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Privately Speaking

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Understanding the border-adjustment tax

As private company leaders mull over the potential impact of tax reform in the United States, many are starting to wonder how the so-called border-adjustment tax might influence their profitability and, therefore, their growth plans.

In this edition of *Privately Speaking*, we take a deeper look at the proposed border-adjustment tax and offer some guidance to private market companies as they plan for the future.

What is the border-adjustment tax?

There are many proposals being discussed as part of U.S. business tax reform, including border adjustability, non-deductibility of net interest expense, immediate expensing of U.S. asset acquisitions, non-taxation of future foreign subsidiary profits of U.S. –based multinationals, and reduced business tax rate. These are outlined in the House Republican's Task Force "Better Way" blueprint. The Administration has also proposed lower rates but has not specifically proposed a border-adjustment tax.

Although the technical details have not yet been released, under the House blueprint, the U.S. tax base presumably would generally consist of business income received from, and business expenses paid to, other U.S taxpayers. And it presumably would generally exclude business income received from, and business expenses paid to, non-U.S. taxpayers. Of course, the way this would play out with companies would depend on each company's unique circumstances, as well as the particular legislative rules that might be included if a border adjustment were enacted.

Putting it into practice

Consider a C corporation company that purchases 100 widgets a year from China at $1 per widget for a total import cost of $100. It sells those widgets at $1.50 each, creating a gross profit of $50. SG&A costs are around $35, leaving an operating profit of $15.

- **Current regime:** Today, that $15 operating profit would be considered taxable income and would be taxed at 35 percent, creating a $5.25 tax liability.
- **Scenario 1:** Under a border-adjustment tax regime, import costs might not be deductible, resulting in taxable income of $115 ($150 minus $35). Taxed at the blueprint's proposed 20 percent corporate rate, that would create a total tax liability of $23. (Keep in mind, though,that the border adjustment could be drafted with rules that would reduce this amount.)
- **Scenario 2:** There could be associated currency effects that decrease the cost of imports. This could affect the impact of the border adjustment. There is debate as to the speed and degree to which currency markets would adjust.
- **Other Scenarios:** Apart from the other scenarios in the chart below, keep in mind that, under a border-adjustment tax regime, export sales might not be includible in income. Thus, if the company sells all its widgets overseas, its gross income might be zero. And, currency adjustments potentially could affect the price of its widgets. Thus, a private company's particular facts could significantly affect how a border adjustment might apply to it.

	Current regime		Scenario 1: 20% income tax, no BA, no FX adjustment		Scenario 2: 20% income tax, w/BA, no econ effects		Including economic effects: Scenario 3: 20% income tax, w/BA & FX effects, no price/volume effects		Including economic effects: Scenario 4: 20% income tax, w/BA, FX effects, & price/volume effects	
	China Mfr	U.S. retailer	China Mfr	U.S. retailer	China Mfr	U.S. retailer	China Mfr	U.S. retailer	China Mfr	U.S. retailer
FX (Yuan-RMB/USD)	¥1.15	$1.00	¥1.15	$1.00	¥1.15	$1.00	¥1.15	**$0.90**	¥1.15	$0.90
Quantity	100	100	100	100	100	100	100	100	**95**	**95**
Selling price	$1.00	$1.50	$1.00	$1.50	$1.00	$1.50	$1.00	$1.50	$1.00	$1.50
Revenue	¥115	$150	¥115	$150	¥115	$150	¥115	$150	¥109	$143
COGS	¥60	$100	¥60	$100	¥60	$100	¥60	**$90**	¥60	**$86**
Gross profit	**¥55**	**$50**	**¥55**	**$50**	**¥55**	**$50**	**¥55**	**$60**	**¥49**	**$57**
SG&A		$35		$35		$35		$35		$35
Operating profit		$15		$15		$15		$25		$22
Taxable income		**$15**		**$15**		**$115**		**$115**		**$108**
Tax rate		35%		**20%**		20%		20%		20%
Tax		$5.25		$3		**$23**		$23		$22
After tax income		**$10**		**$12**		**-$8**		**$2**		**$1**

- Cells highlighted in red highlight changes to key variables that in turn drive changes to tax and after tax income, under the scenarios.
  - Scenarios 3 and 4 are illustrative of the indirect economic effects of the tax reform proposals such as USD appreciation and a shift in demand
  - Scenario 3 represents a hypothetical where the USD appreciates 10% relative the Yuan, offsetting partially the higher tax liability
- Scenario 4 additionally considers a decline in retail consumer demand for the imported product
- These scenarios are not exhaustive. For instance, it is possible to consider another scenario where additional tax burden on imports can be passed to the prices of output to improve after tax income levels

The border-adjustment tax could have significant implications for private companies:

Depending upon how it is drafted and how quickly currencies adjust, the border-adjustment tax could have significant implications for private companies. Consideration should be given to:

1. Currency and price impacts
2. Potential impacts on trade agreements
3. Tax treaty evolution, and
4. Value chain adjustments.

Modeling outcomes, planning growth

While the specific text of tax reform legislation is still a long way from final and enactment is not certain, we believe that private market leaders should be assessing the impact of various scenarios on their business and acting accordingly. For some, that may mean considering growth and investment plans. For others, it may mean more active lobbying and direct discussions with legislators. But first, it will require a clear understanding of how the various scenarios may impact your business.

At KPMG, we often work with private market executives and financial leaders to assess the impact of changes in the tax code. And we have developed economic models that adjust for not only tax reform changes, but also the subtler behavioral changes that might result from the border-adjustment tax and the broader tax reform package.

Whether you are running a partnership, an S corporation, a C corporation, or a limited liability company, our models can help you assess the business and individual tax impact of the proposals now on the table.

Insights on Trade & Customs

Click here to learn from KPMG professionals who offer a deep understanding of import and export laws and regulations, the global supply chain, and trade processes and controls that can be customized to a business unit, company or industry.

Next steps for all private company leaders

1. Read the House Blueprint and understand the specific implications for your business.
2. Scrub your data to ensure that scenario assessment is based on realistic and reliable data.
3. Review all potential scenarios for tax reform, including border-adjustment tax and the potential resulting impacts on consumer behavior.
4. Review your long-term business plan to reassess growth potential and future business models.
5. Align operations to minimize tax liabilities and maximize growth.

"It's not as simple as thinking that exporters will win and importers will lose. Multiple variables will factor into the calculation, including taxes, exchange rates, customer behavior, global supply chain footprints, and tax treaty treatments. You need to consider all of the variables if you really want to understand the impact of the border-adjustment proposals on your business."

—**Scot Guempel,** Partner, KPMG's Federal Tax practice

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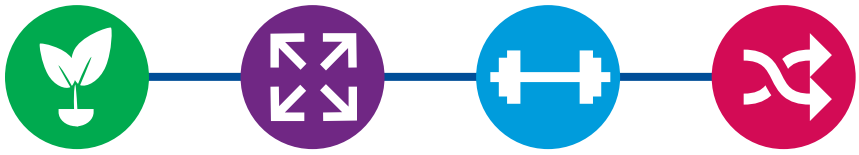

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