Macro

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The border tax and other U.S. tax issues

Investors eagerly await U.S. tax reform, but are as confused about the border tax as are Republicans. Even without it, the corporate tax reform won't be an easy ride.

- Companies and investors alike are hoping for a swift corporate-tax reform.
- We believe the border adjustment tax is a poor instrument at this time.
- Either way, tax reform is a arduous task that will test the Republicans' unity.

Trump, tax and trade

Potential tax reform is one of three reasons why U.S. equity markets have rallied since the elections. For now, it also remains the most likely to keep markets on the edge. One item that is limiting investors' enthusiasm is the Border Adjustment Tax. They are not alone.

"Anytime I hear border adjustment, I don't love it. Because usually it means we're going to get adjusted into a bad deal. That's what happens. And it's too complicated. They get credit on some parts and not other parts. Where was the part made? I don't want that. I just want it nice and simple." [1] On that, at least, Donald Trump's views are not all that controversial.

We believe there to be plenty of low-hanging fruits in reforming the byzantine and loophole-ridden U.S. tax code. We are skeptical of the broader agenda as presented by Representative Kevin Brady, chairman of the powerful House Ways and Means Committee, and House Speaker Paul Ryan, however. In particular, we fear that bundling tax cuts with the controversial border adjustment tax (BAT) risks derailing the reform altogether. "It is fine if they lower the tax on production, but they shouldn't raise taxes on trade", says David Bianco, Deutsche AM's Chief Investment Strategist in the Americas. The worst-case scenario, from a market perspective, would be no tax legislation passing Congress this year.

Trump has pushed stock prices but not earnings forecasts

[1]Consensus-EPS forecasts for S&P 500 Index; Source: Thomson Reuters Datastream, Deutsche Asset Management Investment GmbH; as of 2/21/17.

Our base case is that the BAT will be scrapped and that the tax bill, including a corporate-tax-rate cut to 25%, will still be signed

[1]Source: Wall Street Journal, as of 1/16/17

this year. This could add 10 U.S. dollar to S&P 500 Index earnings per share (EPS), either in 2017 or 2018, depending on when tax cuts are implemented. Markets, we believe, have not priced in this figure. While the S&P 500 Index has rallied double digits since the election, it has done so in line with global markets and on the back of improving economic data. Thus, markets have not been irrationally enthusiastic about the tax reform. This is also visible in earnings forecasts for 2017 and 2018 that have hardly moved (from a seasonal pattern, this is already a slightly positive sign). Investors could, however, be disappointed. Even if the BAT is scrapped, other elements of the tax reform could still meet resistance within the Republican Party (GOP). Moreover, the politics behind the BAT proposals, as well as some of Mr. Trump's statements point to the potential for other, more targeted protectionist measures. While it is too early to judge the progress of tax policies after roughly one month, one cannot be blind to the challenges still lying ahead.

U.S. tax-reform scenarios

More Likely

	Current	Trump 2016 Plan	House GOP Plan
System	Worldwide (with deferral)	Worldwide (eliminate deferral)	Territorial
Tax Rate	35%	15%	20%
Deemed Repatriation (One time & mandatory)	No	10%	Cash: 8.75% Non-cash: 3.50%
CapEx Deprecation	Over Time	Optional / Immediate	100% / Immediate
Interest Expense	Deductible	Not deductible if immediate CapEx elected	Not deductible
Border Adjustment	No	No	Yes

Less Likely

Source: Tax Foundation, Tax Policy Center, Deloitte, GOP Tax Plan, Deutsche Bank Securities Inc., as of 02/2017.

Triggers for the tax reform

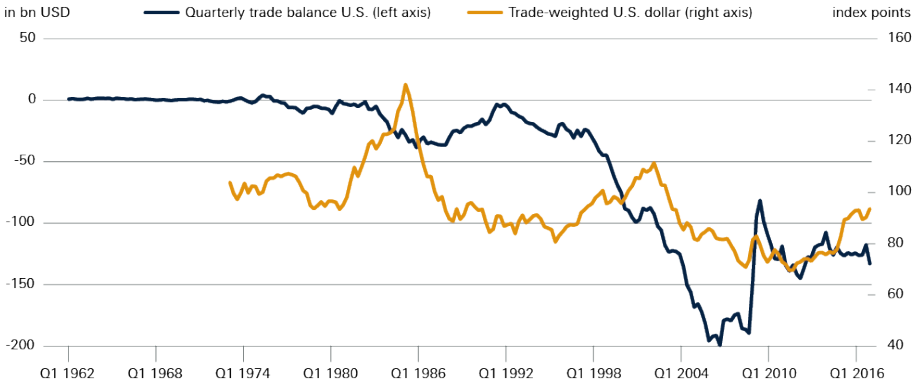
When Trump won the White House and the Republican Party secured their majority in Congress, hopes were running high that there would be swift progress on tax reform. There are various topics the GOP is likely to address with the reform: cutting U.S. corporate tax rates currently at 35% to at least get them in line with the OECD average of 25%; stopping tax avoidance; encouraging repatriation; and reducing the trade deficit as well as increasing U.S. employment by substituting domestic for foreign goods. These were the goals behind the comprehensive tax package introduced in June 2016 by Brady and Ryan, as part of the "A better way" agenda. This proposal is also referred to as "house GOP plan". The main points are:

