

THE DBCFT: THE RADICAL NEW US TAX PROPOSAL AND ITS IMPACT ON THE REST OF THE WORLD

Republican members of the House of Representatives have proposed replacing the US Federal corporate income tax with a "destination-based cash-flow tax" (DBCFT) (sometimes referred to as a "border adjustment tax").

The DBCFT taxes cash flow, rather than profits. It is "border adjusted": imports are taxed but exports are exempt from tax. Exchange rates may move dramatically to compensate, with some envisaging the US dollar appreciating by up to 25%. To the extent it does not, the DBCFT will behave like a tariff.

The effects of the DBCFT would therefore be felt well beyond the borders of the US, and would impact any business exposed to trade with the US or to the US dollar.

What is the DBCFT?

The destination based cash-flow tax (DBCFT) was outlined in a corporate tax [Blueprint](#) by Paul Ryan and Kevin Brady, senior Republican members of the US House of Representatives.

The DBCFT would entirely replace the existing US Federal corporate income tax code, and would work as follows:

- Businesses would be taxed in fundamental respects on a cash flow basis, not on their profits.
- Sales within the US would be taxable; sales to outside the US would be exempt.
- Expenditure would be generally deductible, with two important exceptions.
 - First, expenditure on imported goods/services would be non-deductible.
 - Second, interest would be non-deductible, eliminating the ability of a business to reduce its US tax base by leverage (although interest deductions could be carried forward and used to shelter DBCFT on any future interest receipts).
- Capital expenditure would mostly be deductible (as opposed to the usual requirement that capital assets only be expensed as they depreciate). Expenditure on the acquisition of land would not be deductible.

- There would be very limited other reliefs/deductions available.
- The rate would be 20%.

The DBCFT is therefore arguably more similar to a VAT than it is to a conventional corporate income tax (and, as we discuss below, whether the DBCFT can be considered a "VAT" or indirect tax is a critical question from a WTO standpoint).

At present there is no draft legislation, only the Blueprint of proposed principles. There is much implementation detail to be resolved before the DBCFT could be introduced. It is also, at the time of writing, unclear whether the DBCFT will be enacted in anything like the proposed form – in particular, the Trump administration has yet to reach a formal position on the DBCFT, although President Trump recently suggested there would be a major tax announcement before the end of February.

Why reform US corporate tax?

The US Federal corporate income tax system is often described as 'broken'. It has the highest rate of corporate income tax in the developed world (35%). It applies to the worldwide profits of US-headquartered groups (generally including the profits of their foreign subsidiaries). By contrast, many countries now tax corporate profits on a "territorial" basis, exempting foreign profits.

Whilst it applies a high rate and worldwide base in principle, the complexity of the US tax system creates numerous loopholes and planning opportunities. In particular, it is common for US-headquartered groups to implement structures that permit them to retain their foreign profits in offshore subsidiaries and, provided those profits are not distributed to the US, they can escape US corporate tax altogether. It has been estimated that over \$2 trillion is held offshore in this manner.

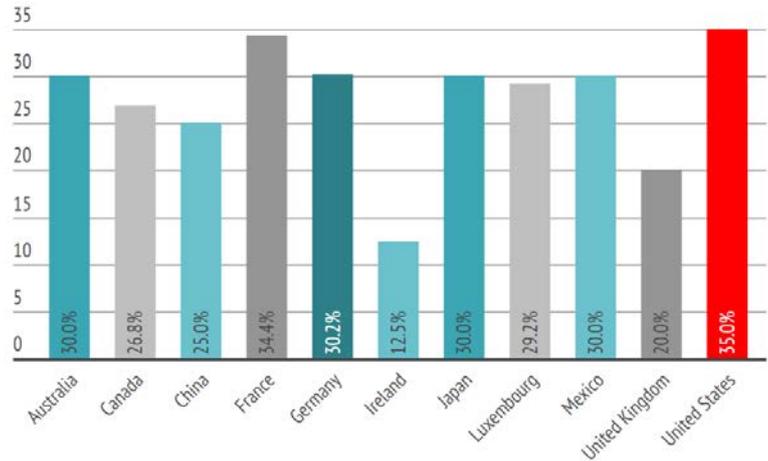
All of this has a number of undesirable effects.

- US groups have an incentive to establish complex offshore structures and/or "invert" to become owned by a non-US parent.
- Cash retained offshore generally cannot be invested in the US, or returned to shareholders.
- Multinationals have an incentive to engage in activities to erode their US tax base.
- US groups' offshore structures have often been used as vehicles for eroding the tax base of their subsidiaries' home jurisdictions (and indeed countering these arrangements was one of the principal drivers behind the [OECD BEPS Project](#)).

