

BORDER ADJUSTMENT TAX

Implications for Multinational Corporations

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Border Adjustment Tax

By definition, a border adjustment tax (or BAT) is a short name for a destination-based cash flow tax. According to CNN Money, the border adjustment tax proposed by the current administration “would give tax breaks to American companies that ship products to other countries, and it would strip away tax breaks from American companies that import goods from other countries” (Gillespie). A border adjustment tax is supposed to encourage companies to make goods in the United States and to remove the incentive for companies to move jobs overseas for tax reasons. Initially, a border adjustment tax makes it cheaper to export goods and more expensive to import products from abroad. The border adjustment tax being considered by the new administration aims to discourage the shifting of profits and activities offshore and eliminate incentives for corporate inversions.

To understand the implications of a border adjustment tax, we must first figure out why this policy is under consideration: to reduce corporate incentives of a tax inversion. With the U.S. having one of the world’s highest corporate tax rates, many multinational corporations are finding a corporate tax inversion a significant benefit in allowing them to save tax dollars and remain competitive in our growing global economy.

Border Adjustment Tax History

Although the concept of a border adjustment tax may seem to be something invented by our new administration, it is a concept that has been around for nearly twenty years. Alan J. Auerbach developed the idea of a border adjustment tax in two papers from 1997 and 2010. Auerbach described a “corporate tax system” in which the “incentives” would be aligned with the “national interest.” In his 2010 paper, “The U.S. corporate tax system debuted more than 100 years ago and had evolved little to meet the challenges of today’s economy. The

country would benefit greatly from a reform of this system that maintains corporate tax revenues while increasing incentives for businesses to locate, invest, and produce in the United States, thus offering the prospect of higher wages and better job opportunities for American workers” (Auerbach). In the 1960s, corporate income tax accounted for more than 20% of all federal revenues; however, after tax cuts in 1981, the corporate tax has provided less than 12% of federal revenues.

Auerbach proposed two critical steps to corporate tax reform involving “a shift in the corporate tax from equity to debt, to deal with the tax incentive to borrow, and a change in the treatment of cross-border flows, to alter the terms of international tax competition fundamentally” (Auerbach). The first would convert the corporate income tax into a cash-flow tax. The second would apply the cash-flow tax on a destination basis, limiting the focus of the tax to transactions occurring exclusively in the United States.

The Case for a Border-Adjusted Tax

As discussed in *The Choice* by Russell Roberts, there are many benefits to free trade and producing goods in foreign countries. In a world of free trade, American producers are forced to keep up and surpass foreign ingenuity. In a world of restricted trade and protectionism, there is no need for originality as producers spend their time lobbying the government for ever-wider restrictions. The ability of a company to move production overseas allows them to keep their production costs low. For example, a study by the Marketplace found that an iPhone produced domestically may retail for as much as \$2,000 compared to the present retail price of around \$700 (Smith). Most of this price difference comes from producing the components in the United States. Marketplace estimates that the iPhone components currently cost about \$190 per phone, but would cost up to \$600 per phone if produced in the United States. Although one industry

may lose their jobs when outsourcing production to another country, other sectors benefit as a result. Nonetheless, today's political discussions about corporate tax reform in the United States have led to many sources providing a case for a border-adjusted tax aimed at reducing the shift of profits and activities offshore, ultimately affecting all businesses that operate internationally.

“The Case for a Border-Adjusted Tax” by Alan Auerbach and Michael Devereux explains the significance of a border-adjusted tax. “The reform should appeal broadly...But there remains much-misplaced criticism of the reform and its potential, and much misunderstanding about who the winners and losers will be if it is adopted” (Auerbach and Devereux). Free-market critics of the tax argue that the suggested border adjustments would act as a tariff and affect world trade. Importers claim that the border adjustment tax would redistribute income away from sectors focused on imports. Parties on the political left express concern that the tax isn't progressive enough. Finally, other critics argue that the new system would be too complicated. Ultimately, Auerbach and Devereux argue that “In the end, the short-run economic adjustments required would be a small price to pay for an enduring, fair and rational tax system” (Auerbach and Devereux). To fully understand their viewpoint, one must first understand what a corporate tax inversion is and how corporations may benefit from a tax inversion.

Corporate Tax Inversion

Tax inversion, or corporate inversion, is the practice of relocating a corporation's legal headquarters to a lower-tax nation while retaining its operations in its higher-tax country of origin. Tax inversion, however, has led American companies to move profit-driving activities to foreign countries as multinational corporations try to avoid America's high corporate tax rate – the third highest general top corporate income tax rate in the world ([see Figure 1](#)). The U.S.

