Border-Adjustable Taxes under the WTO Agreements

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This client alert summarizes the World Trade Organization (WTO) disciplines on border adjustable internal taxes and provides a general framework for assessing any future United States corporate tax plan that incorporates a border adjustment.

In the coming weeks, Republican leadership in the US House of Representatives will introduce legislation to reform the corporate tax code, converting the current worldwide income tax into a "destination-based" tax on corporations' US sales (including sales of imports), accompanied by a "border adjustment" that excludes export sales from the tax. The Republican proposal would be a radical departure from the current US corporate income tax system, essentially imposing an internal tax on imported goods for the first time in the United States, while permitting a rebate or exemption for US exports. Such a plan differs from President-elect Trump's apparent proposals to impose a steep border tax or tariff on imports into the United States from domestic companies that invest abroad, though many have speculated that the Republican tax proposal could serve as a final compromise between Congress and President-elect Trump on the issue of "outsourcing" and border taxes.

The details of the proposed tax plan are not publicly available – the current plan is only summarized in a House Republican "blueprint"[1] and legislative text reportedly has not been finalized – but the border adjustment proposal has already become one of the most hotly-debated elements of the Republican tax reform proposal. A significant part of that debate has centered on whether the tax plan would be consistent with WTO rules on border adjustable taxes, with some commentators and business groups already expressing serious concerns that the Republican proposal would violate the United States' international obligations and thus expose US exports to WTO-sanctioned retaliation.

A border adjustable tax raises complex international trade law issues that may be summarized as follows, based on what we know of the Republican proposal:

- First, WTO rules in general permit border adjustments on "indirect" taxes, which the WTO Agreement on Subsidies and Countervailing Measures ("SCM Agreement") defines as "sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges."

- Second, in order for a US tax measure to be generally permitted under WTO rules, it also (i) must be levied on imported products at a rate or amount no higher than the rate/amount levied on domestically produced "like" products (to be consistent with GATT Articles II and III); and (ii) must provide a border adjustment on exports that is no greater than the amount of tax actually levied or owed on those goods (to

[1] *A Better Way: Our Vision for a Confident America (Tax)*, at 28 (Jun. 24, 2016) http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf ("The cash-flow based approach that will replace our current income-based approach for taxing both corporate and non-corporate businesses will be applied on a destination basis. This means that products, services and intangibles that are exported outside the United States will not be subject to US tax regardless of where they are produced. It also means that products, services and intangibles that are imported into the United States will be subject to US tax regardless of where they are produced.").

be consistent with Article 3.1 of the SCM Agreement). Publicly available descriptions of the Republican proposal raise concerns that it would permit certain deductions (and thus establish lower tax rates) for domestically-produced goods, while denying the same deductions for the same imported products.

- Third, in order to avoid designation of a border adjustment as a prohibited export subsidy, based on item (e) of the SCM Agreement's Illustrative List of export subsidies, the proposed tax must not be a "direct tax", as defined in the Agreement. The Republican proposal might pass this test if it is deemed to be, for example, a "subtraction method" VAT, but at this stage there is insufficient information to answer this question. If the tax does not clearly fall within the SCM Agreement's definition of "direct tax," then it could be permitted where the tax is found (i) to be "borne by" or directly levied on a product; and (ii) to ensure "trade neutrality" between imported and domestically-produced goods.

Until the text of the tax legislation is published, it is not possible to make definitive conclusions with respect to these issues. Nevertheless, the following analysis should prove useful in assessing whether the final Republican proposal risks future WTO disputes and, in the case of US non-compliance with an adverse dispute settlement ruling, eventual retaliation by US trading partners.

What is a "Border Adjustable" Tax?