- Corporate tax cut from 35% to 20%
- Immediate full expensing of capital purchases instead of depreciation over time
- No more expensing of interest payments
- Border adjustment tax: export revenues and import costs to be excluded from taxation

Unsurprisingly, point 1 is met with little resistance, provided a way can be found to pay for the tax cut. Points 2 and 3 would have significant ramifications for accounting, investing and tax

strategies. But it is point 4 that has attracted most attention and criticism, as it could severely impact different U.S. sectors, the U.S. dollar, foreign companies and potentially global trade.

U.S. trade deficit: no pay back since 1975



Source: Thomson Reuters Datastream, Deutsche Asset Management Investment GmbH; as of 2/21/17.

BAT – the GOP's unwanted gift to America

One of the main intentions of the BAT is to refinance the reduction of the federal corporate tax rate. The BAT is expected to raise 1 trn USD over a 10-year period. Structuring the tax reform in a budget-neutral way (over a period of 10 years) may help avoid the need for a filibuster-proof majority. Instead, the GOP could pass it through the reconciliation process, which requires only 50 and not 60 votes (Republicans only hold 52 seats). The basic idea behind the BAT as proposed by Ryan/Brady is pretty simple: export revenues are no longer taxed while import costs are no longer tax deductible. However, there are various misperceptions about this special Ryan/Brady BAT as well as uncertainties in the academic literature on how such a tax might and should work. Most of the confusion stems from wrongly likening the BAT to a value-added tax (VAT) system or to tariffs. It is neither.

- BAT proponents complain that U.S. companies are treated unfairly in global trade as they lack the kind of VAT that for example France has. This is said to put a U.S. car manufacturer, say, at a disadvantage. Unlike its French competitor, the U.S. manufacturer is not being reimbursed for the VAT on exported goods. However, this is only logical as the U.S. manufacturer never paid any VAT in the first place, while the French manufacturer has. The VAT is due at each step of the value chain and recollected on the next sale, submitting only the incremental amount to the government. The buyer of a car in France has to pay 20% VAT, independently of where the car was built. Meanwhile, the buyer of a car in the U.S. does not pay any tax similar to VAT (apart from local sales taxes), independently of where the car was built. So the U.S. and the French car builder face exactly the same costs in each respective territory. The end customer, however, does not.
- The second confusion often arises from the fact that the BAT is implemented by means of recognition in the profit and loss account. This gives it a much broader und non-discriminatory feel than import tariffs or export subsidies.

- The simultaneity of the export and import component of the BAT is a very important element. BAT proponents claim that this ensures that the rules of the World Trade Organisation (WTO) are not breached as trade volumes will be unaffected.
- This however, would only be the case if the dollar were to appreciate instantly to an extent that would offset the higher import and lower export prices from a U.S. perspective. With a corporate tax rate of 20%, this appreciation would need to be 25%. This would have massive repercussions for U.S. investments abroad, but also foreign U.S. creditors. Hard-currency debt issuers from emerging markets would be significantly affected.
- We believe, however, that a full currency adjustment on the day the BAT is introduced is unlikely. Think of controlled currency regimes, for example. An incomplete dollar adjustment would favor U.S.-based producers. In the short term, however, the opposite might happen: the dollar strengthens in anticipation of the BAT. But until it is put in place, U.S.-based exporters would face the disadvantage of a stronger dollar without benefiting from lower taxes.
- Who would be affected by the BAT in a non-ideal world? Put simply: importers, foreign exporters, U.S. consumers. But while it is little surprising that some of the biggest importers are opposing the tax, even some apparent beneficiaries have been voicing doubts. They fear the disruptions and unintended consequences of a BAT. There are many variables that will determine how the bill is being split between consumers, U.S. importers and non-U.S. exporters. They include: the price elasticity of the goods and services in question, income and substitution effects among consumers, the impact on U.S. wage growth and potential retaliation measures by other countries.
- What about budget neutrality? The BAT is supposed to raise revenues in order to partly pay for the corporate tax cut. However, it only raises revenues as long as the U.S. is running a trade deficit. In 2016 this amounted to 502 bn USD and the U.S. has recorded deficits since 1975. While this seems to refute economic wisdom that trade deficits cannot last forever the BAT would likely reduce the deficit by favoring exports vs. imports and thereby reduce additional revenues over time. Josh Feinman, U.S. Chief Economist for Deutsche AM, adds: “Corporate taxes account for less than 10% of federal tax receipts. The government could easily find other ways than a BAT to refinance a corporate tax cut. “

Corporate taxes are no major contributor to total tax receipts

Source: OECD, Deutsche Asset Management Investment GmbH; as of 2/21/17.

