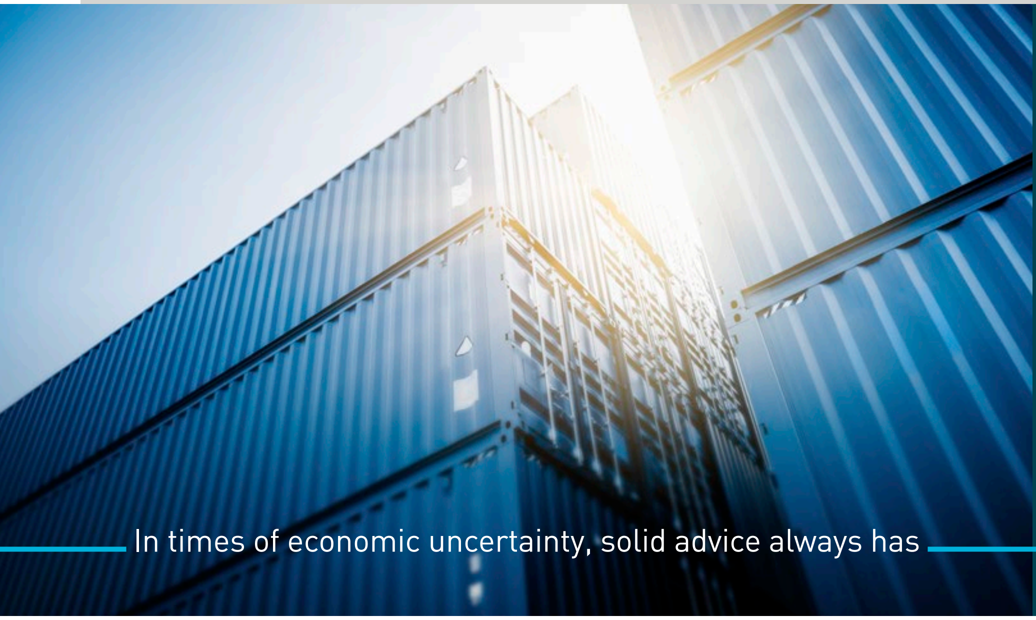
Fixed Income Perspectives



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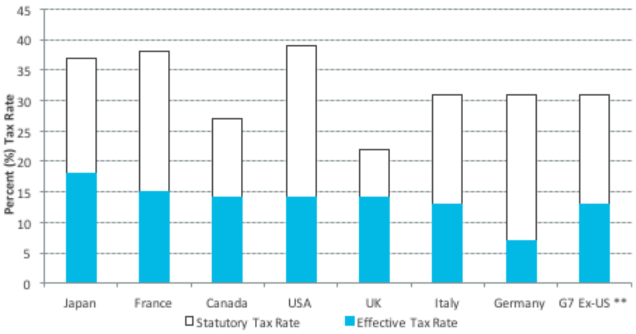
Understanding Border Adjustment Tax Proposals And Their Implications For Investors

The corporate tax system in the United States is one of the most complex in the world. The United States has the highest marginal statutory rate in the OECD at 39% (when the average state tax is included). Furthermore, the United States tax system is highly inefficient, with the largest gap in the G7 between its statutory tax rate and its effective tax rate.

Statutory Versus Effective Tax Rates In G7 Countries



Source: OECD, Goldman Sachs Global Investment Research
*** GDP-weighted average*

It is therefore understandable that corporate tax reform is high on the agenda for the incoming U.S. administration. There is a broad consensus that fundamental tax reform could benefit the economy in the long run, offering higher prospects of real reform than at any point in recent history.

There is also a growing sentiment amongst some of the Republican leadership that tax reform could be one of the underlying factors that is dampening economic growth in the United States. Specifically, the view is that the current tax system discourages domestic investment, which in turn has lowered productivity and potential economic growth.

Reform of the corporate tax system can take many forms, such as changes to the statutory corporate tax rate, changes to the deductibility of capital expenditures and interest deductibility, and destination-based border adjustment taxes.

This latter reform relating to a border adjustment tax has important implications for Canadian investors because of its potential impact on the overall Canadian economy and the Canadian Dollar, but also in its impact on specific Canadian equity and debt securities that our clients' portfolios are invested in.

What is a border adjustment tax (BAT)...?

A border adjustment tax is simply a tax on goods based on where they are sold. Therefore, goods that are exported are exempt from tax, while goods that are imported and sold in the country are subject to tax in that country.

