THE REAL ECONOMY

MIDDLE MARKET FACES TIGHT LABOR MARKET

OFFSETTING LABOR CHALLENGES WITH FINANCE AND ACCOUNTING OUTSOURCING

BORDER ADJUSTED TAX PROPOSALS MAY IMPACT EXPORTERS AND IMPORTERS
ABOUT THE AUTHORS

Our thought leaders are professionals with years of experience in their fields who strive to help you and your business succeed. Thought leaders who have contributed content to this issue include:

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# TABLE OF CONTENTS

Middle market faces **tight labor market**

- 4

**Offsetting labor challenges** with finance and accounting outsourcing

- 6

**Border Adjusted Tax proposals** may impact exporters and importers

- 8
The U.S. economy entered the year at full employment, a far different condition than what prevailed earlier in the economy’s ongoing cyclical expansion. This carries distinct implications for the economy, particularly the middle market.

With the economy likely to continue generating far more jobs per month than necessary to stabilize the unemployment rate (80,000 new jobs per month are needed to maintain a stable unemployment rate), labor market dynamics will continue to generate upward pressure on wages.

Meanwhile, policy changes around the country are slowly moving minimum wages toward $15 per hour. We expect wage growth to exceed 4 percent by the end of the year, with risk to the upside related to a pronounced shift in bargaining power to labor from firm owners, a much different dynamic than has been prevalent in the United States since the late 1990s.

Wage pressures will intensify as economy adjusts to full employment

by Joe Brusuelas, Chief Economist, RSM US LLP

Wage pressures rising across the economy

We anticipate that the economy will continue to generate between 125,000 to 150,000 jobs per month, somewhat below the 180,000 average in 2016, with the unemployment rate likely to drop below 4.5 percent by the end of the year amid strong job growth across most sectors and only 1.4 individuals available per job opening.

Average hourly earnings, which closed out 2016 at a cyclical high of 2.9 percent, will likely move above 3.5 percent this year. Moreover, the momentum in the wage market at the end of last year pushed wages up 4.7 percent on an average annualized pace, a reflection of an economy that is now at full employment.

At this point, the public has bought into the durability of the cyclical expansion, and wage expectations (currently at 3.6 percent) have improved to their best point since the recession. This mirrors the movement in the compensation expectations index within our own proprietary RSM US Middle Market Leadership Council survey, which in the fourth quarter of last year pointed to much higher wages by mid-2017.

Rising wage pressure across U.S. economy

Source: RSM US, BLS

Small firms plan to increase compensation

Source: RSM US, Bloomberg

MIDDLE MARKET INSIGHT

Middle market firms may face significantly higher wage premiums to hire new workers.
Business planning to increase compensation

In addition, the wage data that we culled from the recent monthly employment report is in line with other measures, such as the quarterly Employment Cost Index and the Atlanta Federal Reserve’s Wage Tracker, both of which are pointing toward greater strength in underlying wage growth than is generally acknowledged.

Labor market dynamics and policy changes around the economy will create a significant period of adjustment for middle market firms in 2017.

MIDDLE MARKET INSIGHT
Recruitment and retainment of labor pose rising challenge for middle market firms.

Middle market businesses frequently are forced to deal with large company problems with small company capabilities. In the year ahead, middle market businesses will need to adjust to the challenges of recruiting and retaining workers in a labor-market environment where there is a 5 percent premium, on average, to retain workers who have other opportunities. For skilled workers in areas such as value-added manufacturing, technology, life sciences and finance, those premiums may rise into the double digits.

As a result, the middle market will need to craft a delicate balance between retaining workers who are the key to supporting current productivity, meeting overall demand and narrowing profit margins. While there may be relief coming via policy changes on regulation, corporate taxes and individual tax rates, many middle market businesses don’t have the luxury of waiting to see how those changes unfold if they want to remain competitive. We continue to urge our client base to address labor needs now rather than waiting for the time when revenues are rising and margins are expanding.

