THIRD WAY

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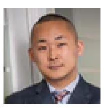
Q&A on Border Adjustability



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Takeaways

- Border adjustability has some attractive features such as significantly reducing incentives to shift profits overseas and engage in other international tax avoidance practices.

- But there is also uncertainty about how much currencies will adjust to offset the new taxing scheme and how long it would take. The unanswered and unanswerable questions could have important impacts on many industries.

Could the stars finally be aligning for an effort to reform business taxes? A recent proposal to modernize the code is getting significant attention from the White House and on the Hill. Will it curb international tax avoidance and boost production in the United States? Or will it punish consumers, aid some industries at the expense of others, and run afoul of international trade law?

The proposal that has caught everyone's attention is the House Republican plan to replace the corporate income tax system with a destination-based cash-flow tax (DBCFT), which taxes domestic consumption instead of worldwide profits. At the center of the DBCFT system are ***border adjustability*** and a rate cut from 35% to 20%. In this primer, we focus in on border adjustability—explaining what is, how it works, and its most important implications.

EXCHANGE RATES: The Foundation for Understanding Border Adjustment

A central question around border adjustability is how much exchange rates will respond. If they fully adjust, border adjustability will not have much of an effect on U.S. imports and exports. If exchange rates do not fully adjust, there would be a new boost to exports and a hindrance to imports.

The rates at which the dollar can be exchanged for pounds, Euros, and other currencies are constantly changing in response to global supply and demand. Demand for currencies tends to reflect demand for goods and assets that are denominated in that currency. [1] Here's how this works:

If foreign demand for an American product were to rise, foreign consumers would need more dollars to buy that product. This increase in demand for dollars would drive up the dollar's value: it would take more pounds or Euros to buy dollars. A more valuable dollar, or "stronger" dollar, would also make American products pricier for foreigners, and Americans would have more buying power when purchasing foreign goods.

There are other factors that influence a currency's exchange rate, such as the actions of central banks to change the currency's supply and the fiscal health of governments. But those who believe that demand (and supply) are primary determinants of exchange rates believe that tax adjustments on imports and exports will trigger demand and a large enough appreciation of the dollar to offset any trade effects.

Whether this is true in practice and how much the dollar will actually appreciate, however, is the great unknown.

What's the current situation?

The top U.S. statutory corporate tax rate, the highest among OECD countries, is 35% on all business profits (which rises to 39.2% when average state corporate taxes are factored in). [2] Under this top rate are myriad tax rules, deductions, and credits that can bring the actual rate a business pays to a lower figure. [3] The U.S. applies these taxes to domestic profits as well as all American company profits that are made overseas when those earnings are brought back (repatriated) to the United States, but our code often incentivizes companies to keep that money overseas. Some foreign income (such as royalty income) is taxed in the U.S. the year it is earned, but for other income, taxation is contingent on repatriation. This often motivates profit shifting and mergers and acquisitions intended to lower tax exposure, and leads to increased jobs and investment overseas.

Looking at the Fortune 500, the world's largest 500 companies are spread across 33 countries, employ 67 million people, and generated $27.6 trillion in revenue and $1.5 trillion in profits in 2015. Simply put: globalization and technology have transformed where companies locate, expand, hire, sell, and buy. But while the global economy is rapidly changing, the U.S. tax code has not. In fact, it's been three decades since the last overhaul, despite calls from both the right and left for a modernization.

Speaker Paul Ryan and House Republicans have outlined a tax reform plan (dubbed the Blueprint) that would overhaul how we tax domestic and international business. Most significantly, instead of taxing American business profits from all over the world, the plan would tax income earned on products consumed within the United States. Put another way, the plan would tax businesses based on *where they sell their goods and services*—instead of *where they book their profits*.

What is border adjustability?

Because the goal of a DBCFT system is to tax only income from domestic consumption, *border adjustments* allow income derived from sales to foreign customers to be exempt from a company's taxable income. However, when U.S. companies purchase foreign goods, those expenses may not be deducted in their tax computation. An analogy for border adjustability exists in the way state-level sales taxes are currently handled in the U.S. If a widget is manufactured in Detroit and sold in Des Moines, the customer pays sales taxes based on the state in which the final purchase takes place, Iowa. No Michigan sales taxes is paid. The same concept is at work in a DBCFT. When a good is produced in the U.S. and sold overseas, the U.S. makes no effort to tax the transaction. Conversely, when a foreign good is sold here, the U.S. gets to tax it. [4]

To see how this works in practice, picture an American widget manufacturer. [5]

The American company makes and sells 1,000 widgets to *American consumers* at $20,000 per unit. This brings in $20 million in gross income (1,000 widgets x $20,000/widget). Let's assume that it costs $15 million to actually make those widgets in the United States. Thus, the company would make a profit of $5 million ($20 million in income - $15 million in costs).