Treasury is starting to feel the effects of these inversions through decreased tax revenues, but corporations find the inversion necessary to save money in taxes and maintain competitiveness in the global market. However, many politicians insist that corporations are taking advantage of business resources in the U.S. without paying their fair share of taxes.

Typical company mergers involve one company acquiring the net assets of another company in a mutual decision between the two resulting in a larger first company. A corporate tax inversion, however, is considered a “reverse” merger. In the reverse merger, a U.S. company merges with a foreign one, dissolves its United States corporate status, and reincorporates in the foreign country. The U.S. company becomes a subsidiary of the foreign one, but the original U.S. firm still controls the foreign firm. The goal of a corporate tax inversion is for U.S. companies to have a new foreign parent while still maintaining its control.

Benefits

One of the main advantages of a corporate tax inversion is U.S. tax savings. The U.S. tax rate for corporations is one of the highest in the world at 35%. The United States is also one of the few countries that tax corporations on worldwide earnings with credit for foreign taxes paid. When a corporation goes through a tax inversion, it no longer has to pay tax on global income. After a corporate tax inversion, they only pay U.S. tax on income earned in the country. A corporate tax inversion may have more benefits than just avoiding paying U.S. tax on income earned globally. Corporations also save millions and even billions of tax dollars by reincorporating into another country with a lower corporate tax rate such as Ireland with a tax rate of 12.5% or the Bahamas and the Cayman Islands with a 0% income tax rate. Saving tax dollars allows companies to remain competitive in our global market.

Another benefit of a corporate tax inversion is that it allows a multinational corporation to bring its profits back to the U.S. while avoiding U.S. taxes. When a multinational company earns profits abroad, the company leaves the money in the foreign country to avoid paying U.S. taxes on it if they brought it back. After a corporate tax inversion, however, there is a significant benefit for corporations to bring “trapped cash” back to the United States. After an inversion, a “hopscotch loan” can be used to carry the trapped cash back to the foreign parent by issuing a loan to the U.S. subsidiary. The parent entity pays a small amount of taxes, but it is much lower than U.S. corporate taxes. Since this is a loan, there is no income to the U.S. since the loan is not income. However, the U.S. subsidiary will most likely never pay the loan back and just pay the interest expense.

Inversion Considerations

As demonstrated, there are many benefits of a corporate tax inversion, but there are many ethical considerations that may play a part in the decision for a multinational corporation to go through a corporate tax inversion. Some of these factors include public opinions regarding inversion, possible loss of customer loyalty, and potential effects of new laws.

Public opinion seems to show that most politicians and people in the United States do not agree with corporations going through inversion to avoid taxes because they are taking advantage of these resources to avoid paying their fair share of U.S. taxes. Tax inversions lead to a loss of income tax revenues that could be used for infrastructure support and other investments in the U.S. economy. Secondly, it is possible that some customers may develop a negative opinion toward the corporation because of their decision to partake in a tax inversion. Loss of customer loyalty could lead to decreased revenues for the company in the U.S. Lastly, and most importantly, a multinational corporation must consider how changing laws could affect

the corporation after a tax inversion. New legislation could undo the work of the inversion, make it more costly, and worst of all waste the firm's valuable time and resources.

Political Implications

After exploring the benefits and reasons for a multinational corporation to undergo a corporate tax inversion, it is easy to see how this would encourage companies to relocate their headquarters to a foreign country. With our new administration, the suggested border adjustment tax aims to encourage businesses to make goods in the United States and to remove the incentive for companies to transfer activities overseas for tax reasons.

Despite the benefits, the proposed border adjustment tax essentially implements a tariff on imported goods and could trigger retaliation in the form of increased tariffs on American imports in other countries or through a World Trade Organization dispute settlement. To see potential side effects of such a tax, we can look to America's most infamous trade law: the Smoot-Hawley Tariff Act of 1930. This act raised U.S. duties on approximately 900 imported goods to record levels and is often associated with, and even blamed for, the onset of the Great Depression, the collapse of world trade, and the global spread of protectionism in the 1930s.

Signed into law on June 17, 1930, the Smoot-Hawley Tariff raised the average rate on dutiable goods from 40 – 48% while it reduced the volume of dutiable imports by 17 – 20% (*"The battle of Smoot-Hawley"*). The volume of American imports dropped by 15% in the year before the act was passed and fell by another 40% in the two years following its passing (*"The battle of Smoot-Hawley"*). American GDP fell, and deflation amplified the effects of existing tariffs and the Smoot-Hawley increases. As deflation continued, effective tariff rates climbed and further discouraged imports. By 1932, the average American tariff on dutiable imports was 59.1% (*"The battle of Smoot-Hawley"*).