LABOR PARTICIPATION
BY MEN AGES 25 TO 54
REMAINS A PRESSING PROBLEM

We ended 2016 with 2.1 million jobs having been created and the unemployment rate declining to 4.7 percent. Since 2008, about 54 percent of all jobs created were of the low-wage variety, (though the last three years saw a 50/50 split in the composition of hiring between low- and high-wage jobs). Meanwhile, over that same period the number of individuals facing part-time involuntary unemployment, and those marginally attached to the labor force, declined to near historical averages. One ongoing problem that will spill over into the Trump era is what to do about the roughly 15 percent of men aged 25 to 54 that do not meaningfully participate in the labor market, an issue that creates numerous economic and social costs.
Several economic factors are significantly impacting the hiring and retention practices for key finance and accounting personnel in every industry. However, many successful middle market companies are counteracting these challenges by leveraging outsourcing strategies to gain efficiency, overcome staffing difficulties and better manage costs.

A significant shift is currently occurring with some economic indicators, as demonstrated in the recent RSM US Middle Market Business Index. Salaries are expected to rise in 2017, with hiring increasing and unemployment subsequently falling. With these challenges in mind, competition for talent is rising, and middle market organizations will face numerous risks when looking to attract and retain skilled finance and accounting personnel.

Middle market organizations require several unique characteristics and skill sets to effectively manage the finance and accounting function. These include:

- The right systems and technology environment, as well as the clerical ability to turn data into actionable information
- Effective management to understand industry regulations to accurately record and report information
- Resources to make strategic decisions for budgeting, forecasting and spending
- Tax strategy and technical accounting compliance knowledge to organize financial and management reporting within the organization

Unfortunately, these skills are all different, and finding a single individual with experience in each of these areas is often a challenge. Therefore, to fill each of these roles with qualified resources, middle market organizations are increasingly implementing outsourcing strategies to take advantage of fractional resources with a myriad of diverse skill sets.

Attempting to hire one person with all the needed capabilities and a high salary is a risky proposition. The wrong hire can require additional resources, and higher costs to augment their skills with more outside assistance. However, hiring an outsourcing firm with finance and accounting capabilities allows businesses to focus on their core management decisions.

Hiring internal resources also comes with hidden costs, including benefits and training. In addition, with a competitive personnel environment, a productive employee may choose to leave, resulting in potential opportunity costs. However, an external firm that provides finance and accounting outsourcing provides a redundant system to leverage additional capabilities if someone goes on leave, a critical situation befalls someone, or if someone leaves for another opportunity.

Outsourcing can help combat hiring challenges with flexibility and coverage by leveraging standardized processes and technology solutions that help deliver necessary finance and accounting services. It provides a diverse skill set base with technical accounting skills, financial reporting and analysis, and an understanding of the business and key performance indicators that is difficult to replicate internally without a significant cost.

By Jim Cashin, Partner, RSM US LLP
In many cases, firms with outsourcing capabilities can attract and retain a strong talent base by incenting employees with diverse opportunities. A situation where personnel experiences many different circumstances, environments and industries are often more attractive to qualified professionals than working in one singular location. Firms with outsourcing capabilities have a unique opportunity to attract scarce talent, by challenging employees with constant opportunities for growth.

Competition for talent is only expected to increase, as the number of individuals becoming CPAs has not matched that need. In a recent survey, the American Institute of Certified Public Accountants found that enrollment in accounting programs reached an all-time high in the 2013-14 academic year, but with hiring also at record levels, the supply has yet to meet the demand in the marketplace.

A smaller amount of talent will inherently add to the risks involved in hiring and retaining accounting and finance personnel. Without a proper framework for continuous training and personnel development, the performance of the finance function can suffer. While many middle market companies do not have the resources to support this structure, firms with outsourcing capabilities can provide resources on demand with the necessary experience and skill sets.

With the opportunities they present to personnel, outsourcing firms typically have a growing group of talent both in accounting and technology platforms that they continue to develop. By working with multiple companies and industries, employees better understand a variety of business aspects and challenges. Firms can replicate finance and accounting best practices to help organizations become more efficient and see real-time information as needed to help make better business decisions.

In a rapidly evolving economy, rising salaries, falling unemployment, and the supply not meeting the demand for CPAs are creating difficulties for middle market businesses to hire and retain effective finance and accounting resources.
A new destination-based tax regime may be part of an increasingly likely comprehensive tax overhaul, but details remain unclear

By Ben Wasmuth, Manager, RSM US LLP
Jamison Sites, Manager, RSM US LLP

A comprehensive tax overhaul appears to be near the top of the 2017 legislative agenda. Included in the tax policy proposals put forward by Speaker Paul Ryan and the House GOP during the election season was a potentially significant change in U.S. international tax policy. They have proposed a “destination-based” tax, where income from goods and services are taxed based on where they are consumed, as opposed to where they are produced and sold. As described in the House Republican Tax Reform Blueprint (the Blueprint), this would be facilitated by so-called “border adjustments” which would result in generally taxing imported goods and services while exempting exported goods and services from U.S. tax.

