HONG KONG TAX ALERT

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The Trump Administration and U.S. Tax Reform

Summary

- While on the campaign trail, President Trump outlined a tax plan that borrows heavily from the Republican Party's "Blueprint on Tax Reform" released in June 2016. While the blueprint and President Trump's proposed tax reform policies are closely aligned, there are differences between the proposals.

- Nothing has been finalized yet. If prior tax reform efforts are of any indication, the process will not be fast moving. However, President Trump has stated that tax reform is a priority for 2017 and the political climate is favourable for changes to be made.

President Donald Trump has stated that tax reform is a priority for his administration. While on the campaign trail, he outlined a tax plan that borrows heavily from the Republican Party's "Blueprint on Tax Reform" released in June 2016. This suggests that the blueprint will be the likely starting point for his tax reform. While the blueprint and President Trump's proposed tax reform policies are closely aligned, there are differences between the proposals.

The blueprint proposes a number of dramatic changes to the tax code, pushing the tax system closer to a consumption-based tax and away from an income-based tax. These changes are intended to encourage GDP growth but could have significant implications for U.S. multinational businesses and foreign companies doing business in the U.S. or with U.S. companies.

The following is a summary of key proposals common to both the blueprint and the President's proposed reforms.

Business Tax Proposals

Blueprint Proposal

- Lower the corporate tax rate from 35% to 20%
- Cap the tax rate on business income from pass-through at 25%
- Disallow interest expense deductions, except against interest income
- Allow full / immediate expensing of investment costs on tangible property and intangible assets (but not land)
- Eliminate the majority of special-interest tax credits / deductions
- Switch from a worldwide income to a territorial-based tax system, with distributions from foreign subsidiaries and income from foreign branches being exempt from US tax (and foreign tax credits being disallowed)
- Move toward a destination-based tax system where business income is taxed based on the location of consumption (i.e., where goods are sold or services are performed, not the location of production)
- Provide for border adjustments exempting exports and taxing imports
- Foreign earnings under the old system may be repatriated subject to a transition tax - cash at 8.75% and property at 3.5%, payable over 8 years

Trump Proposal – Key differences from Blueprint

- Lower tax rate on business profits generally to 15%
- In lieu of disallowing a net interest expense deduction altogether, allow firms engaged in manufacturing in the U.S. to elect to expense capital investment and lose the deductibility of corporate interest expenses
- More broadly, eliminate most tax expenditures (i.e., preferential exclusions, deductions, deferrals, credits and tax rates), but allow tax incentives for infrastructure development and increase certain childcare business tax credits / deductions
- In lieu of the transition tax, impose a one-time 10% tax on all previously untaxed earnings of non-US subsidiaries

Individual Tax Proposals

Blueprint Proposal

- Simplify and lower tax rates and establish three brackets only — 12%, 25%, and 33%
- Amounts equal to a "reasonable compensation" will be taxed as ordinary income, potentially inclusive of carried interest
- Allow a 50% deduction for dividends, interest, and net capital gains income (effective tax rate reduced to 6%, 12.5%, or 16.5%)
- Increase the standard deduction but cap the exclusion for employer provided healthcare
- Eliminate itemized deductions except for home mortgage interest and charitable deductions
- Eliminate the majority of other tax credits/deductions
- Repeal the alternative minimum tax, estate tax and generation-skipping transfer taxes

Trump Proposal – Key differences from Blueprint

- Allow tax deductions, but cap them at USD$100,000 / USD$200,000 for single / joint filers
- Clearly identifies carried interest to be taxed as ordinary income in full
- Retain the 20% maximum capital gains rate, and not permit the 50% deduction for dividends, interest and net capital gains
- Repeal estate tax, but tax certain capital gains over US$10 million at death

Highlight on Border Adjustments

Border adjustments were not originally part of President Trump's reform plan, although recent reports suggest he may be considering it. The issue is controversial. The border adjustment seemingly intends to promote U.S. growth and encourage domestic production by exempting income from U.S. exports from tax and taxing imports (including all products, services, and intangibles). While not certain, it appears that the proposed import tax may not allow for deductions for all or part of imported inputs. This could mean greater taxes for U.S. companies selling imported products to U.S. buyers. Conversely, net exporters in the US would likely benefit from such change.

While this type of border tax is commonly seen in conjunction with VAT systems, it is typically not used in conjunction with income tax. It is unclear if this type of income tax arrangement is allowable under World Trade Organization rules, so this proposal may be challenged.

What does this mean for 2017?

Nothing has been finalized yet. If prior tax reform efforts are of any indication, the process will not be fast moving. However, President Trump has stated that tax reform is a priority for 2017 and the political climate is favourable for changes to be made.

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