Not only did the Smoot-Hawley Tariff Act raise tariffs to record levels, but it harmed trade relations with other countries. By September 1929, twenty-three trading partners protested at the prospect of higher tariffs (*“The battle of Smoot-Hawley”*). America’s biggest trading partner, Canada, imposed extra duties on some American goods and cut tariffs on imports from the rest of the British empire. U.S. iron and steel exports decreased by 85.5% by 1932 due to Canada’s retaliation (Phalan). European retaliation raised tariffs so high that U.S. exports to Europe declined by 82% (Phalan). Smoot-Hawley caused a dramatic loss of export markets and declining farm income leading to agricultural bank failures. Due to the uncertainty of trade conditions, each of the ten largest world economies had their secondary financial markets crash. International financial chaos ensued leading to foreign debt repayment suspensions; as a result of thousands of bank failures, the U.S. money supply dropped by 29 percent (Phalan).

Implementing a border adjustment tax as proposed by our current administration could lead to similar side effects as caused by the Smoot-Hawley Tariff Act of 1930. According to estimates from Chad Bown of the Peterson Institute for International Economics, the proposed border adjustment tax could draw \$385 billion in retaliatory tariffs from our trading partners based on a historical application of WTO tariff formulas (Bown).

Macroeconomic Implications

According to the paper “Quantifying the Economic Impacts of a U.S. Border Adjustment Tax” by Dan Ciuriak and Jingliang Xiao, the border adjustment tax would have many effects that would flow through globalized networks:

“As these effects materialize and the U.S. dollar appreciates, the BAT would be anything but neutral as the ripple effects flow through globalized production networks:

- Countries with differing exposure to U.S. trade would be impacted differentially: Terms of trade would change, and there would be pervasive impacts on economic welfare across countries.
- At the firm level, different firms would have different capabilities of switching input-sourcing, meaning that there would be non-neutral impacts across firms.
- At the product level, conditions of competition in the United States would shift pervasively, with significant variation across products.
- Finally, there would also be differences across products regarding the ability of firms to pass through higher costs to consumers. The BAT would not be neutral in that aspect, either” (Ciuriak & Xiao).

Imposing a border adjustment tax would have consequences not only on macroeconomic factors in the United States but globally. The real GDP and welfare would decline due to loss of competitiveness and higher consumer prices. A BAT is projected to have significant adverse welfare impacts on our major trade partners – the European Union and China – and disproportionately substantial negative impacts on our closest trading partners (Canada and Mexico). Many U.S. firms import goods from Canada. The import component of a BAT would lead U.S. firms to source away from imports towards domestic products and would cause Canada’s real GDP and prices to fall.

Border Adjustment Tax vs. Value Added Tax

Many economically advanced countries utilize a value-added tax (VAT) to an efficient, non-trade-distorting consumption tax. With a VAT tax, the same tax applies to imports as to domestic purchases, so all goods sold within the same country are subject to equal taxation. At

the same time, all VAT paid on inputs to produce products which are in turn exported are refunded to provide a level playing field for exports. Under our new administration, there seems to be a lot of confusion between the difference between value added tax and border adjustment tax.

According to several sources, a border adjustment tax has the potential to cause significant shocks to established value chains involving U.S. firms. The current proposed tax reform requires the repeal of the U.S. corporate income tax to be replaced by the destination-based cash-flow tax. This tax would tax imports and exempt exports, similar to a VAT.

Many of the concerns surrounding this current tax proposal focus on the impact of the border adjustment tax on the balance of trade and value of the U.S. dollar. The initial effects of an import-reducing (because of higher tax rates on imported goods) and export-expanding (because of tax exemptions on goods sold internationally) would increase the value of the U.S. dollar in currency markets. A stronger U.S. dollar has the consequence of making exported goods relatively more expensive to other countries which may decrease U.S. trade competitiveness. Because of these opposite effects, a border adjustment tax seems to have a neutral impact on net exports in the long run; however, differences in magnitudes of these shifts makes it uncertain what impact raising the costs of imports and subsidizing exports would have on the economy. This type of tax essentially places a tariff on imports and would affect a corporation's decisions when deciding whether to import input materials or source them domestically. A company that is currently importing inputs from abroad would be able to reduce their taxable income by switching to locally sourced goods. The same concept would be true regarding companies that have the choice to export a good or sell it domestically. The company

would face a tax liability on revenues from the domestic sale but not on the export sale and would thus choose to make the export sale.

