over time the tax disadvantages by cutting costs, reorganizing their supply chains to source locally in the US market, and improving the quality of their products. Of course, this will not eliminate any short-term competitive drawback.

Within the EU, corporate taxation is subject to national law, and Member States would thus in principle be free to follow the US move. The United Kingdom, upon to quit EU membership, has already hinted to adopt some sort of DBCFT. Fuest (2017), focusing on Germany as an example, sees heavy_implications for the European economy of a fundamental change in US corporate income taxation. To avoid discrimination of European exports to the US, which would carry – in addition to national profit taxes in the EU – the burden of the new US import tax, the EU could also adopt the US tax system. Hallerberg (2017) suggests right away to have the EU switch over to a DBCFT, as it would balance out some of the trade effects of the US move, and in addition might have positive political implications for Europe. Net EU exporters to the US would still suffer, while net importers from the US would gain. In a global perspective, the border adjustment is prone to restrain tax evasion by multinational companies.

This should also be a perfect occasion to intensify EU efforts towards unifying corporate taxation. Following many years of negotiation, the European Commission has only recently adopted a revised proposal for a Council Directive on Common Consolidated Corporate Tax Base (CCCTB), COM(2016) 283 final and 285 final. Given the principle of unanimity for all tax decisions at EU level, early progress in harmonizing the calculation of companies' taxable profits seems rather unlikely. On the other hand, there are impediments to purely national solutions of corporate income taxation which disregard the common rules on VAT as stipulated in the VAT Directive (2006/112/EC). It is also an open question, given some recent decisions by the European Court of Justice, if an exclusion of exports from corporate taxation could not be qualified as state aid (Becker – Englisch, 2017).

A possible solution would be to adapt the traditional European system with the aim of alleviating competitive disadvantages for EU companies. As a minimal reaction, Becker – Englisch propose to provide, in all national tax laws, for the deduction of DBCFT-related costs from the corporate tax base. However, this would increase the under-taxing of European multinationals and would not hamper the relocation of production in favor of sites in the US. Other possible measures would be a stepwise moderation of the comprehensive income definition for corporate taxation and a corresponding broadening of the tax base for the value-added tax. Hallerberg (2017) favors a parallel introduction of border adjustment also in the EU which would diminish, though not eliminate, the discrepancy of how importers and exporters are treated in bilateral trade.

Should the experience of the Trump administration with abandoning Obamacare be symptomatic, it might well be that attempts to reform US corporate taxation may take a while before becoming acceptable for both the US House of Representatives and the Senate. As suggested by Bown (2017), the intermediate phase should be utilized by European politics to initiate bilateral US-European negotiations on the final version of the US tax reform. It should be in the interest of the US, too, to avoid any lengthy trade conflict with high costs and uncertain outcome. However, erratic statements by US officials as to their foreign relations strategy diminish the likelihood of such an outcome.

SUMMARY

There is a broad understanding that the US corporate tax system is complex and inefficient, and thus cries for a comprehensive reform. Republicans of the US House of Representatives have proposed a switch from the current origin-based corporate income tax to a destination-based cash flow tax. Such a tax would shift production and profits back to the US and it could also contribute to simplifying the overall tax system. The new US administration under President Trump has not (yet) subscribed to a comprehensive reform, as the financing side is currently missing. The envisaged massive US tax cuts could be answered by EU countries individually, as corporate taxes are set on a national level. However, the resulting "race to the bottom" would endanger the fiscal stability in all participating countries. In the long run, a more promising answer would be to motivate companies to reorganize supply chains and improve product quality. As long as the tax reform is not voted by Congress, though, any assertion of its effects remain speculative. All the concepts discussed do not just affect the US economy, but are hanging like a sword of Damocles over the relations between the US and its trading partners. The EU can only prepare possible reactions by evaluating various scenarios that are likely to cover the intentions of the Trump administration. One such road could be to follow-up and finalize the proposals concerning the Common Consolidated Corporate Tax Base in the Union. An equally burdensome approach would be to engage in negotiations with US officials to secure a competition-friendly final version of the tax reform.

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