POLICY & LEGAL ISSUES RAISED BY THE PROPOSED U.S. BORDER ADJUSTABLE TAX

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ABSTRACT

This article considers the policy and legal issues raised by the Border Adjustable Tax (hereinafter "BAT"), part of the tax reforms proposed by the Republican Tax Reform Task Force. After explaining the BAT and the functions it is intended to serve, it examines the compatibility of the BAT with World Trade Organization (hereinafter "WTO") obligations, concluding that it is likely to violate a number of WTO Agreements. It suggests modifications to the measure to assist with WTO compatibility while still addressing concerns about boosting United States (hereinafter "U.S.") tax revenue.

KEYWORDS: *World Trade Organization (WTO) law, Republican Tax Reform Task Force, Border Adjustable Tax (BAT), Destination Based Cash Flow Tax (DBCFT), General Agreement on Tariffs and Trade (GATT), General Agreement on Trade in Services (GATS), Agreement on Subsidies and Countervailing Measures (SCM Agreement)*

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I. INTRODUCTION

President Donald Trump has, on numerous occasions,[1] talked of using additional taxes levied to fund the "Wall"—the border wall between Mexico and the U.S. Of course, a 20% tax on Mexican imports into the U.S. would be considered outright discrimination and a violation of both international trade and tax treaties, which is unfeasible in light of the political backlash the U.S. is likely to suffer. Instead, a Republican Tax Reform Task Force (hereinafter "the Task Force") announced by Paul Ryan, Speaker of the House of Representatives, and led by Congressman Kevin Brady, Chairman of the House of Representatives Ways and Means Committee, has come up with a comprehensive tax reform plan (hereinafter "Blueprint").[2] Amongst other tax reforms contained within the Blueprint of laws to be spearheaded under the Republican conservative agenda, "border adjustability" is a key feature which the Task Force claims will level the playing field between American-made and imported products,[3] and which the White House has said could be used to finance the Wall.[4]

In Part II, this article seeks to explain the proposed BAT measure within the proposed Destination Based Cash Flow Tax (hereinafter "DBCFT") and how it purportedly fulfils the functions claimed by the Task Force.[5] Part III then goes on to consider that the reforms are likely to be illegal *vis-à-vis* the U.S.' obligations as a Member of the WTO, in particular such a tax would definitely not be allowed under the General Agreement on Trade and Tariffs 1994 (hereinafter "GATT"), the General Agreement on Trade in Services (hereinafter "GATS"), and might not be allowed under the Agreement on Subsidies and Countermeasures

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[1] *Donald Trump's Mexico Wall: Who Is Going to Pay For It?*, BBC NEWS (Feb. 6, 2017), http://www.bbc.com/news/world-us-canada-37243269; Jeremy Diamond, *Trump Floats 20% Tax on Mexican Imports to Pay for Wall, but Considering Other Options*, CNN POL. (Jan. 27, 2017, 4:02 PM), http://edition.cnn.com/2017/01/26/politics/donald-trump-mexico-import-tax-border-wall/.

[2] *A Better Way: Our Vision for a Confident America*, A BETTER WAY (2016), http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf [hereinafter *A Better Way*].

[3] *Id.* at 28.

[4] Adriana Barrera, *Mexico Economy Minister Says Doubts US Border Tax Will Materialize*, REUTERS (Feb. 15, 2017, 5:53 AM), http://uk.reuters.com/article/uk-usa-trump-mexico-tax-idUKKBN15T2WV?il=0.

[5] The Blueprint does not refer to these measures as a "Border Adjustable Tax" or a "Destination Based Cash Flow Tax". However, the Blueprint does refer to "border adjustments" (*A Better Way*, *supra* note 2, at 27-28). It has been noted that "border adjustments" are in fact taxes or tax exemptions (Alan J. Auerbach & Douglas Holtz-Eakin, *The Role of Border Adjustments in International Taxation*, AM. ACTION F. (Nov. 30, 2016), https://www.americanactionforum.org/research/14344/). Additionally, it has been said that the Blueprint contains a "destination-based cash flow tax" (Kyle Pomerleau & Stephen J. Entin, *The House GOP's Destination-Based Cash Flow Tax, Explained*, TAX FOUNDATION, (June 30, 2016) https://taxfoundation.org/house-gop-s-destination-based-cash-flow-tax-explained/. *See also* Reuven S. Avi-Yonah & Kimberley Clausing, *Problems with Destination-Based Corporate Taxes and the Ryan Blueprint* 17-19 (U. Mich. L. & Econ., Research Paper No. 16-029, 2017)).

(hereinafter "SCM"). Part IV offers suggestions for how the DBCFT and BAT proposals could be modified to conform to WTO requirements, as well as alternative tax reforms aside from DBCFT and BAT that would not trigger WTO violations but also help boost U.S. tax revenue. Part V then briefly elaborates on actions, such as multilateral and unilateral remedies, that U.S. trading partners could take if the U.S. implemented the current proposal. Part VI concludes.

II. DESTINATION BASED CASH FLOW TAX AND BORDER ADJUSTABLE TAX

The Blueprint contains several major changes to the way corporate taxes are to be calculated in the U.S.: (i) replacing the worldwide taxation approach of the U.S. with a territorial one;[6] (ii) reducing the corporate taxation rate to 20% (from the existing 35%) and removing the second-tier corporate minimum alternative tax altogether;[7] (iii) allowing capital investments to be fully written off or expensed in the year in which they are purchased;[8] (iv) prohibiting interest expense deductions as a business expense (except where deducted against corresponding interest income);[9] (v) directing the tax jurisdiction to follow the location of consumption rather than the location of production—meaning that the tax base is only made up of corporate income earned through domestic sales, and tax need not be paid on profits earned overseas;[10] (vi) "border adjusting" the corporate tax, exempting exports and taxing imports within the context of the transformed business tax system;[11] (vii) halving the tax rate on dividends and capital gains earned by individual shareholders;[12] (viii) reducing the corporate tax rates of sole proprietorships and pass-through entities;[13] (ix) allowing indefinite carry-forward and indexation of net operating losses;[14] and (x) repealing "special-interest deductions and credits". Changes (iii), (iv), and (v) turn the taxation regime into a DBCFT,[15] coupled with change (vi), the BAT. This section focuses on the workings of the BAT and the remedies it allegedly provides to the U.S.