A "border adjustable" tax as understood under WTO rules is a domestic ("internal") tax on the sale of a product that may be adjusted at the border by levying the tax on imports and rebating or exempting it on exports. Border adjustable taxes are sometimes equated with "indirect" taxes, *i.e.,* taxes borne directly by a product, although, as discussed below, the equation of border adjustable tax with indirect tax is imprecise. Indirect taxes are to be distinguished, and treated differently under WTO rules, from "direct" taxes like income or profit taxes. The economic theory underlying this distinction is that indirect taxes are passed through to the price of the product whereas direct taxes have a more complex relationship to price. The most common form of border adjustable tax is the VAT, which typically is levied on the customs value of a product plus duties and is collected on imports at the time of customs clearance.[2] Many WTO Members, including the EU (at standard rates varying among member states from 15% to 27%), utilize a border adjustable VAT – a fact that some Republicans have cited to justify the new US corporate tax proposal.

What Do WTO Rules Say about Border Adjustable Taxes?

WTO rules allow for the adjustment of certain types of internal taxes at the border under certain conditions. The main conditions are summarized below.

The tax must be applied equally to imports and "like" domestic products

Any domestic tax levied on imported products must, regardless of whether it is border adjustable, be done so at a rate no higher than the rate levied on domestically produced "like" (similar) products. The general rule of GATT Article II:1(b) is that, other than customs duties, imports must "be exempt from all other duties or charges of any kind." However, GATT Article II:2(a) allows a government to impose at the time a product crosses its border "a charge equivalent to an internal tax imposed… on a like domestic product," as long as the internal charge is imposed consistently with the "national treatment" principle of GATT Article III.[3] The imposition of an internal tax at the border will therefore be consistent with the GATT non-discrimination rules where it conforms to the provisions of GATT Article III:2, *i.e.,* that the imported good is "not 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" (emphasis added).

The WTO Panel in US – FSC (Article 21.5 – EC) clarified that the national treatment disciplines for internal taxes apply not only to "indirect taxes" like VATs but also to "direct taxes" like corporate income taxes:

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2 A tax need not be applied economy-wide or at a uniform rate in order to be eligible for adjustment under WTO rules. VAT is typically applied economy-wide, but sometimes is applied at different rates on different products. Excise taxes apply only to certain products (usually gasoline, alcohol and tobacco) but they too may be adjusted at the border under WTO rules.

3 This rule is confirmed by the Ad Note to GATT Article III, which states that "any internal tax or other internal charge, … which applies to an imported product and to the like domestic product and is collected… in the case of the imported product at the time or point of importation, is nevertheless to be regarded as an internal tax or other internal charge… and is accordingly subject to the provisions of Article III."

"nothing in the plain language of [Article III:4] specifically excludes requirements conditioning access to income tax measures from the scope of application of Article III," so that "Article III:4 of the GATT 1994 applies to measures conditioning access to income tax advantages in respect of certain products."[4]

The tax must be "borne" by a product and not be "direct" (as defined by WTO rules)

WTO rules are based on the "destination" principle that taxes on products should be levied at their point of sale so as to align the tax treatment and conditions of competition of imported and domestic products in the marketplace. This principle has two general consequences for the permissibility of border tax adjustments under WTO rules:

- First, because traditional "credit-invoice" VATs, sales taxes and other consumption taxes are levied directly on products, they are undoubtedly eligible for border tax adjustment. Just as a country would not violate WTO non-discrimination principles by levying a domestic sales tax on imported products under GATT Article II (thereby establishing equal sales tax treatment between imported and domestic goods in the country), the country also may exempt exports from the sales tax, or rebate taxes paid, because the exported products will face equal treatment (*i.e.,* subject to the importing country's local sales tax) once they reach their final destination.

