



The Daily Dish

Border Adjustment and Tax Base Integrity

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On Thursday President Trump said that he will be making a tax-related announcement in the coming weeks. The president's comments came during a meeting with airline executives at the White House where he told the executives that he wants to lower the overall tax burden on American businesses. In the past President Trump stated that he would like to see the corporate tax rate lowered to 15 percent.

Last week Federal Reserve Bank of Chicago President Charles Evans stated that he believes the Federal Reserve could raise interest rates three times this year. Evans said the U.S.'s fiscal policies, thus far, seem to point toward positive gains for the U.S. economy. He went on to state that he foresees the U.S. economy growing at a rate of 2 – 2.5 percent annually “for the next couple of years” before slowing down to 1.75 percent.

Eakinomics: Border Adjustment and Tax Base Integrity

The border adjustment provision of the House “A Better Way” tax reform Blueprint has generated tremendous discussion, yet is still widely misunderstood. It is a piece of tax policy and not trade policy. Indeed, it should not alter net imports on bit. It is not intended to force production into the United States. Instead, it is neutral with respect to the location of production; granted a change from the current system that favors foreign production over domestic production.

But the most important role of border adjustment in the Blueprint is to protect the integrity of the tax base against profit shifting and (legal) tax avoidance. The House proposal would be implemented at tax-filing time by ignoring any cross-border transactions when computing the tax base. So, if a company had revenue from sales into Iceland, the revenues would be ignored in calculating total revenue and, thus, exports would be untaxed. If the firm had costs from imports of intermediates from Argentina, those costs would be ignored, not deducted, and thus subject to tax.

Simple enough. But notice that if the firm is discarding cross-border transactions, then the value of those transactions cannot affect the firm's tax liability. This is really important. The Blueprint is a territorial tax system in which firms are only taxed on their earnings in the United States. (In contrast, the current tax law is a worldwide system — a relic of the 20th century long-since discarded by our competitors and responsible for the spate of “inversions” by U.S. companies.) If it is possible to shift profits to an overseas low-tax jurisdiction, they could then be repatriated — tax-free — to the U.S. It is a huge opportunity for tax avoidance. Under border adjustment, this possibility is eliminated.

Consider an example. DHE Enterprises sells economics lectures and earns \$1 million (allow me my fantasies) in the U.S. It has travel and other costs that total \$500 thousand, also in the U.S. Due to the popularity, it has established an Irish subsidiary Fiontair DHE, that produces t-shirts featuring monthly live-action shots of economics lectures. DHE Enterprises sells Fiontair DHE photos of recent appearances and buys back the finished t-shirts for sale in the United States. The photos are part of the costs of DHE Enterprises and are sold to

the subsidiary for \$100 each (for a total of \$1,200 a year). In turn the finished t-shirts cost \$10, which DHE Enterprises sells for \$15. Due to the rising popularity of economics, sales are currently 1,000 each month.

Taken at face value, the cash flow of DHE Enterprises is \$500,000 from lectures (\$1 million in revenues minus \$500,000 in costs) plus \$1,200 in sales of photos to Fiontair DHE and \$180,000 in t-shirt sales revenue. From the latter must be deducted \$120,000 in costs of t-shirts purchased from Fiontair DHE. The upshot is \$500,000 net cash flow from lectures and \$61,200 from the t-shirt business for a total of \$561, 200. Notice that Fiontair DHE has profits in Ireland of \$118,800.

The incentives in a territorial system, however, are for DHE Enterprises to understate the the value of its sales to its subsidiary. In this case, to seek the photos for \$1 each and reduce the annual revenue to \$12. Similarly, it should pay Fiontair DHE \$15 per t-shirt, thereby eliminating its profit from the t-shirt business. This would put it U.S. net earnings at \$500,012. Fiontair DHE would have profits in Ireland of \$179,988. The abuse of the prices at which photos and t-shirts are transferred shifts over \$60,000 in profits to the low-taxed subsidiary, which can then (after Irish tax) be brought back to the U.S. tax-free. There is an open invitation to degrade the tax base in the U.S.

Border adjustment stops this. DHE Enterprises has a tax base of lecture revenues (\$1 million) plus t-shirt revenues (\$180,000) minus domestic costs (\$500,000), or \$680,000. It does not matter if it raises the price at which it buys the t-shirts from Fiontair DHE — import costs are discarded in calculating deductions — or lowers the price at which it sells photos — export revenues are not included in the tax base. The only thing DHE Enterprises can do by playing its previous games is raise its Irish taxes, and thus its overall worldwide taxes. This is a profound disincentive for tax avoidance.

Border adjustment is not the centerpiece of the House Blueprint; the focus should be on the lower rate, investment incentives and reduced distortion of corporate finance decisions. It is, however, the key to preventing abuse of the U.S. tax base.