[6] *A Better Way*, *supra* note 2, at 15.
[7] *Id.* at 24-25.
[8] *Id.* at 25-26.
[9] *Id.* at 26.
[10] *Id.* at 27.
[11] *Id.*
[12] The Blueprint claims this will reduce the "effective double taxation of corporate income". *Id.* at 25.
[13] *Id.* at 23.
[14] *Id.* at 26.
[15] *Id.* at 15.

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Border adjustments are taxes or tax exemptions that apply when payments for goods and services cross international borders.[16] In adopting a DBCFT, all domestically produced goods would carry an inherent tax (the 20% tax on corporate earnings generated from domestic revenue) in addition to the sales taxes imposed in most states. The BAT would levy a tax on goods imported into the US to be consumed domestically, causing both imported and domestically produced goods to internalize the same 20% tax. Similarly, the BAT rebates the 20% corporate tax on domestically produced goods that are exported. This relieves those exports of the comparative disadvantage of having to internalize any direct income tax levied in the US, leaving them taxed only via any value-added tax (hereinafter "VAT") that may be levied by a foreign state on all goods and services consumed in that foreign state. Thus it is opined, "[u]nlike tariffs on imports or subsidies for exports, border adjustments are not trade policy . . . they are paired and equal adjustments that create a level tax playing field for domestic and overseas competition."[17] Although prices of exports take a one-off cut and imports face an initial price hike, proponents of the policy expect exchange rate fluctuations to offset the adjustments, restoring equilibrium to trade.[18] Thus the BAT should not have an effect on the demand of imports (or domestic goods) and will neither encourage nor discourage trade.

The U.S. does not impose a VAT on a federal, nation-wide level. The Blueprint claims that this absence of a destination-based tax self-imposes a "unilateral penalty on U.S. exports and a self-imposed unilateral subsidy for U.S. imports."[19] The introduction of a DBCFT with BAT is intended to reduce the tax incentives for companies to engage in profit-shifting to low-tax jurisdictions. [20] Although not universally accepted to be disadvantageous,[21] implementing a DBCFT with BAT is said to "redress the seeming unfairness inherent in WTO rules that allow value-added taxes".[22]

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[16] Auerbach & Holtz-Eakin, *supra* note 5, at 2.
[17] *Id.* at 1.
[18] *See, e.g.*, GARY CLYDE HUFBAUER & ZHIYAO (LUCY) LU, PB 17-3 BORDER TAX ADJUSTMENTS: ASSESSING RISKS AND REWARDS 1 (2017), https://piie.com/syste m/files/documents/pb17-3.pdf.
[19] *A Better Way*, *supra* note 2, at 28.
[20] *Id.* at 29.
[21] *See, e.g.*, Luis de la Calle**,** *A Border Adjustment Tax Threatens Disruption for U.S. and Its Neighbors*, FORBES (Jan. 18, 2017, 4:19 PM), https://www.forbes.com/sites/themexicoinstitute/2017/01/18/the-view-from-mexico-border-adjustment-tax-economic-impact-wto-consistency ("Contrary to what is often said, not having a VAT does not put the United States at a disadvantage: its exports do not carry a latent tax to be reimbursed, while VAT paid at the border is fully recovered by US exporters at first sale.").
[22] Hufbauer & Lu, *supra* note 18, at 2.

In addition to the goal of a "level playing field",[23] the DBCFT and BAT have the objective of raising tax revenue. The current corporate tax system has a *headline* rate of 35%, but the *effective* rate is reduced by many loopholes, credits, deductions, and transfer mispricing opportunities. In 2008, the effective corporate tax rate was 27.1% in the U.S.,[24] and evidence suggests that the largest American corporations in fact pay far less than this aggregate effective rate.[25] The bigger picture is of a system of federal tax revenues relying less and less on federal corporate income tax. The relative share of corporate income tax as a proportion of federal tax receipts has dropped by two-thirds in sixty years—from 32% in 1952 to 10% in 2013.[26]

The DBCFT and BAT work simultaneously to discourage profit-shifting schemes, remove incentives to move corporate headquarters out of the U.S., and make up for a shrinking domestic tax base.[27] If corporate headquarters remain in the U.S., jobs, research and intellectual property also remain in the U.S. Domestic earnings are taxed equally, regardless of whether local or foreign corporate structures are involved, and regardless of whether goods are produced using local or foreign assets.[28] In one sense the tax base is reduced, in that it does not include profits earned overseas, nor products produced domestically for export. However, this reduction is outweighed by including importers' domestic sales, because most

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[23] *A Better Way*, *supra* note 2, at 28.

[24] Compared with 27.7% (a GDP-weighted average) for all other OECD countries. Jane G. Gravelle, *International Corporate Tax Rate Comparisons and Policy Implications* 3 (Congressional Research Service, Research Report No. R41743, 2014).