While we believe a textbook BAT has some merits for clearly defined purposes, we judge it a poor instrument at this time for two main reasons:

It threatens to delay and complicate tax reform. It risks implementation chaos and trade disruptions. Even if you think that U.S. profits and jobs moving abroad is indeed a major policy problem, there are better ways to stop this. Furthermore, trading partners might feel alienated and retaliate. As the European Commission's Vice President Jyrki Katainen said: "We have our own mechanisms to react." And some officials already stated that they see the BAT affecting WTO rules[2]. That might not bother the U.S. directly, as they have ignored WTO rulings in the past, but it would certainly add to trading partners' resentment.

Scrapping the BAT could, however, lead to another unfavorable outcome. Instead of having a rules-based comprehensive tax system, some kind of ad-hoc tariffs could be installed, which could give Trump more leeway in deciding which company to sanction for unpatriotic behavior.

Expected Timeline and political camps

Trump announced a phenomenal tax reform to be introduced very soon. An obvious opportunity to do so would be on February 28th, when he will address a joint session of Congress. While he might again be short on details, we might get more clues about his general willingness to accept higher deficits. The following time line looks plausible: By May 2017 U.S. House and Senate pass the Fiscal Year 2018 budget to facilitate the passage of a U.S. tax reform. Once the House Ways and Means Committee approves a tax bill before August, the Senate will have its vote by October so that by December Congress and President Trump could sign the tax reform. This, however, could prove to be an optimistic scenario.

While the tax reform seemed to be a sure and fast thing to be put in place with the support of a Republican-controlled Congress, we believe there to be little unity about the details between Trump, the Ryan/Brady camp and much of the rest of Republicans in the House and Senate. We expect the BAT to be scrapped in its current form, resulting in roughly 100bn USD less revenues per year. Based on

[2]Source: Financial Times Ltd. as of 2/14/17

calculations by the Tax Foundation[3], the corporate tax cut to 20% lowers revenues by 1.8trn USD over ten years. The gap would be reduced to 1.2 trn USD if the corporate tax rate was to be cut to only 25%. Both figures are static, in the sense of not considering the potential benefits to economic growth. Using dynamic calculations would reduce the gap resulting from a cut to 25% to 0.7 trn USD. With some additional creativity on the part of Congressional number crunchers, this might still be presented as budget neutral.

While we don't consider the BAT to be the issue that makes or breaks a tax reform, we fear there could be other road blocks. Even in case we only see a corporate-tax-rate cut to 25%, broadening the tax base and closing loopholes is likely to invoke controversies and heavy lobbying from all industries (and senators) affected. Frank Kelly, Deutsche Bank's Head of Public Affairs in the Americas, clarifies: "The tax reform needs speed and the full endorsement of the President. If not it gets killed in Congress because of the many vested interests affected."

[3]Source: Tax Foundation, as of 02/2017, see also: https://taxfoundation.org/details-and-analysis-2016-house-republican-tax-reform-plan/

Glossary

Earnings per share (EPS)

Earnings per share (EPS) is calculated as a companies' net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Emerging markets (EM)

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

European Commission (EU Commission)

The European Commission (EU Commission) is the executive body of the European Union (EU) which represents the interests of the EU.

Filibuster

A filibuster is a procedure in the U.S. Congress, in which the debate on a proposed piece of legislation is extended, potentially leading to entirely preventing the legislation's finalization.

Hard-currency bonds (debt)

Hard-currency bonds (debt) are bonds (debt) issued by legal entities in a hard currency such as the U.S. dollar, euro or Swiss franc.

House of Representatives

The United States House of Representatives is a legislative chamber consisting of 435 Representatives, as well as non-voting delegates from Washington, D.C. and U.S. territories. Representatives are elected for two-year terms and each state's representation is based on population as measured in the previous Census.

OECD

The Organization for Economic Co-operation and Development (OECD) started in 1948 as the Organization for European Economic Co-operation (OEEC) and changed its name in 1960, now representing 34 countries with democratic governments and market economies.

Reconciliation Process

The reconciliation process is a measure used by the Senate to facilitate resolutions that adjust tax and spending levels to a present budget resolution.

Republicans

The Republican Party (Republicans), also referred to as Grand Old Party (GOP), is one of the two major political parties in the United States. It is generally to the right of its main rival, the Democratic Party.

S&P 500 Index

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Sales tax

A (conventional) sales tax is a tax only levied on goods and services to the final consumer.

United States Congress

The United States Congress is the legislature of the federal government. It is comprised of the Senate and the House of Representative, consisting of 435 Representatives and 100 Senators.

United States Senate

The United States Senate is a legislative chamber consisting of 100 Senators, with each state being represented by two Senators. Senators are elected for six year, overlapping terms in their respective state.

Value-added tax (VAT)

A value-added tax (VAT) is a consumption tax that is collected based on the incremental value added in each stage of production (as opposed to a sales tax where only the final consumer is taxed).

World Trading Organization (WTO)

The World Trade Organization (WTO) is an international organization based in Switzerland, which regulates commerce between nations through mutually agreed rules.

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