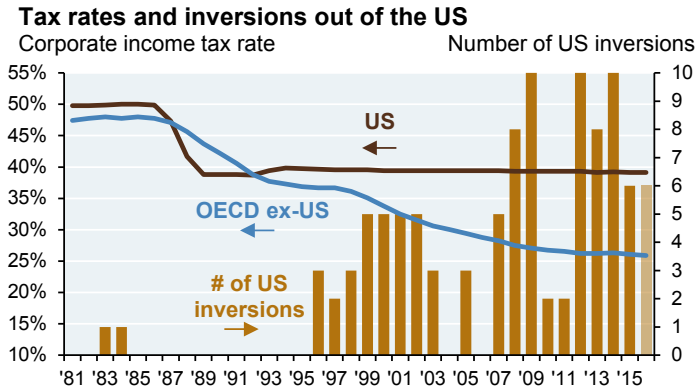
A mercifully brief note on destination based taxation

Look before you leap. I know it's the week before Christmas but this topic is important, so I wanted to comment on it before year end, and before the release of our 2017 *Eye on the Market* Outlook on January 1st. The topic: a proposal by some GOP House members to change the corporate tax code and adopt a "destination based cash flow tax" (DBCFT). One could write either 4 or 400 pages on this, so I'm going with 4 to keep it simple. **A DBCFT taxes output where it's consumed, rather than taxing income where it's reported; and generally disallows deductibility of interest expense**. Without getting too caught up in tax jargon, this would effectively convert the US from a worldwide income tax jurisdiction to a territorial system, and adopt a hybrid of a value added tax (it differs from a regular VAT by allowing deductibility of labor costs). The implications would be transformational: imports by US firms would no longer be deductible, and export revenues of US firms would no longer be taxed. Supporters of DBCFT assume that the dollar would appreciate and prevent windfalls for US exporters or pain for US importers, but that may be a brave assumption in a complex world.

What are supporters of DBCFT hoping to accomplish? Among other things:

- Eliminate incentives to locate business operations outside the US
- Reverse the pattern of tax inversions (when US companies re-incorporate overseas for tax purposes)
- Eliminate incentives for firms to "strip" income out of the US with the use of inter-company debt, transfer prices and other similar means
- Increase incentives for capital spending relative to incentives to borrow

As shown below, US tax inversions picked up in the 1990s when corporate tax rates around the OECD fell while US corporate rates stayed the same. If the US adopted the House DBCFT proposal, incentives to locate operations offshore, invert and/or engage in transfer pricing would fall since US taxes would be applied where output is consumed and not where companies report that income is earned; since interest deductibility is disallowed; since offshore income would no longer be taxed; and since corporate tax rates would be cut to 20% from 35%. The ultimate irony: from the perspective of transfer pricing, the US could become a "low-tax" jurisdiction for non-US firms.

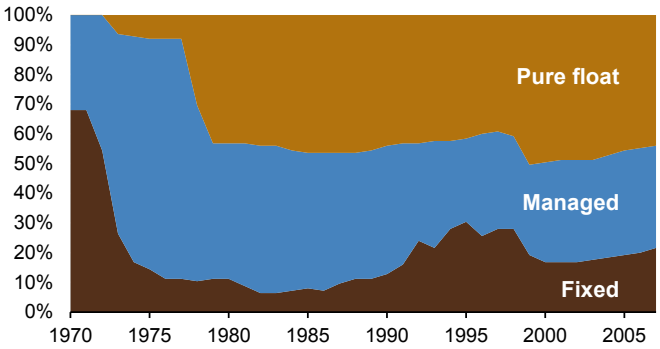


Source: Mercatus Center at George Mason University. 2016.
Note: Pending inversions shown for 2016.

What's not to like? Well, there are risks around what happens to exchange rates. **Supporters of the DBCFT believe it will not create windfalls for US exporters or distress for US importers, since in such a system, the US dollar would appreciate substantially in real terms**. If so, the benefits of tax exemption for exporters would be offset by reduced demand, and pain for importers from loss of deductibility would be offset by lower import prices. However, this is a theoretical premise which may or may not play out in real life.