Border adjustments are not a new concept in global taxation, and the feature is common in those countries, including Canada, that operate value-added tax (VAT) regimes. In these regimes, border adjustments are made by applying VAT to both imports and exports in an offsetting way that results in the tax costs being borne and balanced between exports and imports. These adjustments work to ensure that tax under a value-added tax system is ultimately paid in the country of final consumption.

This is different to the current tax incidence in the United States, where exports from the United States bear the cost of U.S. income tax, but imports into the United States do not bear any U.S. income tax. This results in a de facto penalty on exports while subsidizing imports.

In addition, under World Trade Organization (WTO) rules, border adjustments are permitted for indirect taxes such as value-added taxes, but are not permitted for direct taxes such as income taxes which the U.S. tax system predominantly relies upon for taxing business income.

Interestingly, border adjustment taxes are also not the brain-child of the incoming U.S administration. Rather, the idea was considered well before the election by the House Republicans and is documented in a blueprint dated June 24, 2016: *https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf*.

The final form and potential implementation of any border adjustment tax is still highly uncertain. Earlier this year, U.S. President Trump has called the proposal "too complicated" and U.S. Treasury Secretary Mnuchin has indicated it would only apply to "a small number of companies that have moved their jobs or are moving their jobs, putting products back into the United States, and taxing them".

However, the broader Republican leadership believes that a border adjustment tax is necessary to support, and in particular to fund, any broader tax reform and reduction in the corporate tax rate. And the inconsistency of comments from both President Trump and White House Press Secretary Spicer suggest that the proposal remains under consideration. Furthermore, Rep. Brady (Chair of House Ways and Means) has recently indicated that he is confident that Trump and Corporate America are coming around to his tax plan, adding that although there should be no exemptions for importers of any kind, Republicans were open to working with businesses that rely heavily on imports to develop ways to ease new tax burdens.

Macroeconomic Implications

At Leith Wheeler Investment Counsel, we are fundamental, value-based investors with a focus on bottom-up analysis. We do not build event-driven portfolios with a view to capitalize on idiosyncratic events such as election outcomes or new government policies. Recent history has demonstrated just how wrong political forecasters can be. We recognize and apply the same limitations to predicting the likelihood or form of any border adjustment tax.

However, we firmly believe that the border adjustment tax proposal, in whatever form, would likely have a significant impact on the global economy, capital markets and trade.

Border adjustment tax proposals are aimed at encouraging exports and reducing the U.S. trade deficit. However, economic theory suggests that under such tax reform, the impact on the U.S. trade deficit would be limited because the value of the U.S. Dollar would appreciate versus each of its trading partners to equalize prices in local currency terms.

For example, Royal Bank of Canada estimates that the imposition of a border adjustment tax would represent a significant terms-of-trade shock for Canada – potentially in the range of 4% to 5% – that would require a weakening in the Canadian dollar alongside to offset the impact on trade.

In practice, however, it is extremely difficult to predict the direction and extent by which the U.S. Dollar would move in response to a border adjustment tax. This is because there are many other forces that affect exchange rates, including foreign capital flows and domestic imbalances between savings and investments. In particular, trade flows are actually relatively small in comparison to flows of financial assets. In addition, any adjustment in a currency's value would likely occur over a period of time, and some of that adjustment might have already occurred to reflect the probability of a border adjustment tax being implemented.

Nonetheless, the potential implications of a further, sharp U.S. Dollar appreciation are significant. The Bank of International Settlements has repeatedly warned about the sharp increase in U.S. Dollar-denominated debt in emerging market economies, where a rising U.S. Dollar increases net debt levels in local currencies and makes local currency refinancing harder in the future.

The implications for global inflation are even less clear. In the short-term, a border adjustment tax would put upward pressure on the price of imported goods and services in the United States, to the extent that companies are able to pass through higher import costs to consumers. Currently, import prices account for approximately 7% of personal consumption expenditure. This impact would be offset by a stronger U.S. Dollar that would have a dampening effect of inflation in the United States. The reverse effect would occur in other countries, including Canada.

The border adjustment tax would have a significant impact on the U.S. fiscal deficit. Very roughly, the tax revenue raised would be equal to the statutory rate (20%) times the trade deficit. Goldman Sachs estimates that the amount of revenue the Tax Policy Center estimates that it raises would be sufficient to lower the statutory corporate tax rate to roughly 25%.