While the Blueprint is light on implementation details, the proposal is likely based on a more detailed proposal from the report of the President’s Advisory Panel on Federal Tax Reform (issued during the George W. Bush administration), allowing some concepts to be outlined. However, at this time, the specific parameters of this “border adjusted tax” (BAT) are far from clear, with many potential variations possible.

How a BAT might work

One of the border adjustments that might be included in a destination-based tax system is an exemption for sales of goods and services outside the United States. Thus, a domestic manufacturer that sells a product abroad is not subject to tax on the gross revenues from its foreign sales. Under another adjustment, the taxpayer may deduct its “domestic” cost of goods sold (CGS) but not its “foreign” CGS. Determining which costs are foreign vs. domestic is easier said than done, but presumably, actual legislative language will shed light on this point when it emerges.

Just as a destination-based system would exempt exports from U.S. tax, it would likely subject imports to a U.S. tax. As set forth in the report from the President’s Advisory Panel, “Purchases from abroad are taxed by either making them nondeductible to the importing business or by imposing an import tax.” The Blueprint does not suggest which of these methods would be adopted, although it does indicate that the move to a destination-based system will not involve a new tax, suggesting that costs incurred for imported goods would not be deductible.
Royalties on intellectual property held in the United States may become an exempt export, providing a powerful incentive for U.S. companies to keep their intangible assets home; however, this is still unclear.

These rules outline a simple approach to a BAT. The following examples illustrate how it would apply to importers and exporters.

**Example 1**

Let’s first consider the case of an importer. Under current law, a company that imports goods from abroad for resale in the United States or incorporates into goods sold in the United States (such as retailers or domestic manufacturers) might have a federal tax calculation that looks like this:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross sales</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>8,000,000</td>
</tr>
<tr>
<td><strong>Gross margin</strong></td>
<td>2,000,000</td>
</tr>
<tr>
<td>Other expenses</td>
<td>500,000</td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td>1,500,000</td>
</tr>
<tr>
<td>Tax rate</td>
<td>35%</td>
</tr>
<tr>
<td><strong>Tax liability</strong></td>
<td>525,000</td>
</tr>
</tbody>
</table>

If the BAT rules described above were to apply, the taxpayer’s liability would be radically different. Assuming a corporate tax rate of 20 percent (the rate proposed in the GOP Blueprint), and no other proposed blueprint adjustments, the taxpayer’s federal BAT calculation would be as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross sales</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>-</td>
</tr>
<tr>
<td><strong>Gross margin</strong></td>
<td>10,000,000</td>
</tr>
<tr>
<td>Other expenses</td>
<td>500,000</td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td>9,500,000</td>
</tr>
<tr>
<td>Tax rate</td>
<td>20%</td>
</tr>
<tr>
<td><strong>Tax liability</strong></td>
<td>1,900,000</td>
</tr>
</tbody>
</table>

Since the entirety of the taxpayer’s CGS arises from import purchases, no deduction for those expenses would be allowed. This results in the taxpayer being taxed almost entirely on gross sales. The magnitude of this impact is inversely proportional to an importer’s gross margin.
Example 2

Alternatively, consider a U.S. manufacturer that primarily produces for export, deriving 80 percent of its sales from customers located outside the United States. Assume that this manufacturer’s gross revenues and expenses are identical to those of the importer, except that all raw materials, labor costs and other production inputs are incurred domestically. Without border adjustments, this manufacturer might have a simplified tax calculation under current law that is identical to that of the importer considered above as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross sales</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>8,000,000</td>
</tr>
<tr>
<td><strong>Gross margin</strong></td>
<td>2,000,000</td>
</tr>
<tr>
<td>Other expenses</td>
<td>500,000</td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td>1,500,000</td>
</tr>
<tr>
<td>Tax rate</td>
<td>35%</td>
</tr>
<tr>
<td><strong>Tax liability</strong></td>
<td>525,000</td>
</tr>
</tbody>
</table>

