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2017 Tax Reform & Border Adjustability: What We Know Now

In June 2016, House Ways & Means Chairman Kevin Brady (R-TX) released a Tax Reform Blueprint that will serve as a framework for writing major tax reform legislation in 2017. Speaker Paul Ryan (R-WI) included the plan in "A Better Way," which establishes the Republican vision for policies on health care, tax, national security, and other issues. While the Blueprint would lower the corporate tax rate to 20 percent, it proposes a new "**border adjustability**" provision that could significantly raise costs for importers and consumers.

What is Border Adjustability?

This Blueprint calls for taxing corporate and non-corporate businesses on a destination basis, exempting exports from tax and subjecting imports to tax. This applies to goods, services, and intangibles. It is designed to counter the "border adjustability" feature of value-added tax (VAT) systems that many U.S. trading partners utilize. With a border-adjusted VAT, these countries impose the VAT on a product when it is imported and provide a rebate when a product is exported. The Blueprint argues, since the U.S. does not have a similar tax system, U.S. exporters face a global disadvantage.

How Would This Work in Practice?

The Blueprint outlines tax reform principles and does not offer details on how this concept would work, but the President's Advisory Panel on Federal Tax Reform made a similar recommendation on border adjustability to the Bush administration in 2005 that could serve as a guide. To shift to a destination-based tax system, the 2005 proposal recommended providing U.S. exporters with a tax rebate based on the cost of producing the export while ***eliminating a company's ability to deduct the costs of imports as a business expense***.

Even though businesses would be taxed at a lower corporate rate (20 percent under Chairman Brady's Blueprint), making imports non-deductible would effectively increase taxes on imports. For example, consider the company that imports a $25 shoe and sells it to a retail partner for $50. Today, the company might include the cost of importing the $25 shoe in its cost of goods sold, deducted from its net income, and therefore pay 35% tax on the $25 profit. Under the border adjustment proposal, the import would no longer qualify as a deductible expense and its cost would be added to the company's taxable income – taxing the entire $50 at 20%.

This is a significant change for import-dependent industries including footwear, apparel, tech, retail, and energy. The 2005 report from the President's Advisory Panel acknowledged, "until exchange rates or domestic prices adjust after the imposition of the tax on imports, businesses that import significant amounts of goods could operate at a loss after taxes, because they would receive no deduction from income for the costs of their imports. They could thus be paying taxes greater than their net pretax cash income." The Panel therefore recommended a phase-in for border adjustability.

World Trade Organization (WTO) rules do not allow border adjustments for income-based tax systems. The Blueprint asserts that because the plan will move the U.S. from an income-based tax system toward a consumption-based tax system, border adjustment would be consistent with WTO rules.

What are the Chances Border Adjustability Passes?

Both President-elect Trump and Congress have identified pro-business tax reform as a top priority for 2017. For the first time since 2010, one party controls both chambers of Congress and the White House, significantly increasing the opportunity to enact major reforms. In addition, the border adjustability proposal originated from the chair of the tax-writing committee in the House and was adopted by the Speaker of the House as part of the Republican vision on tax reform. While this concept is controversial – pitting exporters against importers – it aligns with the campaign rhetoric on domestic manufacturing and does not increase tariffs. The Blueprint states that border adjustability will eliminate incentives for companies to move or locate operations outside of the U.S. This proposal may be modified or removed from a final tax reform bill, but the current political environment increases the prospect of passage and makes congressional advocacy critical.