[25] In 2010, all profitable US companies with assets of over $10 million paid U.S. federal income taxes amounting to 12.6% of the worldwide income that they reported in their financial statements (although this assessment excluded income taxes paid in foreign jurisdictions) (*Corporate Income Tax: Effective Tax Rates Can Differ Significantly from the Statutory Rate* 14 (U.S. Government Accountability Office, Research Report No. GAO-13-520, 2013)). In addition, a survey of 288 corporations drawn from the Fortune 500 listings of 2008-12 concluded that those firms paid an effective federal income tax rate of 19.4% over that period (ROBERT S. MCINTYRE ET AL., THE SORRY STATE OF CORPORATE TAXES: WHAT FORTUNE 500 FIRMS PAY (OR DON'T PAY) IN THE USA AND WHAT THEY PAY ABROAD—2008 TO 2012 3 (2014), http://www.ctj.org/corporatetaxdodgers/sorrystateofcorptaxes.pdf).

[26] *Fact Sheet: Corporate Tax Rates*, AM. FOR TAX FAIRNESS (2014), https://americansfortaxfairness.org/tax-fairness-briefing-booklet/fact-sheet-corporate-tax-rates/. The Office of Management and Budget supports the claim (*Historical Tables: Table 2.1—Receipts by Source: 1934-2021*, WHITE HOUSE, https://www.whitehouse.gov/sites/whitehouse.gov/files/omb/budget/fy2018/hist02z1.xls). This claim gained prominence when cited by Bernie Sanders in August 2014; it was subsequently found to be "Mostly True", notwithstanding some changes in the way corporate and personal income tax were measured in the intervening 61 years (Louis Jacobson, *Bernie Sanders Says Tax Share Paid by Corporations has Fallen from 33% to 9% since 1952*, POLITIFACT (Aug. 28, 2014, 5:16 PM), http://www.politifact.com/truth-o-meter/statements/2014/aug/28/bernie-s/bernie-sanders-says-tax-share-paid-corporations-ha/).

[27] H.C., *The Economist Explains: How America's Border-Adjusted Corporate Tax Would Work*, ECONOMIST (Feb. 13, 2017), http://www.economist.com/blogs/economist-explains/2017/02/economist-explains-9.

[28] *A Better Way*, *supra* note 2, at 27.

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industries are net importers.[29] Since the U.S. has a perpetual trade deficit, not just in relation with Mexico,[30] but also in aggregate,[31] taxing sales of imports and not exports would have a base broadening effect, raising more tax revenue, which would offset the administration's proposed tax rate reduction.[32]

Under the DBCFT, the tax base is computed similarly to a VAT—namely the difference between the business's taxable sales and its purchases of taxable goods and services,[33] literally a tax on the "value add". The DBCFT imposes a tax on cash flow, allows expensing of capital expenditures, and disallows net interest expense—the hallmarks of a subtraction method VAT.[34] However, the DBCFT deviates from a VAT in one key manner: domestic producers are allowed to deduct domestic inputs including labour costs.[35] The tax base of a traditional VAT is comprised mainly of "two factors of production, labour (about 2/3 of base) and income from capital or rents".[36] This means that for a domestic producer, the effective tax would be lowered through the inclusion of a narrower net taxable income after allowing for the deduction of domestic inputs including wage expenses, whereas the importing producer bears VAT-level taxes.

III. A PERMITTED TAX UNDER WTO RULES—DOES DBCFT AND BAT MEET THE REQUIREMENTS?

This article now examines the key features of the Blueprint—the DBCFT and BAT—in light of the legal disciplines imposed by the WTO. WTO rules allow for border adjustment of certain types of internal taxes if the taxes meet conditions set out in the GATT, GATS and SCM. Section A analyses whether the DBCFT can be considered an "indirect tax", in WTO jargon, as WTO rules in general permit border adjustments on "indirect"

[29] Caroline Freund, *PIIE Debates Border Adjustment Tax*, PETERSON INST. FOR INT'L ECON. (Feb. 9, 2017, 11:00 AM), https://piie.com/blogs/realtime-economic-issues-watch/piie-debates-border-adjustment-tax.

[30] The U.S. goods and services trade deficit with Mexico was U.S. $49.2 billion in 2015 (OFFICE OF THE U.S. TRADE REPRESENTATIVE, U.S.–MEXICO TRADE FACTS, https://ustr.gov/countries-regions/americas/mexico).

[31] AVI-YONAH & CLAUSING, *supra* note 5, at 10.

[32] Auerbach & Holtz-Eakin, *supra* note 5, at 8.

[33] U.S. CHAMBER OF COMMERCE, AN INTRODUCTION TO THE VALUE ADDED TAX (VAT) 3 (2010).

[34] AVI-YONAH & CLAUSING, *supra* note 5, at 6.

[35] Labour costs are not explicitly excluded from the tax base in the Blueprint. However, their deductability has been widely reported; *see, e.g.*, *Republican Tax-Reform Plans Face Many Hurdles, Including Donald Trump*, ECONOMIST (Jan. 21, 2017), http://www.economist.com/news/finance-and-economics/21715002-mr-trump-will-soon-have-confront-his-economic-policies-internal; *see also* AVI-YONAH & CLAUSING, *supra* note 5, at 7; Auerbach & Holtz-Eakin, *supra* note 5, at 8.

[36] AVI-YONAH & CLAUSING, *supra* note 5, at 7.

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taxes.[37] Based on this understanding of the legal nature of the DBCFT and BAT, Section B goes on to consider their legality under WTO law based on a view of the reforms in isolation from their global context. Section III takes a macro view of how the DBCFT and BAT sit within the existing U.S. taxation regime. This analysis will demonstrate that the chances of the DBCFT and BAT to fulfil WTO requirements with regards to imports are extremely low. Regarding the treatment of exports, while taking a narrow view of the DBCFT and BAT could lead to the conclusion that they are legal under WTO law, putting them into a broader context shows that they will most likely violate the SCM Agreement.