  The permissibility of border tax adjustments was first addressed by the 1970 GATT Working Party on Border Tax Adjustments, which concluded that "there was a convergence of views to the effect that taxes directly levied on products were eligible for tax adjustment … [and] … that certain taxes that were not directly levied on products were not eligible for tax adjustment", citing social security charges and payroll taxes as examples of the latter.[5] The Working Party's conclusion was applied in subsequent GATT/WTO work, including dispute settlement. For example, the GATT panel in *United States – Taxes on Petroleum and Certain Imported Substances* stated that the 1970 Working Party Report showed that "… the tax adjustment rules of the General Agreement distinguish between taxes on products and taxes not directly levied on products."[6] The un-adopted first GATT panel in the "Tuna-Dolphin" dispute concluded that "under the national treatment principle of [GATT] Article III, contracting parties may apply border tax adjustments with regard to those taxes that are borne by products, but not for domestic taxes not directly levied on products."[7]

  The principle also applies to WTO subsidy rules. GATT Article VI:4 prohibits the application of countervailing (anti-subsidy) duties for rebates or exemptions upon exportation of taxes "borne by the like product." Thus, the Note Ad Article to GATT Article XVI (on subsidies) states that "[t]he exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties of taxes in amounts not in excess of those which have been accrued, shall not be deemed to be a subsidy." That language is repeated in footnote 1 of the SCM Agreement, and is implied in the Agreement's "Illustrative List" of prohibited export subsidies (Item (g) and Footnote 60).

- Second, WTO export subsidy rules are distinct for (i) "indirect taxes," which are levied directly on products (border tax adjustment allowed) and (ii) "direct taxes" which apply to income, profits and factors of production (border tax adjustment not allowed). The SCM Agreement's "Illustrative List" of prohibited export subsidies expressly includes "[t]he full or partial exemption remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises" (emphasis added). Footnote 58 of the SCM Agreement defines "direct taxes" as "taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property," and "indirect taxes" as "sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges" (emphasis added).

[4] Panel Report, *US – FSC (Article 21.5 – EC)*, paras 8.142 and 8.144.

[5] GATT (1970) *Report of the Working Party on Border Tax Adjustments, adopted on 2 December.* (L/3464), paragraph 14, *available at* https://www.wto.org/gatt_docs/English/SULPDF/90840088.pdf ("1970 WPR").

[6] GATT Panel Report, United States – Taxes on Petroleum and Certain Imported Substances, L/6175, adopted 17 June 1987, BISD 34S/136 , para 5.2.4.

[7] GATT Panel Report, United States – Restrictions on Imports of Tuna, DS21/R, DS21/R, 3 September 1991, unadopted, BISD 39S/155, para. 5.13 (emphasis added).

These two principles were addressed in a dispute settlement challenge by the EU to US tax legislation on the Domestic International Sales Corporation (DISC) and its successor the Foreign Sales Corporation/Extraterritorial Income Acts (FSC/ETI). The law exempted DISC income (*i.e.,* export sales income) from corporate income tax and allowed partial deferment of tax on that income received by shareholders. The United States contended that the tax advantages granted to the export activities of US companies through the DISC and the FSC/ETI were analogous to tax advantages enjoyed by EU companies as a result of (i) the EU's use of the "territorial" system of direct taxation that exempted income from "foreign economic processes" (*e.g.,* overseas production for exports)[8] and (ii) the ability of EU companies to exempt VAT from exports and levy it on competing imports. The WTO Panel and the Appellate Body examining the FSC/ETI measures disagreed with the United States, concluding that FSC/ETI payments constituted a prohibited export subsidy under Article 3.1(a) of the SCM Agreement. The Panel in particular noted that the payments were specifically the type of prohibited border tax adjustment subsidy found in item (e) of the SCM Agreement's the Illustrative List because they constituted "full or partial exemption remission, or deferral... of direct taxes... paid or payable by industrial or commercial enterprises."[9]

The Panel and Appellate Body rejected the US analogy between the FSC and EU "territorial" taxation because the WTO did not prescribe what kind of taxation system a Member should use but it did prohibit a Member, having chosen its taxation system (direct, world-wide taxation in the case of the United States), from exempting from that system foreign source income attributable to exports. That, the Panel said, constituted a prohibited export subsidy.

