



Research

Tax Topics: Border-Adjustments and Importing Firms

GORDON GRAY | JANUARY 25, 2017

The new administration and Congress have signaled their intention to undertake fundamental tax reform in the coming months. Lawmakers will need to weigh the costs and benefits of numerous policy trade-offs as they begin this effort. Among the most visible debates already underway concerns “border adjustability,” or moving the U.S. tax code to a cash-flow tax with a destination-basis.^[1]

This reform, as proposed in the House Republican Tax Reform Blueprint, moves the U.S. toward a consumed-income tax base.^[2] Under this proposal, the current system of depreciation for capital investment would be swapped for full expensing, while the current deductibility of interest expense would be repealed. Levying this tax on a destination basis would remove exports from the tax base, while fully taxing imports.

The latter element has sparked considerable debate among policymakers, industry, and other observers. On its face, the reform appears to favor exports over imports, a misperception that the reform’s proponents and detractors both seemingly feed. However, this ignores the consensus in the economics literature that such a reform would be trade-neutral, owing to currency appreciation.^[3] Leaving this effect out of the debate provides as incomplete a picture as ignoring the tax rate or other key elements of the reform.

This potential reform would chart a significant departure from current U.S. tax policy and should be scrutinized carefully. This policy brief seeks to build on existing analysis of this potential reform and provide additional examples of how this proposal would work in practice, in this instance with respect to an importing firm.^[4]

Table 1: Example Firm under Current Law with \$10 in Imports

| Tax Base | Taxable Revenues | Wages & Salaries | Capital Purchases | Depreciation | Other Purchases | Interest Expense | Total |
|----------|------------------|------------------|-------------------|--------------|-----------------|------------------|-------|
| Current | 80 | 15 | --- | 15 | 30 | 5 | 15 |

In this example, consider a firm that under current law has \$80 in revenues. It has \$65 in deductible expenses – \$15 in wages and salaries, \$15 in depreciation allowances for certain business investments (such as machines or equipment) \$5 in deductible interest (such as loans to finance its machines) and \$30 other deductible business

expenses, \$10 of which are from imports. This leaves a \$15 taxable profit. Now consider the firm's tax base in a move to a destination-based cash-flow tax.

Table 2: Example Firm under Destination-Based Cash-Flow Tax with \$10 in Imports

| Tax Base | Taxable Revenues | Wages & Salaries | Capital Purchases | Depreciation | Other Purchases | Interest Expense | Total |
|----------|------------------|------------------|-------------------|--------------|-----------------|------------------|-------|
| New | 80 | 15 | 20 | --- | 20 | --- | 25 |

Under the new tax system, a few things change. First, the move to a cash flow tax replaced the current system of depreciation and interest deduction in favor of full expensing. For the sake of this example, we assume these are equivalent in dollar terms. More significantly for this example we exclude the \$10 in imports from the firm's deductible expenses. What is left is a tax base of \$25. If there were no applicable tax rate, then despite the difference in the tax bases between the old and new system, the firm would still be left with \$15 in both cases, since it still paid for the \$10 in imports, even if it can't deduct them.

Table 3: After-Tax Profits of Example Firm *without* Currency Effects

| Tax Base | Taxable Sales | Deductible Expenses | Non-Deductible Expenses | Pre-Tax Profit | 20% Tax (Tax Base) | After-Tax Profit |
|----------|---------------|---------------------|-------------------------|----------------|--------------------|------------------|
| Current | 80 | - 65 | - 0 | = 15 | - 3 (15) | = 12 |
| New | 80 | - 55 | - 10 | = 15 | - 5 (25) | = 10 |

In this example, we consider the same firm's profitability under the old and new system with a 20 percent rate applied *without* considering currency effects. In this hypothetical, the importing firm is clearly worse off under the new system, which would seem on its face to be disfavor importers. But the goal of the tax system is not to favor exports or disadvantage imports. The goal of the tax reform is to improve the tax system, and be trade neutral. Consideration of the economics of the proposal and the effect of a proportional currency appreciation reveals this to be the case.

Table 4: After-Tax Profits of Example Firm *with* Currency Effects

| Tax Base | Taxable Sales | Deductible Expenses | Non-Deductible Expenses | Pre-Tax Profit | 20% Tax (Tax Base) | After-Tax Profit |
|----------|---------------|---------------------|-------------------------|----------------|--------------------|------------------|
| Current | 80 | - 65 | - 0 | = 15 | - 3 (15) | = 12 |
| New | 80 | - 55 | - 8 | = 17 | - 5 (25) | = 12 |

A 20 percent tax rate should lead to a 25 percent dollar appreciation, which makes foreign goods cheaper. This diminishes the cost of the example firm’s foreign inputs to \$8, leaving the exporting firm’s profitability the same under both the current tax system and the new system. Thus, the firm remits higher tax payments, but it’s fundamental profitability is the same.[5]

[1] <https://www.americanactionforum.org/insight/tax-topics-destination-vs-origin-basis/>

[2] https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf

[3] See Alan J. Auerbach, “The Future of Fundamental Tax Reform” American Economic Review 87, 2 (1997): 143–46 and artin Feldstein and Paul Krugman, “International Trade Effects of ValueAdded Taxation,” in A. Razin and J. Slemrod, eds., Taxation in the Global Economy (Chicago, IL: University of Chicago Press, 1990), 263–82. Also see <https://www.aei.org/publication/border-tax-adjustments-wont-stimulate-exports/> for a further review of the literature.

[4] <https://www.americanactionforum.org/research/14344/>

[5] Note that this example by design ignores the effects of moving from the current high rate to a lower rate and the positive economic effects of expensing for the purpose of isolating the implications of moving to a destination-based tax system.