A. The Tax Must Not Be a Direct Tax nor Operate as One

Under WTO law, Article II:2(a) of the GATT allows WTO Members to impose at any time on the importation of any product "a charge equivalent to an internal tax imposed consistently with the provisions of paragraph 2 of Article III in respect of the like domestic product or in respect of an article from which the imported product has been manufactured or produced in whole or in part". The 1970 GATT Working Party on Border Tax Adjustments elaborated on this provision, identifying "a convergence of views to the effect taxes directly levied on products were eligible for tax adjustment. Examples of such taxes comprised specific excise duties, sales taxes and cascade taxes and the tax on value added."[38] This description conforms with the modern day understanding of direct taxes in the WTO. The report added that "convergence of views to the effect that certain taxes that were not directly levied on products were not eligible for tax adjustment. Examples of such taxes comprised social security charges whether on employers or employees and payroll taxes".[39] These are understood today as indirect taxes. Under the SCM, only remission of direct taxes related to exports are included in the Illustrative List of prohibited export subsidies. As explained in the SCM (at footnote 58), indirect taxes are taken to mean "sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges" whereas direct taxes mean "taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property". The underlying rationale of this distinction was that "indirect taxes are entirely passed

[37] Scott S. Lincicome & Richard Eglin, *Border-Adjustable Taxes Under the WTO Agreements*, WHITE & CASE (Jan. 19, 2017), https://www.whitecase.com/publications/alert/border-adjustable-taxes-under-wto-agreements.
[38] Working Party on Border Tax Adjustments, *Report by the Working Party on Border Tax Adjustments*, GATT Doc. L/3464, at 3-4 (Nov. 20, 1970).
[39] *Id.* at 4.

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forward in product prices, whereas direct taxes are entirely absorbed in lower factor incomes".[40] Thus, a tax not levied directly on products or, more generally, an indirect tax is not permitted to be border adjusted.

Looking to the DBCFT, it is stated expressly that it is *not* a VAT but a business tax replacing the existing structure for corporate tax.[41] The tax is levied not on the good (or service) itself, nor is to be paid directly by the purchaser or consumer of the product, but levied on the sales revenue (minus certain deductions) to be paid by the entity booking the profits. It is apparent that the DBCFT in holding itself out to be a form of corporate taxation *prima facie* places it within the definition of a direct tax. The Blueprint, however, claims that the "move toward a consumption-based tax approach, in the form of a cash-flow focused approach for taxing business income . . . [gives] the opportunity to incorporate border adjustments in the new tax system consistent with the WTO rules regarding indirect taxes".[42] This begs the question—is the DBCFT an indirect tax?

Indirect taxes operate in a certain manner that makes them BAT-compatible:

1. The tax does not introduce any distortion;
2. Foreign and domestic goods receive like tax treatment in the domestic market; and
3. The tax component in exports and imports is measurable based on the price of the product.[43]

Given the available deduction for wage expenses, the tax base of domestic and foreign goods (as explained above) is intrinsically different, leading to differing instances of taxation and thus different tax treatment. Since the wage bill varies across sectors, there will be a "web of different tax rates for domestically produced goods", while imports will be charged a uniform 20%.[44] Further, even though it has been suggested that the DBCFT will be absorbed by companies through price hikes to consumers similar to a VAT, academics and economists do not agree.[45] The Congressional Budget Office estimates that owners of capital bear 75% of the corporate tax rather than passing it onto the price of the good. Thus in both form and substance, the DBCFT cannot be said to be a tax on goods to be paid for by consumers (and thus not a consumption tax like the VAT), nor is it the

[40] Hufbauer & Lu, *supra* note 18, at 5.
[41] *A Better Way*, *supra* note 2, at 15.
[42] *Id.* at 28.
[43] AVI-YONAH & CLAUSING, *supra* note 5, at 7.
[44] Caroline Freund, *Trump Is Right: "Border Adjustment" Tax Is Complicated*, PETERSON INST. FOR INT'L ECON. (Jan. 18, 2017), https://piie.com/commentary/op-eds/trump-right-border-adjustment-tax-complicated.
[45] Alan Reynolds, *Second Doubts About a Border-Adjustable Corporate Tax (BACT)*, CATO INST. (Jan. 31, 2017), https://www.cato.org/blog/second-doubts-about-border-adjustable-corporate-tax-bact.

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BAT compatible in the same way as an indirect tax. Although the DBCFT bears similarities to a subtraction-method VAT, of which the GATT-compliant determination has not been made, to date, as Japan is the only country currently employing this method,[46] its permitted deductions mean that it is unlikely to be characterized as an indirect tax under which BAT is permitted. Can the wage deductions be characterized in a manner which places the DBCFT in line with a subtraction-method VAT?

It has been put forth that in substance the DBCFT is an equal rate cash flow tax plus a reduction in payroll taxes. In the U.S., the payroll tax is a Federal Insurance Contributions Act (hereinafter "FICA") tax, imposed on both employees and employers to fund Social Security and Medicare. Payroll tax ordinarily takes the form of a tax of around 15.3% of wages, varying depending on the income bracket of the employee,[47] with the employer bearing half of the amount payable. Allowing companies to deduct wage expenses from their taxable income under the DBCFT whilst simultaneously charging payroll tax would amount to replacing the payroll tax with a DBCFT without wage deductions. Both the DBCFT in relation to wages and the payroll tax compute tax from an identical tax base (labour costs) and there is said to be equivalence between the tax policies.[48] Given this equivalence, "treaties aimed at ensuring that tax policies adhere to particular norms regarding trade and other economic activities should, to be coherent, treat two equivalent policies in the same manner."[49] Since payroll taxes are entirely the domain of internal law and not subject to compliance with international trade rules, the WTO may be slow to deem the proposed DBCFT with wage deductibles incompatible with a BAT due to the tax reforms being *in effect* equivalent to a permitted cash flow tax (which is BAT-compatible) and internal payroll tax adjustment. Thus, although the form of the DBCFT does not fall strictly within the meaning of indirect tax, it may be construed in a manner to conform to the characteristics of a subtraction-method VAT.