A permitted border tax adjustment must not subsidize exports

A border tax adjustment may not serve to subsidize exports in violation of Article 3 of the SCM Agreement.[10] As noted above, rebating or exempting indirect taxes such as VAT on exports is permitted under GATT Articles VI and XVI and the SCM Agreement and is therefore not treated as an export subsidy under WTO rules, as long as the rebate/exemption rate is not greater than the rate at which the tax is levied domestically. On the other hand, such a rebate/exemption will constitute a prohibited export subsidy under the SCM Agreement where it is in excess of the actual tax collected or due.[11] The SCM Agreement's Illustrative List covers various forms of these prohibited export subsidies.

Are Only Traditional Consumption Taxes Eligible for Border Adjustment?

It is often stated imprecisely that only traditional consumption taxes (*e.g.,* sales taxes or "credit-invoice" VATs paid by consumers and applied directly on products) are eligible for border adjustment under WTO rules. Although this may be a useful generalization, it should not be considered as definitive for several reasons. First, there has been no definitive Appellate Body ruling adopted by the Dispute Settlement Body on the general permissibility of border tax adjustments (*e.g.,* establishing an analytical framework for determining WTO-consistency). The US-FSC rulings, discussed above, assessed only one type of tax system (the US corporate income tax – a clear "direct tax"); all other guidance was developed before the WTO came into existence.[12]

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[8] Some European countries tax only income earned domestically, whereas the United States and Japan tax "worldwide" income of their residents, including corporations.

[9] Panel Report, *US-FSC*, para. 7.109.

[10] The SCM Agreement includes tax incentives in its definition of a subsidy and prohibits them if they are contingent on export performance. The legal standard for a prohibited export subsidy is met when the subsidy is "tied" to actual or anticipated exportation.

[11] *See, e.g.,* SCM Agreement, Annex I, Item (g) "The exemption or remission, in respect of the production and distribution of exported products, of indirect taxes in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption." *See also* Items (f), (h) and (i) and fn. 60.

[12] The GATT Panel decisions discussed above are not binding on subsequent WTO dispute panels. However, the Appellate Body has found that adopted GATT panel reports, while not binding, do "create legitimate expectations among WTO Members" and, thus "should be taken into account where they are relevant to any dispute". Unadopted panel reports have no legal status in the WTO system but may serve as useful guidance where relevant. Appellate Body Report, *Japan — Alcoholic Beverages II*, p. 14, 15.

Second, the 1970 Working Party Report and prior GATT Panel reports do not establish when a tax is "borne by" a product, nor do they provide a definitive list of the taxes that are expressly eligible or ineligible for border adjustment. The Working Party Report states only that "certain taxes that were not directly levied on products were not eligible for tax adjustment," including "social security charges whether on employers or employees and payroll taxes."[13] The Working Party also opted not to resolve a "divergence of views with regard to the eligibility for adjustment of certain categories of tax," such as "taxes occultes" and property taxes.[14] Third, the Working Party Report establishes that the underlying "philosophy behind [the GATT rules governing border tax adjustments] was the [e]nsuring of a certain trade neutrality" between imported and domestically-produced goods.[15] It is this neutrality, not the identity of the taxpayer (or type of tax), which WTO rules on border tax adjustments seek to protect.

Finally, the definitions of "direct tax" and "indirect tax" under Footnote 58 of the SCM Agreement, as well as the *US-FSC* Panel ruling, leave grey areas for corporate taxes that share characteristics of both forms of taxation. Potentially falling into this grey area is "business transfer tax" or "subtraction-method VAT," under which a uniform rate of tax is levied directly on corporate sellers (as opposed to products/consumers) based on their sales revenue, less purchases.[16] Such a system is widely accepted as VAT (thus fitting the reference to "value added" in the definition of "indirect tax" in Footnote 58), but it is also a tax on some corporate income (thus meeting the footnote's "direct tax" definition). This ambiguity could protect a border adjustable, subtraction-method VAT from the relatively straightforward analysis of the *US-FSC* Panel under item (e) of the SCM Agreement's Illustrative list of prohibited export subsidies. Furthermore, Japan has imposed a border adjustable, subtraction-method VAT since the early 1990s, without any serious interest or concern from other WTO Members[17] – a strong indication that the system does not raise the same WTO problems as the United States' FSC/ETI measures.