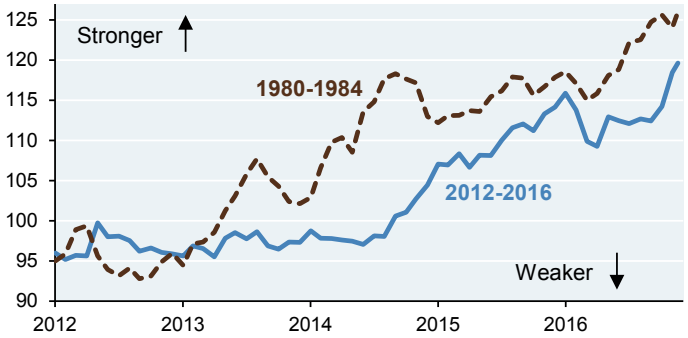
Will the dollar really appreciate as anticipated? Some US trading partners have freely floating exchange rates, while others are either fixed or managed. As shown in the chart below (left), only half of the world's GDP employs floating exchange rates, and that figure includes the US which is ~15% of the total. This could limit the degree of dollar appreciation in real terms[1]. What happens when the ECB eventually withdraws its monetary stimulus and raises rates? And what kind of pricing responses will be adopted by individual foreign firms? Unclear. And if the US dollar *did* appreciate by 25% in real terms (i.e., how much it would need to rise to render US importers indifferent assuming a corporate tax rate of 20%), that would propel the dollar to its highest level on record. This could in turn create problems for non-US issuers of dollar financing and other possibly unforeseen consequences.

The world's FX regimes
Percentage of world GDP, purchasing power basis



Source: "Exchange Rate Regimes in the Modern Era", Rose. 2007.

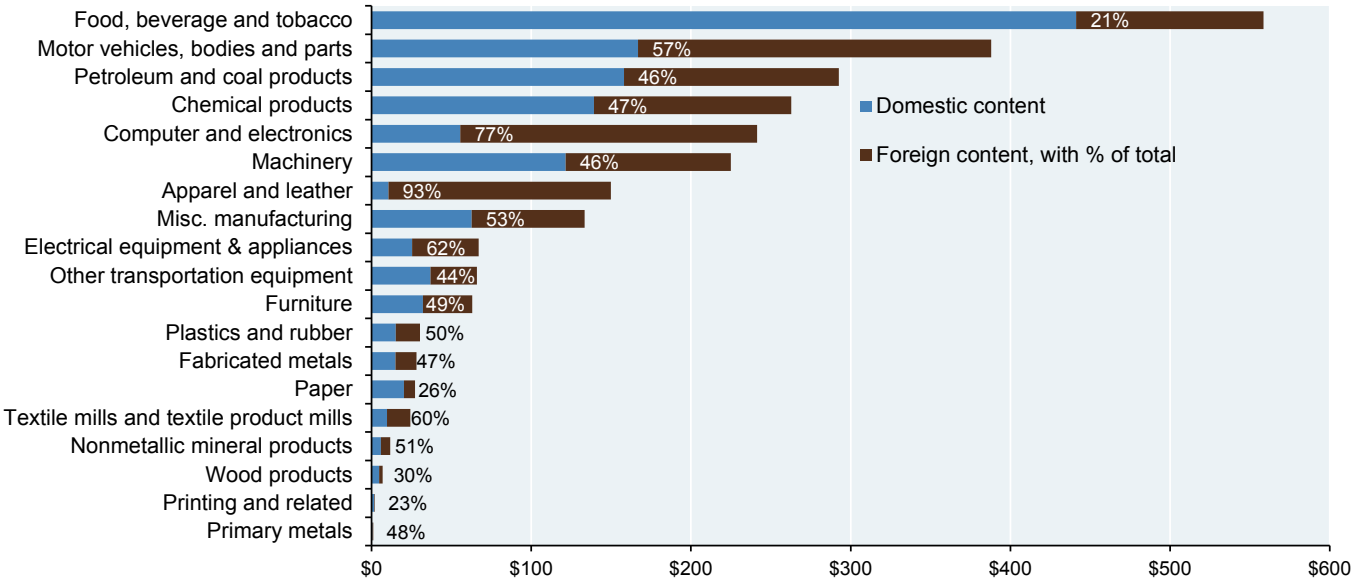
Sharp rise in the dollar parallels early 1980s rise
Real effective US dollar exchange rate index



Source: J.P. Morgan Securities LLC, BIS, Bloomberg. December 15, 2016.

In the past, the dollar did respond to changing US tax rules. One analysis looked at anticipated repeal of US tax-based export incentives in 1997 and changes in the $/£ relationship. However, this episode did not involve the scope and magnitude of exchange rate adjustments associated with wholesale adoption of DBCFT. As a result, rather than thinking about what could go right, it makes sense for investors to think about what could go wrong. **What would happen if sufficient real dollar appreciation *does not* take place?** Companies that import a lot could be hurt the most. The chart below looks at US output by sector, and shows the component of output related to domestic vs. foreign content.