Hence, at first sight, the DBCFT and BAT seem to fall within the definition of direct taxes, being taxes on cash flow based on income. However, a closer examination of the proposed taxes' operation suggests they instead fall in the grey area between direct and indirect taxes.

[46] Auerbach & Holtz-Eakin, *supra* note 5, at 18.
[47] John Olson, *What Are Payroll Taxes and Who Pays Them?*, TAX FOUND. (July 25, 2016), https://taxfoundation.org/what-are-payroll-taxes-and-who-pays-them/.
[48] Auerbach & Holtz-Eakin, *supra* note 5, at 7.
[49] *Id.*

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B. A Narrow Approach to the DBCFT and BAT Under WTO Law

As the DBCFT and BAT have distinct effects on imports and exports, we assess their legality with respect to each.

As regards imports, GATT Article III:2 states that the products of the territory of any WTO Member imported into the territory of any other Member shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. This obligation applies regardless of whether the DBCFT qualifies as an "indirect tax" like a VAT or a "direct tax" like corporate income taxes.[50] GATS Article XVII:1 also requires Members to accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.

As under the DBCF and the BAT only taxable receipts and deductible amounts that are effectively connected with the conduct of trade or business within the U.S. are included or deducted in the computation of net business income, the amount of the cash flow tax would be higher on imports than on domestic products. For example, if a company made and sold a widget for $100, and spent $70 on its workers' pay, under the Blueprint only the remaining $30 would be subject to the 20%. That would produce a $6 tax bill. If the same company imported the same product, it would be forced to pay the 20% tax on the entire $100 sale, producing a $20 tax bill. This result appears to violate the national treatment obligation under the GATT. Replacing the widget by a provision of legal services would similarly lead to a violation of national treatment under the GATS.

Furthermore, allowing a deduction for domestic costs but not for imports could amount to a subsidy under the SCM. SCM Article 3.1(b) prohibits subsidies that are contingent upon the use of domestic over imported goods. Under the DBCFT, a lower tax on domestic products would stem from the use of domestic input materials depending on whether the cash-flow tax already collected on the sale of domestic input materials themselves offsets the value of the deduction for using the domestically made input in the final product. In this sense, companies may have an incentive to purchase local inputs instead of imported products, leading to a possible violation of SCM Article 3.1(b).

With regard to exports, the DBCFT and BAT could also run afoul of the SCM. Under the SCM, a subsidy entails a financial contribution by a

[50] Panel Report, *United States — Tax Treatment for "Foreign Sales Corporations"—Recourse to Article 21.5 of the DSU by the European Communities*, ¶¶ 8.142, 8.144, WTO Doc. WT/DS108/RW (adopted Jan. 29, 2002).

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government that confers a benefit.[51] A financial contribution includes where "government revenue that is otherwise due is foregone or not collected".[52] This occurs when exceptions are provided to a general rule of taxation.[53] If the DBCFT was structured such that exports received an exemption from taxes due or a rebate on taxes paid, it could fulfil this definition as a tax on a companies' cash flow that is foregone by the federal government when the revenue results from exports. However, if exports were not included in the DBCFT because they are not consumed in the U.S., exports would not be subject to an exception from a general rule and the government would not forego revenue. In this case, the DBCFT would escape scrutiny under the SCM.

SCM Article 3.1(a) prohibits subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance. The illustrative list of export subsidies in Annex 1 of the SCM includes "the full or partial exemption remission, or deferral specifically related to exports, of direct taxes" under paragraph (e). Hence, if the DBCFT and BAT are perceived as a direct tax on producers with an exemption for exports, they are likely to amount to an export subsidy.

C. A Macro View at the DBCFT and BAT Within the Existing U.S. Taxation Regime

In addition, GATT Ad Article III paragraph 1 states that where taxes that are "technically inconsistent with the letter of Article III, are not in fact inconsistent with its spirit", they need not be repealed if repealing them would "result in a serious financial hardship for the local governments or authorities concerned". This means that a WTO tribunal would scrutinize both the technical aspects of the tax reform and its economic and trade impact in assessing it under WTO law. Rather than looking at the DBCFT in isolation and determining its congruity to a VAT (and thus BAT compatibility) as section A has done, this section takes a macro view of how the DBCFT and BAT sit within the existing U.S. taxation regime to evaluate their overall impact on trade as well as any protectionist or subsidizing effects with respect to imports or exports.

Aside from the problematic characterisation of the deduction of domestic inputs including labour costs, the DBCFT and BAT do not maintain neutrality of trade in accordance with national treatment

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[51] Agreement on Subsidies and Countervailing Measures art. 1, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1869 U.N.T.S. 14 [hereinafter SCM].

[52] *Id.* art. 1.1(a)(1)(ii).

[53] Panel Report, *United States — Measures Affecting Trade in Large Civil Aircraft (2d complaint)*, ¶ 7.120, WTO Doc. WT/DS353/R (adopted Mar. 23, 2012).

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obligations. The DBCFT is a business tax on a corporation's revenue minus deductions. Only tax residents of the U.S. ought to have to pay U.S. income tax. Consequently, all goods produced in the U.S. should "bear the cost"[54] of U.S. income tax whether sold domestically or abroad. Similarly, goods imported into the U.S. bear the cost of their home state income tax, in addition to U.S. federal excise taxes and sales taxes levied on a state-by-state basis, which are also chargeable on domestically produced goods. The DBCFT upsets this balance due to its confusing and variable "hybrid character", being both a cash-flow style business tax on its domestic companies and a VAT-style levy on importers.