The three charts in this note demonstrate how the US simultaneously has the highest headline rate of corporate tax but below average corporate tax yields (combined with no Federal form of VAT).

These shortcomings are widely acknowledged. However for many years, US tax policy has been caught between those (generally on the Left) arguing that the US should eliminate existing loopholes and those (generally on the Right)

Corporate tax rates worldwide, 2017



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To the extent it does not, the DBCFT will behave like an import tariff."

arguing that the US tax system should become territorial, and only tax US profits.

The DBCFT potentially offers a different, and more radical, way forward.

By levying a tax on the basis of where goods are sold, rather than where companies are headquartered, US policymakers would remove the incentive for US companies to establish offshore structures. The tax is also superficially attractive to those elements of the Trump administration who wish to disincentivise US businesses from manufacturing offshore for sale into the US.

Is the DBCFT protectionist?

On its face, the DBCFT could appear protectionist: exempting foreign sales from tax looks like an export subsidy, and taxing and/or denying a deduction for imports looks like a tariff barrier.

Would the DBCFT therefore give US companies a trade advantage?

Many economists consider that it would not as, at least in principle, the US dollar would appreciate to negate the impact on trade. The tax exemption on exports would lead to lower-priced US exports, causing increased demand for US products and therefore for US dollars. At the same time, the tax on imports could force foreign companies selling into the US to reduce their prices, reducing the supply of US dollars.

It follows from this line of reasoning that the dollar should respond to the DBCFT by appreciating by up to 25%, which could neutralize the trade effect of the DBCFT.

However, economists' views differ about how long it would take for the dollar to appreciate, and whether other factors (e.g. the reaction of speculators and other countries' treasuries) would prevent the DBCFT's trade effects being fully countered by an increased value of the dollar. Some analysts predict an appreciation of only half the theoretical 25%, and that it would take several years before equilibrium is reached.

However, one can crudely summarise the economic effect of the DBCFT as follows. To the extent that the dollar does appreciate, the DBCFT will behave somewhat like a VAT. To the extent that it does not (and during the months or even years when currencies are adjusting), the DBCFT will behave like an import tariff.

How would the DBCFT apply to financial transactions and financial institutions?

Policymakers have historically [struggled](#) to design VAT systems which apply consistently to financial institutions and financial transactions. The difficulties are illustrated by the fact that the financial services exemptions in EU VAT are criticised by some as a [subsidy](#) to the finance sector, and by others as an unfair [cost](#) on the financial sector.

It is therefore unsurprising that the Paul Ryan and Kevin Brady blueprint expressly exempts financial institutions from the DBCFT.

It is therefore possible, and perhaps even likely, that financial institutions will continue to be taxed under the current Federal corporate income tax, albeit modified to some extent.

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Thus the DBCFT may have little direct effect on financial institutions. There will no doubt be complex boundary issues in determining which entities are subject to the DBCFT and which are not.

What are the other implications of the potential US dollar appreciation?

There are several other potential effects:

- A dramatic appreciation would have obvious adverse implications for businesses with unhedged dollar liabilities – for example Asian issuers of USD-denominated debt.
- To the extent that the dollar does appreciate, there would, in effect, be a large wealth transfer from US holders of foreign assets to non-US holders of US assets, with a consequential impact on the balance sheets of US and foreign multinationals. The total wealth transfer has been estimated at over \$7 trillion.
- As and when the DBCFT starts to appear more likely, market participants may start transacting in anticipation of the tax. We may, for example, see a decline in foreign USD issuances, and possibly even early redemption of existing issuances.

What are the implications of the DBCFT for corporate structures?

If the DBCFT is introduced, US multinationals may wish to simplify their existing corporate structures, as their foreign profits will (at least in principle) be exempt from US tax regardless of their corporate structure. If funds held abroad can be immediately repatriated to the US then multinationals will need to consider other constraints on such repatriations, e.g. dividend blocks and local tax considerations.

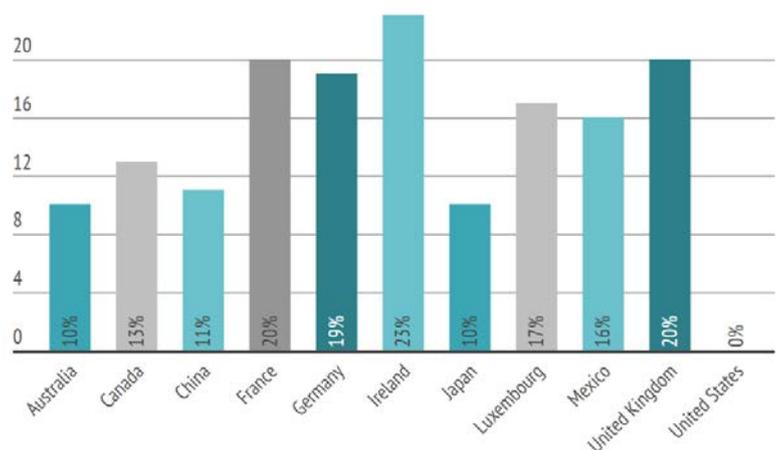
Conversely, the DBCFT represents a potentially significant tax cost for some non-US multinationals with significant US subsidiaries. Jurisdictions which tax on a worldwide basis generally provide a credit for foreign taxes.