Sectors with high import content are exposed to inadequate dollar appreciation under a DBCFT
Domestic demand for manufactured goods, billions of dollars



Source: Department of Commerce, Bureau of Economic Analysis. 2012.

[1] Appreciation in real terms could involve a higher dollar, and/or inflation that's higher in the US than outside it.

Interpreting the chart. Motor vehicles, computers, electronics, apparel and electrical equipment would be hurt the most by loss of import deductibility should the dollar not rally enough in real terms. These sectors are (a) large, and (b) reliant on foreign content for more than half of their output. The last thing some of them need is more pressure on margins, given rising labor costs and declines in consumer activity at brick & mortar stores (see charts on following page). In a December 16th report from J.P. Morgan Securities on the retail sector, the benefit of lower corporate tax rates is estimated to be more than offset by the impact of border tax adjustments:

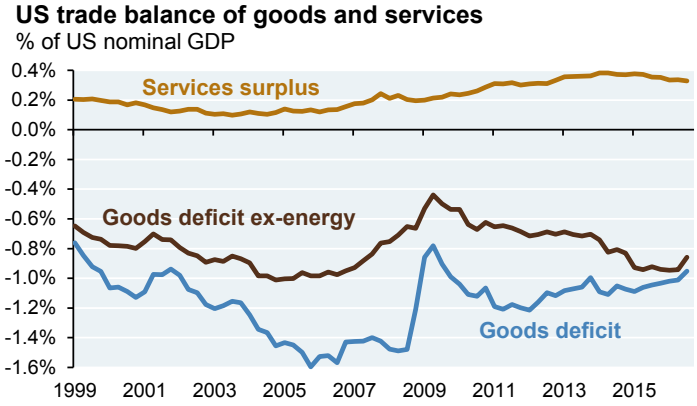
EPS changes assuming 20% corporate tax rate, border tax adjustments, and no exchange rate appreciation

	Dep't Stores	Off Price	Specialty	Apparel	Athletic	Dollar Stores
Change in EPS at 20% corporate tax rate	21%	27%	35%	6%	19%	28%
Change in EPS at 20% corporate tax rate and application of border tax adjustments	-14%	19%	-132%	-34%	-40%	-13%

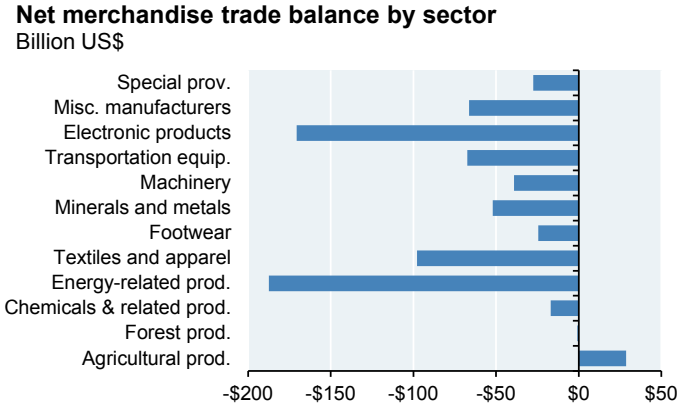
Source: J.P. Morgan Securities LLC. December 2016.

By the way, risks to consumers of inadequate dollar appreciation are similar, since a DBCFT usually **also involves a border adjustment tax on their imports as well;** in other words, border tax adjustments don't apply to businesses only. If this sounds to you like a tariff, I wouldn't disagree with that description. The border adjustment tax rate would be the same as the corporate tax rate, 20% in the House plan. One can easily see the risk of US inflation should the dollar not rally enough to offset the cost of the border adjustment tax.

Of course, the lower the corporate tax rate, the lower the pain from lost import deductibility. The Tax Policy Center estimates that border tax adjustments could raise $1.2 trillion over 10 years, offsetting a large part of the $1.8 trillion estimated cost of cutting the Federal tax rate from 35% to 20%. Why do border tax adjustments raise so much revenue? The US runs a large trade deficit (more imports than exports). Trade deficits are commonplace across US industry: of 12 sectors tracked by the US Trade Commission in 2014, only one had a positive trade balance (agriculture). But even if the corporate tax rate were cut to 20%, without enough real appreciation in the dollar, earnings could suffer as per the table above. If border tax adjustments were only applied to goods and not services, it could raise even more revenue given the US surplus in services, but that might not fly politically.