From the importer's perspective, the DBCFT with border adjustability is a corporate tax "masquerading" as a VAT, so as to impose a second national-level sales tax (on top of the state-level tax) on importers traditionally not caught within the U.S. corporate residency rules. U.S. states consider consumption taxes to be their domain,[55] thus it would be politically difficult for the federal government to implement a nation-wide sales tax. In its place, the DBCFT and BAT subject overseas goods to both a DBCFT and a state-level sales tax (in addition to the inherent home-state corporate tax carried by the goods). This is clearly protectionist and constitutes an additional violation of GATT Article III:2 as domestic goods are taxed only twice in total as compared to three times for the imported good. Or seen another way, the DBCFT and BAT are imposing U.S. corporate tax on foreign businesses whilst disregarding whether the profits are deemed to be sourced in the U.S. by a U.S. tax resident. Claims of "bringing prices up to par" for imports are misconstrued, as the U.S. would be actively perpetuating double taxation for importing businesses that face both their domestic home state tax and DBCFT, which is in no way comparable to domestic producers who are only taxed once under the DBCFT alone.

As for U.S. exports, the same unequal treatment is perpetuated in the opposite direction. The notion that *only* the current corporate income tax is an "implicit" tax on (U.S.) exports is flawed:[56] all countries tax income of their corporations, so the DBCFT would be introducing inequality to the corporate tax regime. With the DBCFT and BAT, exported goods are exempt from U.S. tax and are subject only to foreign VAT. U.S. exporters thus have room to undercut foreign domestic producers as they face only one tax: the foreign VAT, which in any case is borne by the good and paid for by the consumer. The exemption from the DBCFT thus affords

[54] As explained in footnote 28, it is doubtful whether the goods and services sold by a company "bear" the "cost" of income tax paid by the company, however it is recognised that the need to pay tax cuts into corporate profits and may, however slightly, affect pricing strategies.
[55] *A Better Way*, *supra* note 2, at 15.
[56] *Id.* at 2.

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exporters a wider profit margin to price their goods more competitively, acting as an export subsidy for U.S. exports.

Even without taking into account the additional deduction for the cost of labour extended to domestic producers, which only exacerbates the unequal treatment faced foreign producers, the DBCFT coupled with the BAT has a similar effect to a subsidy on domestic goods or a tariff on imports.[57] With the labour cost deduction, the degree of protection and subsidy would depend on individual firm circumstances, as different goods receive the protection and subsidy to different extents, depending on the share of labour in their production costs.[58] Although economists predict that exchange rate changes will offset any advantages to U.S. producers,[59] any exchange rate change will affect all goods equally and be unable to counterbalance the varied degrees of protection and subsidy granted to U.S. goods.

Thus, the chance of the DBCFT and BAT fulfilling WTO requirements with regards to imports are slim whether one looks narrowly at the reforms or takes a broader approach. Regarding the treatment of exports, the future of the DBCFT and BAT seem brighter when looking narrowly at the Blueprint. However, putting them into a broader context shows that they are likely to qualify as an export subsidy.

IV. MODIFICATION AND ALTERNATIVES TO ENSURE COMPLIANCE WITH WTO OBLIGATIONS

A. The DBCFT and BAT Proposal Must Be Separate to Corporate Tax to Ensure Economic Fairness

The DBCFT is incompatible with border adjustability due to the dual nature it possesses when applied with a BAT: The DBCFT is simultaneously a subtraction-style VAT and a corporate tax. To be WTO-compliant, the DBCFT could be modified and implemented as a subtraction-method VAT rather than as a replacement of corporate income tax. However, as mentioned earlier, putting forward a nationwide sales tax would be difficult for the federal government as it would involve tough political negotiation between federal and state lawmakers, since forty-six states fund an important percentage of their operations with a sales tax.[60]

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[57] Wolfgang Schön, *Destination-Based Income Taxation and WTO Law: A Note* 16 (Max Planck Inst. for Tax L. & Pub. Fin., Working Paper No. 3, 2016).
[58] *A Better Way*, *supra* note 2, at 9.
[59] *Trump: Turning Rhetoric into Policy*, ECONOMICS (Jan. 24, 2017), http://country.eiu.com/article.aspx?articleid=1525037536&Country=United%20States&topic=Economy.
[60] Curtis Dubay, *The Value-Added Tax Is Wrong for the United States*, HERITAGE FOUND. (Dec. 21, 2010), http://www.heritage.org/taxes/report/the-value-added-tax-wrong-the-united-states.

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Indeed, to keep tax collection efficient, a federal VAT would require much coordination between the collection of the VAT and state sales taxes.

Alternatively, the DBCFT could be introduced without the BAT. Yet without the BAT, the DBCFT would be unable to function to its full, intended extent. First, the corporate rate cuts are bolstered by the increased tax revenue by taxing importers would not be possible. Secondly, the border tax adjustment under the DBCFT reduces the incentives multinational taxpayers have in manipulating transfer prices and contributes to creating a tax system that fights against aggressive corporate tax planning without needing to engage in large-scale international cooperation.[61] A DBCFT without the BAT thus loses both its edge, in terms of a competitive corporate tax rate, and its teeth, against corporations determined to escape tax.