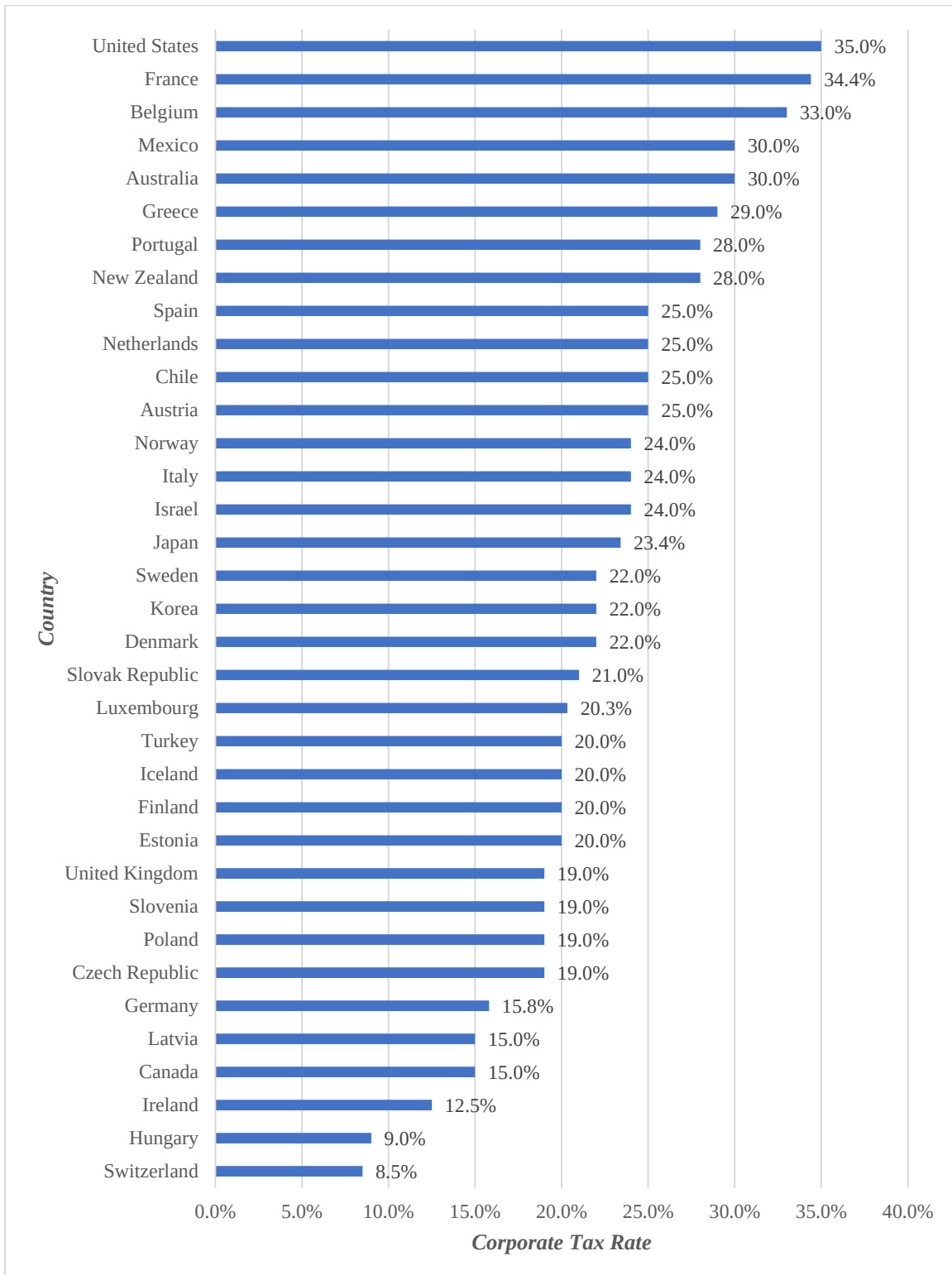
Conclusion

As demonstrated, there are currently many benefits for U.S. companies to partake in a corporate tax inversion to avoid U.S. corporate income taxes. The benefits of free trade and globalization are numerous and allow for countries to produce the goods and services which they have an advantage in creating, leading to lower consumer prices, fair competition, and increased creativity and ingenuity.

A loss of American jobs and corporate tax income to foreign countries has been something that has led to corporate tax reform proposals for many years. Our new administration has proposed a border adjustment tax to encourage U.S. firms to source goods locally to bring jobs back to America. Whether or not this tax will be helpful to the U.S. economy is hard to say, but I feel that it is crucial to examine all possibilities of the implication of this tax as many possible consequences could have a detrimental effect not only on the U.S. economy but a global scale.

Appendix

Figure 1. Corporate Tax Rates Across the World. *Source: OECD.Stat*



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