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House GOP Tax Reform Blueprint: The Border Adjustment Tax Explained

House Ways and Means Committee Chairman Kevin Brady (R-TX) recently appeared on C-SPAN "Newsmakers" to talk about tax reform. Specifically, Brady discussed the tax-writing committee's two-day meeting on the House GOP tax reform blueprint ("blueprint").

"The blueprint is in very good shape," Brady said "All of those key elements are in place, and if we pass this as designed, we've not only eliminated every tax incentive to move American jobs and companies overseas, we've established America as the place to be for the 21st century for that new job, that new manufacturing plant and that new research facility." According to Brady, committee members settled on "multiple decision points and approaches," – of note is the border adjustment tax proposal.

Despite concerns raised by various industry stakeholders, Brady confirmed that the border adjustment tax will be a significant part of tax reform: "This is the key part of our tax code. It is going to stay."

What is the Border Adjustment Tax?

A border adjustment tax is a rebate on exports and a tax on imports, and the blueprint details are scant as to the implementation of the export rebate and import tax. However, based on discussion with staff from the Ways and Means Committee, we believe the adjustment tax would work as follows:

The blueprint describes the rebate on exports as a tax exemption for sales to foreign customers.

Example 1 (Rebate on Exports): Company X purchases domestic goods for $60 that are used in manufacturing widgets. Company X further invests $10 more in the U.S. to finish and sell the widget. The widget is sold for $100 to a widget store in Spain. Under the GOP tax blueprint, Company X would continue to deduct the $70 cost of domestic goods and services (as business expenses), include only $70 into income, and accordingly, the company would have no additional taxable liability as a result of the sale of widgets (an export).

On the flip side, for imports, the cost of goods purchased from a non-resident would not be deductible against U.S. corporate income tax.

***Example 2 (Tax on Imports)*:** Company Y purchases foreign goods for $60 that are used in manufacturing widgets. Company Y further invests $10 more in the U.S. to finish and sell the widget. The widget is sold for $100 to a widget store in the U.S. Under the GOP tax blueprint, Company Y could not deduct the cost of the foreign goods. Without the deduction for this foreign business expense, Company Y's taxable income would be $90 ($100 receipt less $10 domestic business expenses). Without the border adjustment, Company Y's taxable income would have been $30 ($100 receipt less foreign and domestic business expenses of $70).

When businesses are unable to deduct the cost of imported goods, it results in a higher taxable base, which is effectively a tax on the foreign goods.

***Example 3 (Both)*:** Company Z purchases foreign goods for $60 that are used in manufacturing widgets. Company Z further invests $10 more in the U.S. to finish and sell the widget. The widget is sold for $100 to a widget store in Spain. Under the GOP tax blueprint, Company Z cannot deduct the cost of the foreign goods ($60), but would continue to deduct the $10 cost of its domestic inputs. Since Company Z is selling the widget abroad, it would have no income and accordingly, the company would have no additional tax liability given that this is the sale of an export.

Domestic and International Concerns Raised

Many industries have voiced their concerns with the border adjustment tax – namely, the tax treatment of imports. Domestic retailers such as auto dealers and apparel makers have pointed to the negative impact of the tax, arguing that it would result in higher prices for consumers.

Some economists have argued that the tax on imports would be offset by the increase in the strength of the dollar value, resulting in the same after-tax effect. According to Douglas Holtz-Eakin, this would lead to no change in U.S. trade balance.

Broader concerns have also been raised that the U.S.-proposed border adjustment tax would violate World Trade Organization (WTO) rules. Under WTO rules, border adjustment taxes are limited to indirect taxes like the sales tax and the payroll tax. Whether these concerns will impede tax reform efforts remains an open question.

A link to Brady's full C-SPAN interview is available here.

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