B. The OECD's Base Erosion and Profit Shifting (BEPS) Plan

With the DBCFT and BAT unable to be modified to fulfil their purpose, this article moves to explore an alternative avenue of achieving the aims of the DBCFT and BAT. The main thrust of the tax reform blueprint is to increase tax revenues through simultaneously lowering corporate taxes (thus increase the United States' attractiveness as a place of doing business), and tweaking tax mechanisms to remove the impetus for corporations to engage in profit shifting, transfer mispricing, and various tax avoidance strategies to broaden the tax base. Improvements to the tax system aligned with international efforts to the same end would help achieve these goals, without the need to overhaul the tax regime in a way that is not WTO-compliant.

The ideas underlying the tax reform blueprint match the Organisation for Economic Co-operation and Development's (hereinafter "OECD") Base Erosion and Profit Shifting (hereinafter "BEPS"), plan which aims to tackle BEPS structures (primarily aggressive tax planning by multinational enterprises (hereinafter "MNEs"), lack of transparency and coordination between tax administrations, limited country enforcement resources, and harmful tax practices) through a comprehensive package of measures to be implemented domestically and through treaty provisions in a coordinated manner, supported by targeted monitoring and strengthened transparency.[62] Amongst the fifteen action plans set out by OECD, this section focuses particularly on Country-by-Country Reporting (hereinafter "CBCR"),[63] the

[61] Auerbach & Holtz-Eakin, *supra* note 5, at 15.
[62] OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT: EXPLANATORY STATEMENT (2015), https://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf.
[63] *Country-by-Country Reporting*, OECD, http://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/country-by-country-reporting.htm (last visited Sept. 10, 2017).

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adoption of which has an effect that most closely aligns with the tax reform blueprint.

Under the current tax regulations, multinational corporations (hereinafter "MNCs") are able to consolidate the information on all their national accounts into a single set of financial reports detailing regional profits and losses. This method of consolidation erases specific linkages to a country and conceals any cross-border transfer pricing transactions. Allowing consolidated balance sheets effectively places in the hands of the MNC power to declare and report taxes as it wishes, as allocation of profits and costs to different subsidiaries is no longer a transparent exercise supported by individual national financial reports.[64] The MNCs may thus avoid paying the correct amount of tax to the correct states.

CBCR demands that MNCs publish a profit and loss account and limited balance sheet and cash flow information for every jurisdiction in which they trade, as part of their annual financial statements,[65] revealing the trade conducted in each jurisdiction. This requirement removes the cloak of anonymity with which inter-company transactions can otherwise take place, to the detriment of revenue agencies. CBCR thus offers tax authorities access to previously undisclosed and unavailable data, facilitating identification of transfer mispricing by MNCs. Setting mandatory CBCR regulations also makes proving tax avoidance more cost-effective, as investigations into the dealings and transactions of the company require significant time and may even require recourse to legal sanctions before evidence is evinced. With CBCR, tax authorities can scan the range of activities of the MNCs and identify the offending transactions, enabling them to direct scarce resources to tackle specific instances of international tax abuse.

Other than the tax benefits, CBCR bears advantages for other sectors of the economy as well. Most MNC subsidiaries are limited liability companies, which means that the enterprise on the whole is not affected by the losses accrued by its subsidiaries (due to the corporate veil); thus, the risk of the subsidiary's collapse is borne by the state in which it is trading, rather than the parent company.[66] Consolidated reports remove accountability for the MNC's activity in any one state, allowing the enterprise to group all losses in one subsidiary and declare it insolvent, to prevent losses from tainting the profits of the group as a whole. CBCR forces the global corporation to draw specific and tangible links to the local

[64] John Christensen, *Taxing Transnational Corporations*, *in* TAX JUSTICE: PUTTING GLOBAL INEQUALITY ON THE AGENDA (Matti Kohonen & Francine Mestrum eds., 2009).
[65] Richard Murphy, *Country-by-Country Reporting*, *in* GLOBAL TAX FAIRNESS (Thomas Pogge & Krishen Mehta eds., 2016).
[66] *Id.*

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subsidiary, enabling local authorities to appraise the risks the local subsidiary creates and better regulate them.

Signing up to cooperate on an international level and participating in CBCR provides an avenue for the U.S. to reduce the potential for tax avoidance and evasion, while still allowing the federal government discretion to set its own tax rates and allowances, retaining the national basis for taxation and preserving sovereignty.[67] It requires minimal interference with current (WTO-consistent) tax regimes and yet sets to benefit a large section of each national economy in the same way that the tax reform blueprint aims to do. CBCR minimises the possibility of transfer mispricing and broadens the tax base to include all taxable corporate income, not limited to income that U.S. corporations choose to reveal to tax authorities.

As of January 2017, there are fifty-seven signatories to the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports,[68] and many countries continue to move to carry out BEPS and CBCR strategies in their domestic legal orders.[69] This development may be significant for the U.S., as thirteen out of fifteen of its top trading partners[70] are among the signatories. Furthermore, Ireland, the Bahamas, Switzerland and the United Kingdom—countries U.S. companies have traditionally performed corporate inversion to headquarter in[71]—are also under the CBCR programme. U.S. participation in CBCR would allow the tax authorities to monitor its ex-corporate residents and ensure that profits sourced in the U.S. are booked and taxed at the source and rate they ought to be, to the same effect as the tax reform blueprint.

V. NO ALTERNATIVE—FULL-ON DISPUTE OR COUNTERVAILING DUTIES?

In light of President Trump's statements regarding the U.S. trade balance, it remains unlikely that congressional Republicans would be satisfied with CBCR participation alone. This article thus moves to explore how other countries might retaliate against the U.S. for violating the WTO

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[67] Christensen, *supra* note 64.

[68] OECD, SIGNATORIES OF THE MULTILATERAL COMPETENT AUTHORITY AGREEMENT ON THE EXCHANGE OF COUNTRY-BY-COUNTRY REPORTS (CBC MCAA) AND SIGNING DATES (2017), http://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/CbC-MCAA-Signatories.pdf.