Border adjustment taxes would also work to make it more difficult for companies to use international transfer pricing to shift profits earned in the U.S. to lower tax jurisdictions. Gabriel Zucman, a French economist well known for his research on tax havens, suggests that the benefits could be large, with approximately $370bn of U.S. corporate profits going almost untaxed in the top six tax havens.

Finally, there would be significant implications for global trade frictions. For instance, it remains unclear whether the WTO would approve of the border adjustment tax without modification, given that its application isn't to a typical VAT model tax regime. As a result, border adjustment taxes could exacerbate further uncertainties regarding global trade under a more protectionist U.S. administration.

Note: This figure is from Zucman (2014) and charts the ratio of profits reported by US firms in the main tax havens (Netherlands, Ireland, Switzerland, Singapore, Luxembourg, Bermuda and other Caribbean havens) to total US corporate profits (domestic plus foreign).

In addition, the impact on large trade surplus countries such as China would be significant and could trigger retaliatory measures such as policy-based currency depreciation. These changes would arguably be a major negative for global equity markets, by way of dampening the global economic outlook and, over the longer-term, add to global disinflationary pressures.

Implications For Canadian and U.S. Equity and Bond Portfolios

Firstly, the impact of currency movements on foreign equity and bond portfolios is likely to be significant. In particular, for our clients, unhedged U.S. equity portfolios are likely to benefit from any currency appreciation triggered by border adjustment taxes. The impact on unhedged global equity portfolios is less clear as this would be dependent on the extent that the Canadian Dollar moves relative to other currencies such as the Euro or Japanese Yen. The Canadian Dollar is typically a lower volatility currency and more intrinsically linked to the U.S. Dollar, so the currency impact on unhedged global equity returns for Canadian equity investors might, in fact, be negative.

For fixed income investors, the implications for global bond yields are even less clear. If the fall-out from a border adjustment tax is a reduction in risk appetite globally, then bonds would likely rally and depress yields, particularly outside the U.S. where the longer-term effects of U.S. protectionism are particularly deflationary. The implications on U.S. inflation are less clear and dependant on the extent that currency adjustment negates the impact of rising domestic prices. However, with the U.S. economy already running close to full employment, any inflationary shock – even temporary – could actually put upward pressure on U.S. bond yields in the short-term.

At the individual security level, the impact of proposed border adjustment taxes on Canadian corporates varies largely depending on the extent by which their production destination is the U.S. By sector, transportation equipment is the more obvious sector that would suffer, with more than two-thirds of production exported to the United States and thereby impacted by these proposed changes. Other sectors such as chemical products, computer and electronic products, primary metals, machinery, and textiles depend on Americans buyers for at least half of their production.

Within our own Canadian equity portfolio, our analysts consider the impact of any potential border adjustment tax on their return expectations for individual stocks. In the energy sector, the implications of a border adjustment tax would be to widen the spread between U.S. and Canadian oil and natural gas prices, which would ultimately have an adverse impact on Canadian company earnings, particularly in the oil and gas extraction businesses. However, we believe that the probability-based impact of the border adjustment tax proposals have already been largely discounted in energy stock prices which are down year-to-date by 7% to 10%.

Outside of the energy sector, the only other name in our Canadian equity portfolio that would be materially impacted would be Bombardier Recreational Products (BRP Inc.), where a significant share of revenues are from export sales into the United States, including from manufacturing assembly plants located in Mexico. Our discussions with management on the potential implications of any border adjustment tax on this company only serve to highlight the complexities that U.S. trade policy proposals would add to existing multi-national supply chains for companies such as for BRP Inc.

South of the border, large importers such as retailers, whose profit margins are already thin, would be the most obvious companies that would suffer under the border adjustment tax proposals. Meanwhile, other export-oriented sectors including computers and electronic products, electrical and appliances, leather goods—would stand to possibly gain.

Conclusion

The political debate regarding U.S. tax reform is still in its early stages. However, the Republican majority's ability to enact tax reform via a simple majority increases the likelihood of some tax reform. Nonetheless, there remain significant differences between the various proposals of the House, the Senate and the new U.S. administration.

For a border adjustment tax specifically, estimates from U.S. bank and political analysts typically assess the probability of between 20% and 30% of some form of border adjustment tax being passed. That is a high probability for what is arguably the most substantial base broadening initiative in decades.

For this reason, and given the significant implications for Canadian investors outlined above, we believe that this particular U.S. policy proposal warrants particularly close attention for Canadian investors over the coming months.

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