So, for example, a Canadian company with a US subsidiary will currently suffer US tax on the subsidiary's profits, but that will be creditable against the parent's Canadian corporate income tax on dividends from the subsidiary. However the DBCFT is sufficiently different from corporate income tax that it may not be creditable under either double tax treaties or domestic rules. Hence the Canadian parent in this example would incur both DBCFT and Canadian corporate income tax. Resolving this would require a change in domestic law in (in this case) Canada and/or a change to existing tax treaties.

Will businesses seek to pass the cost of DBCFT to their customers?

The conventional view is that the cost of VAT is passed to the end-customer or consumer. Indeed there is a considerable body of evidence that this is the immediate consequence of VAT increases – so-called "full forward shifting".

VAT/GST rates, 2017



The extent to which DBCFT will be passed on to consumers is unclear. The fact that it replaces a corporate income tax, combined with the deduction for labour costs, means that past VAT experience is not necessarily a guide to how businesses will react to the DBCFT. The [incidence](#) of the DBCFT – the question of who ultimately will bear the cost – is currently highly contested.

In jurisdictions which impose VAT, it is standard in commercial and consumer contracts for the consideration to be specified "exclusive of VAT", i.e. the purchaser pays the purchase price plus an amount equal to the VAT which the purchaser is required to account for.

Such provisions are less common in the US, given it has to date had no VAT-like tax, though many business transactions attract state and local sales taxes, rent taxes and other taxes on commercial transactions.

To the extent that a purchaser of goods or services from outside the US is a business that will report and pay the DBCFT on its corporate tax return, it will simply be denied a deduction for the cost of its imports. Thus, such clauses will in most cases not be relevant to it.

However, other types of purchasers of property or services from abroad (e.g., funds or other passive investors) seemingly could be subjected to liability for the DBCFT in a manner similar to a tariff or VAT. It is currently unclear what the collection mechanism from these purchasers would be.

In the short term, parties to contracts under which US persons are buying goods/services may wish to clarify the contractual position to avoid future arguments about whether one party's DBCFT cost can be passed on to the other.

In the long term, a US business who is pricing a contract on the assumption its buyer is in the US (so that its profits are DBCFT exempt) may wish to protect itself against the risk that the buyer turns out not to be in the US. If history is any guide, determining when a sale is made to a US person may not always be straightforward. Buyers may, therefore, start including representations or even indemnities in their contracts.

Is there a possibility of a WTO challenge?

In the absence of a concrete legislative proposal, it is too early to assess whether the DBCFT would be consistent with World Trade Organisation ("WTO") rules. However there have already been [suggestions](#) that the European Commission would consider challenging the DBCFT, if it is introduced.

If exchange rates do not adjust as estimated, and the DBCFT behaves like a tariff or an export subsidy, then the US's trading partners may have a strong motivation to challenge the tax. Even if the exchange rates do adjust to neutralise any impact of the border tax adjustment, that would not eliminate the possibility of a WTO claim.

WTO rules permit border adjustments on indirect taxes, and the definition of the term "indirect taxes" expressly includes VAT. Most VATs are indeed border adjusted. In the EU, for example, VAT is generally applied to all goods and services imported into the EU, companies are entitled to deduct the cost of VAT on goods/services they buy within the EU, and companies are not subject to VAT on goods and services they export to outside the EU.

However the DBCFT is different from VAT in several important respects.

"Parties to contracts under which US persons are buying goods/services may wish to clarify the contractual position to avoid future arguments about whether one party's DBCFT cost can be passed on to the other."

First, there is an important difference of substance: existing VAT systems in the EU and elsewhere do not permit a deduction for labour costs – the DBCFT would. Arguably, therefore, it is not a traditional VAT or indeed not a VAT at all.

Second, there is an important difference of form: VAT is generally applied to imported products at the point of importation; the DBCFT is charged on companies by reference to their imported goods and services. This suggests that the DBCFT may be borne directly by companies rather than products and is therefore a "direct tax" on which border adjustments are not permitted.