[69] *The Latest on BEPS—3 March 2017*, EY (Mar. 13, 2017), http://www.ey.com/gl/en/services/tax/international-tax/alert--the-latest-on-beps---13-march-2017.

[70] *Top Trading Partners—January 2017*, U.S. CENSUS BUREAU, https://www.census.gov/foreign-trade/statistics/highlights/top/top1701yr.html (last visited Sept. 10, 2017).

[71] Danielle Douglas-Gabriel, *These Are the Companies Abandoning the U.S. to Dodge Taxes*, WASH. POST (Aug. 6, 2014), https://www.washingtonpost.com/news/wonk/wp/2014/08/06/these-are-the-companies-abandoning-the-u-s-to-dodge-taxes/?utm_term=.02ae8b642434.

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Agreements. Such retaliation could take the form of bringing a formal claim against the U.S. under the WTO's dispute settlement system (the multilateral track), or imposing countervailing duties against the U.S. subsidies (the unilateral track).

Nullification or impairment of WTO benefits arising from the violation of national treatment with regard to imports has been estimated at USD 220 billion, to which the exclusion for export sales as a violation of the SCM could bring an additional USD 165 billion.[72] WTO Members might be reluctant to bring such a major claim against the U.S. However, they might seek a joint challenge as has occurred frequently, in cases such as *China — Rare Earths* or *China — Raw Materials*.[73] They could also make use of the accelerated procedures under SCM Article 4, which provides that in disputes involving prohibited subsidies under SCM Article 3, the timeframes are half as long as for other WTO disputes. However, it would still take several years for a decision.[74]

A number of U.S. trading partners could instead seek the imposition of countervailing duties, which can be imposed relatively quickly through a domestic process with no WTO involvement. Countervailing duties are additional import duties allowed under WTO rules to neutralize the negative effects of subsidies in a country's domestic market. They are imposed after an investigation which results in a finding by the national authorities that a foreign country subsidizes its exports injuring domestic producers in the importing country. According to WTO rules, a country can launch its own investigation and decide to impose countervailing duties, provided that the imposition of such additional duties is in accordance with Article VI of the GATT, and the SCM.[75] The U.S. could then challenge the imposition of the duties before the WTO if they did not comply with the detailed SCM rules.[76]

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[72] *Border Tax Adjustments and Corporate Tax Reform*, PETERSON INST. FOR INT'L ECON., https://piie.com/events/border-tax-adjustment-and-corporate-tax-reforms (last visited July 22, 2017).

[73] Jennifer Hillman, *Why the Ryan-Brady Tax Proposal Will Be Found to Be Inconsistent WTO Law*, INST. INT'L L. (2017), http://iielaw.org/wp-content/uploads/2015/08/Hillman-IIEL-Policy-Brief-on-BTAs-and-Ryan-Brady-Tax-Plan.pdf.

[74] Hufbauer & Lu, *supra* note 18, at 3.

[75] *See* in particular SCM, *supra* note 51, pt. V.

[76] Understanding on Rules and Procedures Governing the Settlement of Disputes art. 4, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, 1869 U.N.T.S. 401; General Agreement on Tariffs and Trade 1994 art. XXIII:1, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1867 U.N.T.S. 187; SCM, *supra* note 51, art. 30.

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VI. CONCLUSION

In theory, the DBCFT and BAT fall somewhere between direct and indirect taxes, creating uncertainty as to their WTO-consistency. The tax reform blueprint, on paper, creates only benefits and no drawbacks to the U.S.: a simplified form of business tax, which plugs the current loss of corporate tax revenue, raises more tax revenue, fixes trade deficits, and protects domestic producers while cushioning consumers from raising prices through exchange rate changes.

The blueprint has several downsides, albeit apparently not the concern of U.S. policymakers. The DBCFT and BAT lower the tax rate by levying a "business tax" (i.e., corporate tax) on importers, who historically do not form part of the corporate tax base. The reforms purport to improve trade deficits by imposing a double burden on imports: first by levying an *additional* tax, increasing their overall tax burden vis-à-vis that of domestic products and producers, and second through the unequal deductibility of wage expenses by domestic producers. The opposite is true for U.S. exports, which enjoy a form of export subsidy through the border adjustability mechanism of the DBCFT, and none of these varied imbalances can be fully cured by an even appreciation of the U.S. dollar. This inequality is unlikely to withstand the scrutiny of a WTO Panel.

Although the WTO-compatibility of a DBCFT with BAT is uncertain, the WTO Director-General Roberto Azevêdo has pointed out that this matter may not be decided by economists, lawmakers or even the WTO.[77] WTO members might choose not to challenge the legality of a U.S. measure, perhaps other than trade heavyweights such as China and the European Union. Smaller nations might be tempted to impose countervailing duties, as they are more accessible and more immediately effective. However, nations reliant on U.S. trade might instead choose to adopt a similar DBCFT and BAT to neutralize the impact of the U.S. reforms. The emergence of multiple states implementing trade-discriminatory tax legislation could prompt protectionist rather than retaliatory action, leading to greater proliferation of DBCFT and BAT, a trend that could become too widespread to challenge or oppose. Whether the proposed U.S. measures will face a WTO challenge thus lies in the hands of the WTO membership and depends on their timely response to any reforms.

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[77] Brett Fortnam, *Azevêdo: Possible That House Republican Tax Plan Can Be WTO Compliant*, WORLD TRADE ONLINE (Feb. 24, 2017), https://insidetrade.com/daily-news/azev%C3%AAdo-leaves-open-possibility-house-gop-tax-plan-can-be-wto-compliant.

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