Under current law, this $5 million profit would be subject to a 35% tax. Assuming no tax credits and deductions are applied, the company pays $1.75 million in tax. Under the House Republican plan, this $5 million in net cash flow would instead be subject to a 20% tax since all of these products were sold within the United States. Thus, it would owe $1 million to Uncle Sam.

Now, what if this same widget manufacturer instead sold 1,000 units to *consumers in Brazil* at the same price? At least at first, the company would see the same $20 million in gross income, the same $15 million in costs, and the same $5 million in taxable profits. Under current law, this $5 million profit would be subject to a 35% tax rate if the money was brought back to the United States (less foreign taxes paid). However, under the border adjustment within the House Republican plan, the company would actually have a negative tax liability. Under this system, it would have $0 in taxable revenue and $15 million in deductible costs.

Current Corporate Income Tax (CIT) System

Worldwide income^ — worldwide costs* = Total profits | Total profits x 35% = Taxes due
^ *Overseas income is only included if repatriated to U.S. Otherwise, that income is deferred.*
* *Wages included. Capital expenses like factories and equipment must be amortized over multiple years. Interest expenses are allowed as deductions.*

Proposed Destination-Based Cash Flow Tax (DBCFT) System

Domestic income^ — domestic costs* = Total profits | Total profits x 20% = Taxes due
^ *All income from sales outside the U.S. are excluded.*
* *Wages included. Inputs purchased overseas are excluded. Capital expenses like factories and equipment are written off immediately. Interest expenses are not allowed as deductions.*

By not facing U.S. taxes, the company would be incentivized to drop its price to sell more widgets in Brazil. This is where the trade effects of the DBCFT begin to be muted. As discussed above, this discount will, over some period of time, theoretically increase the demand for U.S. dollars as more Brazilians buy American widgets, which would increase the exchange rate and, to some extent, offset the discount offered to the foreign consumer. However, the actual level of appreciation is unknown.

Consider also what would happen if the company were to manufacture the widgets in Mexico and sell them in the United States. Say the manufacturing expenses in Mexico are $5 million and the other $10 million in expenses remain in the United States. All $20 million in sales would be included in taxable revenue, but under a DBCFT, the Mexico-based costs would be excluded from the company's deductions. Its taxable income would rise from $5 million to $10 million, and its taxes owed would rise to $2 million.

This scenario also has foreign exchange implications. The DBCFT would discourage the company from using Mexico-based inputs, reducing the demand for pesos and increasing the demand for dollars. That drives down the value of the peso relative to the dollar, offsetting the effect of the border adjustment. Whether the dollar appreciation would fully offset the trade effects of a border adjustment is what economists are vigorously debating. Even if full currency appreciation is realized, there are questions as to what the economic impacts will be with countries that peg their currency to the dollar, such as the way China pegs the renminbi to the greenback. Currency appreciation would also have serious implications for long-term international contracts and may have negative implications for American tourism.

What's the impact on the deficit?

Because the U.S. currently imports more than it exports on a consistent basis, the border adjustments are a significant pay-for in the Blueprint. Border adjustability is estimated to yield almost $1.2 trillion in new revenue in the first decade, according to the Tax Policy Center.[6] It's important to note, however, that the 20% rate in the Blueprint is not fully paid for. The rate cut costs about $1.8 trillion. Altogether, the corporate tax changes in the Blueprint would increase the deficit $891 billion over 10 years. And if the U.S. were to ever begin running a trade surplus, which is not out of the question, border adjustability would contribute a net loss to overall revenue.

What's the impact on tax avoidance?