The implications of a WTO challenge would be unprecedented. Previous tax-related challenges have related to particular features of a tax system, or particular types of tax-favoured entity. This would be a challenge against a fundamental feature of the US corporate tax system, with very large amounts at stake (potentially many \$100bn).

In addition to, or instead of a WTO challenge, other countries could potentially introduce retaliatory measures, for example their own import tariffs or countervailing duties designed to counter the effects of the DBCFT.

What might the wider effects be?

The DBCFT would be a major re-writing of the US tax code and a more or less unprecedented change in the tax code of a highly developed country. It would be a tax system which has not been trialled in any other tax system. So, whilst many of the immediate effects of the DBCFT are foreseeable, the ultimate consequences of those effects are hard to predict. For example:

Repatriation

If the DBCFT was introduced immediately, with no transitional rules, or with a relatively low transitional tax as envisaged in the Blueprint, then US multinationals would be able to repatriate the \$2 trillion or more of offshore cash, and it is safe to assume that they would do so.

What they would do with the proceeds is less clear.

Much would presumably be returned to shareholders by way of share buy-backs; some of it might be used to fund US M&A activity.

The US as tax haven

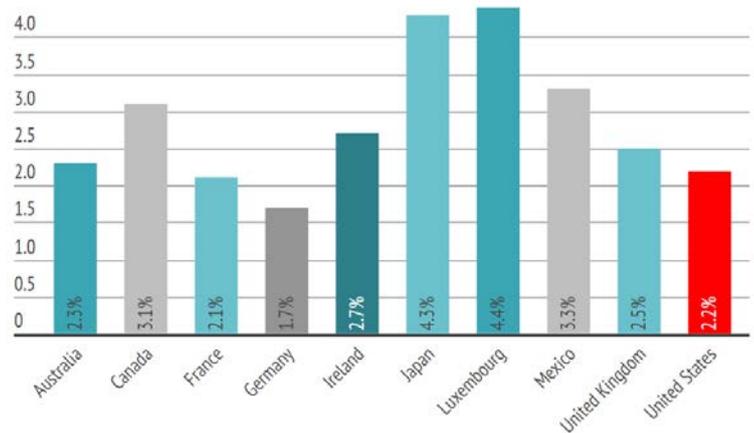
The US would in many respects become a tax haven.

Many countries have double tax treaties with the US that permit payment flows free from local withholding tax. For example, the double tax treaty between the US and the UK exempts UK royalties from UK withholding tax.

Those treaties are negotiated on the assumption that the US will then tax the payment flows in question. However, under the DBCFT the payments would in many cases be exempt from tax.

The immediate effect would obviously be highly favourable for US corporations. The longer-term effects are less clear.

Corporate tax revenues as % of GDP, 2015



We have recently seen widespread criticism of US multinationals for implementing complex structures that enable royalties to be extracted from European subsidiaries free of local tax, and then retained offshore free of US tax.

Under the DBFCT, multinationals would be able to achieve the same result with no structuring at all.

This "double non-taxation" is likely to be regarded disapprovingly by the US's treaty partners. We may therefore see countries revisit their treaties with the US and/or introducing so-called "treaty overrides" to reassert their own taxing rights.

Either way, for royalties and other payment flows to be entirely free of tax seems a result that is "too good to be true", at least for long.

The DBCFT as a model

When FATCA was introduced in 2012, the first reaction of most countries was that this was an outrageous piece of extra-territorial legislation. The more considered reaction was to enact similar legislation – and most countries have [now done so](#).

It is not impossible the DBCFT will follow a similar path. If it is introduced, survives any WTO challenges, and is seen as a success, then other countries may look to it as a model to be emulated.

Whilst radically different in design and approach from the OECD BEPS proposals, the DBCFT achieves many (but not all) of the same objectives.

How likely is the DBCFT to be introduced? And in what timeframe?

In terms of timescale, we expect that the House Republicans would want legislation in place before the mid-term elections in November 2018.

Whether it will in fact become law in anything like the proposed form is a more difficult question.

The novelty and ambition of the tax cannot be over-stated. Furthermore, the politics of the DBCFT are complicated, with both proponents and opponents of the tax [on all sides](#) of the political divide.

Some of the potential losers from the DBCFT, such as US retailers and consumer goods manufacturers, have already started lobbying heavily against its introduction (and establishing groups with such names as "[Americans for Affordable Products](#)"). President Trump has indicated he agrees with some elements of the tax, but that he may regard it as too complicated.

Hence we would say that, on balance, the odds are against the DBCFT being enacted – but it is a realistic enough possibility that we would advise businesses to begin thinking through some of the likely consequences.

For further information, please speak to your usual Clifford Chance contact, or one of the partners listed below.

"Under the DBFCT, multinationals would be able to achieve double non-taxation of payment flows from Europe with no structuring at all."

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