Tariffs, Taxes and Trump: U.S. Border Adjustment Tax…the other threat to our Canadian economy

"NAFTA is the worst trade deal maybe ever signed…" The pervasive "trumpeting" of that rhetoric was heard throughout the recent U.S. election campaign. Finger pointing about unfairness in the context of North American trade was primarily directed at Mexico, with Canada sitting quietly on the sidelines. And, in fact, since the new administration has taken the reigns, there have been assurances that Trump is happy with the trade relationship with Canada[1].

But what does that mean? *If* a renegotiated NAFTA reflects the new administration's favourable view of Canada, do we get a free pass on U.S. protectionism? The answer is likely no. There is a second, less discussed, impediment to Canada's economic well being: the border adjustment tax (BAT), part of the U.S. corporate tax reform proposed by House Speaker Paul Ryan and Ways & Means Committee Chair Kevin Brady. The plan supports a cut in U.S. corporate tax from 35% to a flat 20%, with the use of a BAT to generate additional tax revenue.

What is a border adjustment tax?

The BAT differs from a tariff in that it is a consumption tax, paid by the end consumer. The proposed U.S. plan would apply a 20% BAT to all imported goods. Revenue generated by U.S. businesses from exports would not be subject to the BAT. In effect, it is a tax on the U.S. trade deficit.

In the following example, we illustrate the application of the proposed U.S. tax regime for three U.S. companies. For simplicity, we assume that cost of goods sold (COGS) are comprised entirely of raw materials. In practice, the BAT is an evolving and complex issue that isn't entirely captured by our simple example. Of course, we are not tax experts. However, we would be pleased to connect you to an experienced tax professional if you would like a more nuanced explanation.

	Local	Exporter	Importer	Foreign
Foreign Revenue	-	100	-	100
U.S. Revenue	100	-	100	-
Total Revenue	100	100	100	100
Foreign COGS	-	-	65	65
U.S. COGS	65	65	-	-
Total COGS	65	65	65	65
Gross Profit	35	35	35	35
Gross Margin	*35%*	*35%*	*35%*	*35%*
SG&A	10	10	10	10
Pre-Tax Income	25	25	25	25
Taxable Income (U.S. Revenue less U.S. Expenses)	25	-	90	-
Tax Payable	5	-	18	-
Implied Rate (on Pre-Tax Income)	*20.0%*	*0.0%*	*72.0%*	*0.0%*
Net Income	**20**	**25**	**7**	**25**

The above three scenarios are defined by how each company affects the trade balance with other countries. The Local company does all its business in the U.S. with no impact on the trade balance, and therefore, can subtract U.S. COGS from its revenue to calculate taxable income. The Exporter, on the other hand, contributes to a trade surplus, which exempts its revenue from taxable income. Conversely, the Importer contributes to a trade deficit and therefore cannot subtract Foreign COGS from revenue in calculating taxable income.

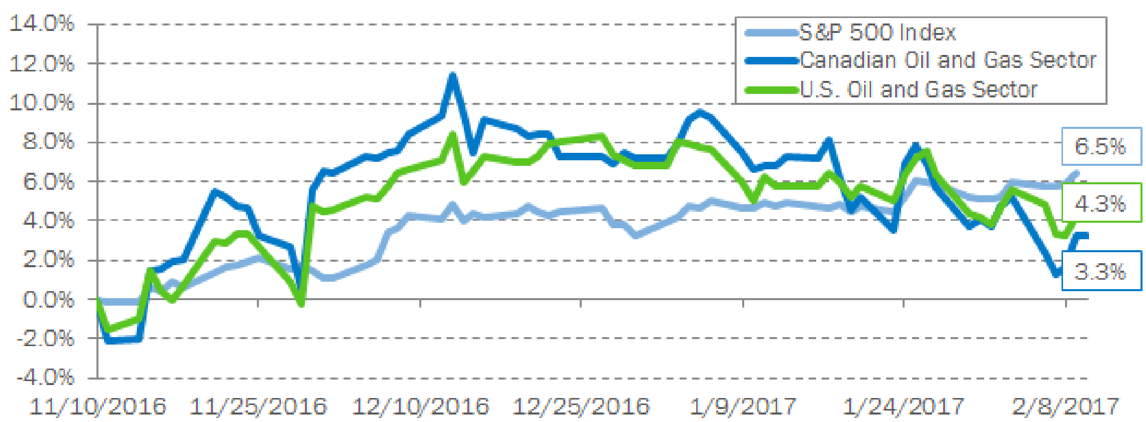
And the consequences?

The obvious, immediate consequence will be an increase in the cost of imports to U.S. buyers. There will be an impact on Canadian exporters, as their U.S. trading partners would have to pay the BAT on any Canadian exports, thus driving up price of those goods. This, in turn, will translate into downward pricing pressure (i.e. a 20% pricing decrease to offset the negative impact to the U.S. importer) or decreased demand for Canadian exports to the U.S.. U.S. sectors that have high net imports will be hardest hit, including retail, auto (also facing a looming threat with the renegotiation of NAFTA), and oil and gas. In response, a lobby group called the Americans for Affordable Products Coalition (AAPC) was recently formed to protest the tax, claiming that it will raise the cost of everyday items such as gas and food. The group includes large retailers (Macy's, Target), and trade associations.

If the BAT becomes a reality, some economists are predicting an increase in the value of the U.S. dollar by as much as 25%, which would effectively render neutral the increased cost of imports. The magnitude of increase is a topic of much debate, however, and it is unclear at this point what the net impact will be.

Oil and Gas: A sector snapshot

While energy shares surged following Trump's election victory, the spectre of a BAT has quashed that early exuberance. Canadian producers are concerned, as they export approximately 3 million barrels of crude per day to the U.S., representing about three-quarters of Canadian production. U.S. oil refineries certainly oppose the BAT; several major mid-west refineries (Koch, Exxon Mobil, BP, Husky Energy) run facilities built to process Canadian crude oil. Recently, there has been some suggestion of an exemption for crude oil, but the uncertainty remains, and will continue through the summer, as the U.S. Congress considers the proposed tax reform bill.



What's next?

Unlike a potential NAFTA renegotiation, Canadians have no direct role to play where the BAT is concerned. We simply have to wait and see what Congress does with U.S. tax reform. Unfortunately, the uncertainty will overhang much of 2017. A recent Nanos poll indicated that 58% of Canadians would support a trade war in response to any new U.S. "tariffs". That would be a mistake. A C.D. Howe Report released last month suggests that while Canada will be worse off with a U.S. border tax, trade retaliation would only further damage the Canadian economy. We should, rather, focus on the limited positives, in the event the BAT is implemented: the possibility that crude oil will be exempt (as the U.S. needs our production to meet their demand), and the benefits to manufacturing that would flow from a lower Canadian dollar. And finally, there is the takeaway lesson for us to contemplate: that our government, in conjunction with Canadian exporters, should continue to invest concerted effort into the development of non-U.S. trading relationships.

What are the M&A implications?

While the likelihood, timing and net impacts remain unknown, Canadian companies that derive significant revenue from U.S. corporations would be impacted by the BAT. To the extent that owners of any such companies are considering a sale, we encourage them to seek professional advice on how this tax uncertainty may impact the value of their companies and the likelihood that their sale processes will be successful in the current climate. Such advice may impact value expectations and result in holding these companies off the market until the uncertainty is resolved.

For those who are considering M&A in the coming months and wish to discuss this further, we would be pleased to assemble a team of experts to assist shedding light on their particular circumstance.