However, under a BAT approach, the exporter’s tax treatment diverges dramatically from the importer’s BAT treatment:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross sales</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>8,000,000</td>
</tr>
<tr>
<td><strong>Gross margin</strong></td>
<td>(6,000,000)</td>
</tr>
<tr>
<td>Other expenses</td>
<td>500,000</td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td>(6,500,000)</td>
</tr>
<tr>
<td>Tax rate</td>
<td>20%</td>
</tr>
<tr>
<td><strong>Tax liability</strong></td>
<td>-</td>
</tr>
</tbody>
</table>

Since the export manufacturer derives 80 percent of its sales from customers outside the United States, only 20 percent of its sales are subject to tax. However, the manufacturer can still deduct its U.S. based costs. As a result, the manufacturer has a large taxable loss, one that could be expected to recur every year, as long as the manufacturer’s customer and cost base remains the same.
Why pursue a BAT?

The GOP Blueprint suggests that the move to a destination–based tax system with border adjustments should boost exports and reduce imports, thus reducing the United States’ overall trade deficit and boosting U.S. manufacturing and domestic employment. Some economists, as well as the original report of the President’s Advisory Panel, however, suggest that macroeconomic changes brought about by switching to a destination–based system (appreciation of the U.S. dollar being one example) would serve to offset any overall trade effects of the change. For example, suppose that an exemption for export sales allows primarily exporting U.S. manufacturers to reduce the price of their goods without initially impacting after–tax profit. Although this would drive up the quantity of the manufacturers’ goods demanded, it would also result in increased demand for U.S. dollars with which to buy those goods, driving up the value of the dollar relative to other currencies. If the increase in dollar valuations cancels out the aggregate reduction in dollar prices of U.S. exported goods, no overall trade impact should result.

Other economists, however, have signaled skepticism that exchange rate shifts to counter the imposition of border adjustments would be either immediate or complete. For example, currencies that are pegged to or otherwise adjusted with respect to the U.S. dollar would be expected to show more or less of an adjustment against the dollar than the “total offset” theory would suggest. Even barring state action, the appreciation of the U.S. dollar would need to be quite significant to offset a proposed border adjustment, more significant perhaps than current markets are willing to allow.

Another cited benefit of moving to a destination–based system is ease of administration. In our current system, which generally attempts to impose tax where value is created (an “origin–based” system), multinational enterprises must construct complex intragroup pricing arrangements, to assign income within their group (and, by extension, amongst the various countries where they operate). These arrangements are often the subject of lengthy and expensive examinations and challenges, as the U.S. and other governments try to ensure that income is not being improperly shifted to low–tax or no–tax jurisdictions. With a move to a destination–based system, there will no longer be a need to assign income throughout the value chain; only the location of the final consumer would matter.

Some commenters have also mentioned that the interaction of a destination–based system with another portion of the GOP Blueprint, which would allow net operating losses to be carried forward only, will result in undesirable, noneconomic merger activity. As an example, a company that only produces for export can expect to have a net taxable loss from every year of operation, which would be of no benefit to it if losses can only be carried forward and refunds cannot be obtained. Another company that is a consistent importer, however, would see value in such a loss, and may seek to merge with exporting companies. Because of the powerful tax incentive at work, this merger may occur whether or not it would otherwise make economic sense.

Finally, there are concerns that a destination–based income tax system would run afoul of World Trade Organization (WTO) rules against export subsidies. While the WTO trade rules allow border adjustments for indirect taxes, such as a VAT, the rules do not allow them for direct taxes (e.g., income taxes). The GOP Blueprint indicates a belief that its reform proposals, when viewed together, would shift the nature of the U.S. business tax enough that it would become an indirect tax, thereby allowing the BAT to be consistent with WTO rules. This view is not universally shared, however, and the consequences of an unfavorable ruling at the WTO can be severe. A previous U.S. tax provision excluding “extraterritorial income” was challenged by the EU at the WTO and ruled illegal, allowing the EU to impose heavy retaliatory tariffs on U.S. products. These tariffs, imposed in 2004, led directly to the swift repeal of the extraterritorial income exclusion later that year.

Conclusion

The debate on the propriety of a BAT is just beginning. Both President Trump and Congress have placed great emphasis on passing measures that will stimulate domestic employment and they have both publicly endorsed imposing a tax on goods produced abroad and imported into the United States. Accordingly, we believe there is a significant possibility that a provision containing some form of BAT may be enacted if international tax reform occurs. Because this may happen as soon as later this year, we believe taxpayers should begin to analyze the impact of these proposals as soon as a bill is introduced in Congress, or sooner.