Source: Bureau of Economic Analysis, Haver Analytics, JPMAM. Q3 2016.



Source: US International Trade Commission. 2014.

Some components of DBCFT can be phased in over time, and/or phased in partially (such as the loss of interest deductibility, and immediate expensing of capital outlays). But border tax adjustments do not lend themselves easily to phase-ins and carve-outs, since so much of their premise relies on immediate appreciation of the US dollar. Given the risks and uncertainties around its implementation, **if DBCFT passage becomes more likely**, prepare for substantial volatility (shoot first, ask questions later) reactions in the market as it relates to highly-leveraged, low-margin firms which import a lot of goods as a percentage of their value added.

What about loss of interest deductibility and immediate expensing of capital investments, which is the other major component of DBCFT? Most versions of these proposals grandfather interest deductibility of existing debt, and create carve-outs for financial firms. But what would this mean for issuers that rely extensively on short-term obligations like commercial paper; would CP no longer be deductible when it's rolled? Unclear. And on the issue of immediate expensing of capital expenditures: this is only a **timing** benefit, nothing more. In a low interest rate environment, benefits are modest when compared to bonus depreciation rules that already exist. Looking just at the interest and depreciation components of DBCFT and ignoring border tax adjustments, the net impact would cut the earnings benefit from lower corporate tax rates roughly in half.

I also think it would be naïve to assume that corporations and their advisors would not try to find ways to minimize taxes under a new set of rules. New anti-abuse statutes and doctrines might be required, and whose enforcement cost might not be that different from what we have now.

One last comment on DBCFT. Given its complexity, there's a lot of misinformation and misunderstanding going around. Some people like DBCFT because they believe that it's **protectionist**, and other people like it because they resolutely believe **that it's not**. That's a strange starting point for transformational tax policy.

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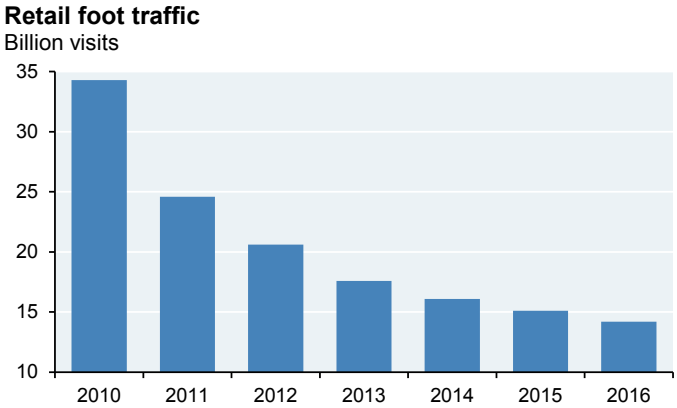
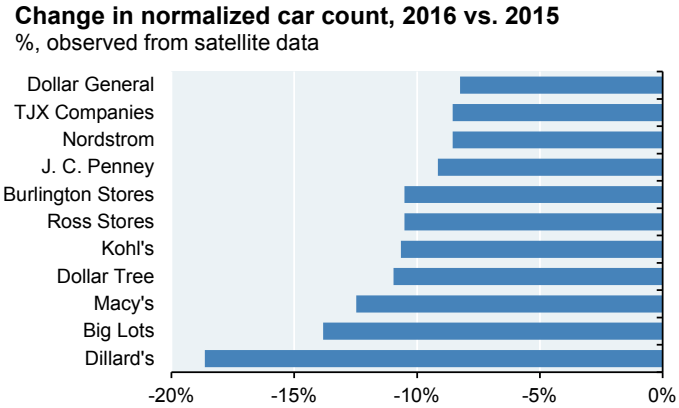
J.P. Morgan Asset Management

Note: the DBCFT would arguably turn the US into a zero tax jurisdiction from the standpoint of transfer pricing by non-US firms, and may violate World Trade Organization rules against border tax adjustments. We do not address here potential objections from US trading partners, or complaints brought against the US in the WTO. While the incoming administration might be indifferent to such objections (should it follow the House's lead and support passage of DBCFT), the WTO does have jurisdiction to authorize member countries to impose large tariffs in retaliation.

Appendix charts on challenges for brick & mortar stores



Source: J. Rogers Kniffen (Future of Retail), Shoppertrak. Dec. 19, 2016.



Source: J.P. Morgan Securities LLC. December 2016.

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