The Border Adjustment Tax

Proposal for Corporate Tax Reform

House GOP Plan has 5 key provisions

- The tax rate would be lowered to 20%
- No more depreciation, fully expensed in the current year
- No business tax on profit earned overseas
- No deduction for interest expense
- Corporate tax would be “border adjusted”

“Border Adjusted”?

- We typically consider VAT (value-added tax) as a border adjusted tax.
- A border adjusted tax is a tax that is applied to all domestic consumption and excludes any goods and services that are produced here, but consumed elsewhere.
- This is a “destination based” principle in which the tax is levied based on where the goods end up (destination) rather than where the goods are produced (origin.)
- VAT follows a destination based principle which may also be applied to retail sales tax. The GOP plan applies this principle to business taxes.

How would this border adjusted tax work?

- Tax would be applied to imports, but exempting exports.

- Revenue from sales to nonresidents would not be taxable.

- The cost of goods purchased from nonresidents would not be deductible. As a result, 100% of sales of imported goods would be taxable income.

- Though similar to a VAT, this plan would allow businesses to deduct payroll expenses. VAT does not.

Sounds like a tariff?

- No, as the tax falls equally on domestic and imported goods consumed in the US.

- Potential objections from the World Trade Organization as the general principle of corporate tax is not eligible for a “border adjustment.” The argument would be that this is an indirect consumption-based tax.

- Primary appeal is the potential to raise $1 trillion or more over the next decade and reduce the US trade deficit.

- Definitely simplifies corporate tax

- A territorial tax - easy to repatriate cash overseas and all foreign tax provisions unnecessary.

Is this a protectionist measure?

- It definitely subsidizes exports and discourages imports.
- Most ***academic*** economists believe either prices or exchange rates (or both) would adjust quickly to offset these effects.
- With a complete price or exchange rate offset, this tax on all goods and services should not change domestic consumption.
- The majority of market economists and financial analysts are concerned that the required adjustments to exchange rates will not be immediate and smooth. There will be an immediate advantage to exporters.
- As US corporations attempt to increase exports and use domestic suppliers, there may likely be fewer foreign buyers with a stronger dollar and less cash as fewer US businesses will be buying their goods.

Example

	No border tax	No economic response	25% dollar appreciation	25% price increase
Revenues				
Domestic	$1000	$1000	$1000	$1250
Foreign sales	0	0	0	0
Costs				
Domestic	300	300	300	375
Foreign inputs	300	300	240	300
Pre-tax income	400	400	460	575
Taxable	$400	$700	$700	$875
Tax @20%	$80	$140	$140	$175
After tax	$320	$260	$320	$400

Theoretically….

- Theoretically, the domestic-based cash flow tax should work to significantly reform corporate taxes.

- The current effective corporate tax rate for the majority of US corporations is well below the 35% stated rate. Small and domestic corporations (like retail) pay close to the top rate of 35%.

- Almost all of the current import and export contracts are denominated in USD.

- If domestic consumption declines as the result of price increases, the full benefits and tax revenue projections will not be achieved.

- Emerging markets will be impacted by a stronger dollar. Some experts believe a 25% increase in the value of the dollar would cause massive financial upheavals and bankruptcies.

- Significant disruptions initially as exporters are the immediate winners and importers are the losers.

Other provisions

- Sole proprietors and S-corps would be subject to tax at personal income tax rates of 12%, 25%, and 33%.

- Active business income would be capped at 25% - advantage to being an independent contractor versus an employee…?

- Alternative minimum tax is repealed.

- Investment income (interest, dividends, and capital gains) would be taxed at half the ordinary rate through a 50% exclusion resulting in a top rate of 16.5%.

Unresolved issues

- What happens when a corporation invests in a financial asset such as a bond?
- The first option is nothing happens. In a true consumption tax environment, financial transactions should be excluded.
- The second option is to treat these assets like any others, deduct the cost at purchase and include the sale price in revenue. Academics supporting the border adjustment tax support the “real-plus-financial” approach.
- There would need to be detailed and comprehensive guidelines with two sets of rules for financial and business transactions.
- There is even more discussion and confusion as to how intangible assets should be treated under this tax plan.
- How would states tax income? Keep the current tax regime, adopt the border adjustment tax, or adopt something entirely different….?

Supporters & Critics

- Paul Ryan and Kevin Brady (House) are the primary supporters.
- Comments from Senators are very skeptical, negative thus far.
- Mnuchin, Secretary of the Treasury, refuses to state an opinion other than the fact that there will be corporate tax reform.
- Wilbur Ross, Commerce Secretary, is open to reviewing the benefits but has not stated he would support the plan.
- Due to the complexity and dramatic change from current tax policy, tax reform is unlikely to be resolved in 2017.
- It would eliminate corporate incentives to shift operations and profits offshore.
- Assumptions of exchange rate and price adjustments to offset the impact are theoretical from academia.

Questions?