The Blueprint's domestic cash-flow-based system, which inherently includes border adjustability, would significantly reduce the need for a number of often maligned but legal practices that companies currently can use to lower their tax burden, such as inversions and base erosion practices to shift profits overseas. That's because it would no longer matter where a company is headquartered, only where the consumption occurs. Income from overseas transactions would no longer be taxed. Whereas capital and corporate residence are easy to move across borders, the location of your end consumer is far less mobile. However, that doesn't necessarily mean that all tax avoidance would become moot. Companies all over the world that sell to consumers outside the U.S. could face an incentive to shift production to the United States. Plus, some tax experts have already speculated on new tax avoidance strategies that would emerge under a DBCFT. [7]

What's the impact on consumer prices?

It is not clear. At least in the short term, and possibly on a permanent basis, the new levy on imports could raise prices on the subset of consumer goods that rely heavily on overseas supply chains. Shoes, electronics, toys, and clothes are all significant import industries and would be subject to heavier taxation because of border adjustment. Those skeptical of exchange rate adjustments offsetting these heavier taxes (as discussed above) say the new tax will lead to consumers in those industries paying more for those imported goods. That's because retailers would not be able to substitute comparably priced domestic inputs and would mostly pass the costs onto consumers as a result. This would fall disproportionally on two groups: 1.) low-income Americans, because they tend to spend a larger share of their income on goods with imported content; and 2.) retirees, because they would only face higher costs without the offsetting benefit of more manufacturing jobs. However, the more the dollar appreciates, the smaller these consumer price effects would be.

What's the impact on industries?

Numerous net exporting companies have said that border adjustability could be a positive for their businesses. [8] But, as previously mentioned, industries that rely heavily on imports (e.g., distributors and retailers of imported electronics, shoes, and apparel) would face a higher effective tax burden and have serious reservations about the speed and extent of currency changes. Refiners of imported crude oil could also face higher tax costs. In the event that currency appreciation is slow or incomplete, the border adjustments under consideration would raise taxes on the auto and retail industries and cut taxes on chemicals and electronics, according to an analysis by Ernst & Young LLP. [9]

Economists that favor this proposal and believe in full currency adjustment respond by arguing that the rise in the value of the dollar will lower import costs, which would offset the higher taxes (on imports) applied through border adjustment. [10]

Industries on both sides of this debate also note that there are unanswered questions about how this would actually affect complex supply chains.

Are border adjustments legal?

There are a number of questions about whether border adjustment would violate World Trade Organization (WTO) rules.

First, the House Blueprint refers to border adjustment not as a *value-added tax* (VAT) but as a *corporate income tax*. Under WTO rules, member countries may use border adjustments for "indirect taxes" like a VAT but may not use border adjustments on a "direct tax" like an income tax system. Even though the DBCFT functions *like* a VAT, it is an open question whether or not the WTO would overlook the name issue.

What's a VAT? A value-added tax (VAT) is a consumption tax collected at each step in the production process. VATs are collected throughout the supply chain, and the end user owes the total of taxes applied at each step. While most developed countries have a value-added tax, they do not allow labor costs and wages to be deducted, unlike the otherwise VAT-like DBCFT proposed by House Republicans.

Second, and more substantive, is that under the Blueprint, domestic wages would be deductible, whereas they are not under a VAT. It is likely that countries would argue that U.S. companies gain an advantage by being able to deduct the cost of workers' pay when calculating their taxes since foreign importers cannot do so. While the specific issue would be a case of first impression, U.S. trading partners could mount a WTO challenge even before the tax is implemented. Rulings could take years to play out, and legal experts believe heavy trade sanctions against the U.S. would be warranted under existing law. [11] It is worth noting the 2005 President's Advisory Panel on Federal Tax Reform chose not to include any revenue that would be raised through border adjustments because of the possibility of legal challenges.

Despite the wage deductibility problem, the U.S. has a credible argument that the tax would largely resemble a VAT, which is WTO-permissible. The U.S. would argue, accurately, that the corporate reform is economically identical to replacing the corporate tax with a type of VAT and imposing a payroll tax cut on the employee side. Many of our trading partners do impose a VAT while at the same time subsidizing payroll. Second, because the cross-border adjustment addresses the global problem of profit shifting and tax avoidance, other countries may adopt the same system. And if they do, it would become harder for the WTO to say no.

Conclusion

While debate continues over border adjustability, there is widespread agreement among Democrats and Republicans that the corporate code must be modernized. Globalization and technology have transformed the economy, making our 1986 tax code both obsolete and uncompetitive. While the contours of the overhaul will be debated, one thing policymakers should not do is wait. It's time to bring our tax code into the modern era.

TOPICS

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END NOTES

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