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The Trump Tax: A Revolution in International Corporate Taxation*

In recent weeks Donald Trump has repeatedly warned that foreign companies which distribute their products in the USA, but do not produce there, will be punished with an import tax of 35 percent. He has not yet explained how he plans to implement this tax. There are, however, strong indications that he may adopt a reform plan put forward by the Republican congressman Paul Ryan. Instead of customs duties, the plan outlines far-reaching reforms in the taxation of company profits. If implemented, the plan stands to revolutionise the international taxation system.

How does the new taxation system work? At the core of the reform lies a border adjustment that has only existed in value added tax to date, but not in taxes on income or corporate profit. Let's look at the example of exporting a vehicle from Germany to the USA. The exporting company incurs production costs of 30,000 euros in Germany, gives the vehicle an export value of 40,000 euros, incurs 5,000 euros in distribution costs in the USA and demands a sales price of 50,000 euros. To date the company has been taxed on profits of 10,000 euros in Germany. In the USA it makes a profit of 5,000 euros, which corresponds to the sales price minus the costs of the imported car and its distribution. According to the new US tax system, the costs of the imported car would not be tax deductible, so the taxable profit on the car in the USA would amount to 45,000 euros.

The question is: how will Germany react to this new system? If Germany sticks with its current taxation system, it faces an additional burden on its exports that amounts to an import tariff equalling the US taxation rate. Ryan has proposed a rate of 20 percent; Trump wants 15 percent rather than 35 percent. The situation would be different it Germany were also to switch its corporate tax system to that of the USA. For exports would then be fully exempt of taxation. The production costs of exports would nevertheless be domestically tax-deductible. The exporting company could offset the production costs of 30,000 euros in Germany and deduct it, for example from profits made on vehicles sold nationally.

A comparison of the existing and the proposed new tax systems reveals that total taxable corporate profits in Germany and the USA amount to 15,000 euros in both cases. The difference is that the right to tax those profits shifts massively towards the USA. In the USA 45,000 euros are taxable instead of 5,000 euros, while in Germany a tax-deductible loss of 30,000 euros is created instead of a profit of 10,000 euros. In this example Germany is at a disadvantage. But no disadvantage would arise if Germany were to import the same volume of goods. If, for example, Apple was to sell i-Phones in Germany that were also worth 50,000 euros, for instance, 45,000 euros in profit would also be taxable in Germany, sales costs being equal. The problem is that Germany exports far more goods than it imports – its foreign trade surplus was around 280 billion euros in 2015, so with a profit tax rate of

30 percent, a switch to the Trump tax system would result in losses of around 84 billion euros for Germany, while deficit countries, including the USA, would gain tax revenues. From a global perspective, the new system would have the advantage of making tax avoidance by multinational companies more difficult. Apple, for example, currently generates a large share of its profits in tax havens, at least before repatriation, because the rights to Apple technology are located offshore. In new tax systems the only factor that counts in taxation is where products are sold – whether a multinational has a letter-box company on the Cayman Islands which administers patent rights or not is irrelevant. That could increase the attractiveness of the Trump tax for the international community. For Germany this benefit would not be large enough to compensate for the losses in tax revenues generated by its foreign trade surplus. The German trade surplus can be expected to disappear in all events as Germany's population ages. By that time, however, US enthusiasm for Trump's tax revolution may have waned.

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Clemens Fuest
Professor of Public Economics and Finance
President of the ifo Institute