How Should One Assess the WTO-consistency of a Proposed US Border Adjustable Tax?

The lack of actual legislation on the proposed US border adjustable corporate tax precludes definitive conclusions about the proposal's consistency with the aforementioned WTO rules. However, it is possible that the proposal could pass muster at the WTO if it adheres to the following general rules.

- First, in order for the tax exemption or rebate on US exports to avoid being designated a prohibited export subsidy based on item (e) of the SCM Agreement's Illustrative List, the proposed corporate tax must not be a "direct tax", as defined in footnote 58 of the Agreement.[18] The Republican proposal might pass this test if it is, for example, a subtraction method VAT. If the tax at issue does not clearly fall within the definition of "direct tax" or "indirect tax" under footnote 58, then a WTO panel could apply the principles set out in the 1970 Working Party Report, examining whether the US tax (i) is "borne by" or directly levied on a product; and (ii) ensures "trade neutrality" between imported and domestically-produced goods.

- Second, if the US tax measure were determined to be generally permitted under WTO rules, it must also (i) be levied on imported products at a rate or amount no higher than the rate/amount levied on domestically produced "like" products (to be consistent with GATT Article III); and (ii) provide a border adjustment on export that is no greater than the amount of tax actually levied (to be consistent with Article 3.1 of the SCM Agreement). More information is needed to answer both of these questions, but various unofficial reports on the Republican tax plan raise some concerns under GATT Articles II and III because

13 1970 WPR, para. 14 (emphasis added).

14 1970 WPR, para. 15.

15 1970 WPR, para. 9. *See also id.* at paras. 22 and 28.

16 *See*, *e.g.,* OECD, *Consumption Tax Trends 2016*, ***available at*** http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/consumption-tax-trends-2016_ctt-2016-en#.WFv0A9IrKUk#page1

17 *See* Reuters, *Japan's Consumption Tax Gets Taxing* , (Nov. 12, 2015),***available at*** https://tax.thomsonreuters.com/blog/onesource/vat-gst-management/japans-consumption-tax-gets-taxing/

18 The other two criteria would be met: (i) the tax would be "paid or payable by industrial or commercial enterprises"; and (ii) the border adjustment would be a "full or partial exemption remission, or deferral" of the taxes at issue.

they indicate that the proposal would permit certain deductions (and thus establish lower tax rates) only for domestically-produced goods, while denying the same deductions for the same imported products.[19]

Once the legislative text is released, however, the two questions above may be answered through a simplified hypothetical assessment of the tax's effect on two identical US companies selling and exporting the same product, with one company selling only imports and the other selling only its own domestically-produced like products. If the total tax paid by the former company is more than that paid by the latter, then the tax system would likely discriminate against imported goods in violation of GATT Articles II and III. If the total border adjustment provided to one of the companies is more than the tax collected (or otherwise due), then the system would likely be a prohibited export subsidy under Article 3 of the SCM Agreement.

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At this stage, it is too early to conclude whether the Republican proposal for a border adjustable corporate tax raises significant concerns under WTO rules. However, our preliminary analysis above should assuage concerns that any such proposal would violate the United States' international obligations. That conclusion will depend on the text of the final legislation and an assessment of whether (i) the tax itself is among those for which border adjustments are permitted; (ii) the system imposes identical tax burdens on imported goods and domestically produced "like" products; and (iii) the border adjustment on exports is no greater than the actual amount of tax collected or due.

Finally, it is important to note that the appearance of WTO-inconsistency does not necessarily mean that the United States will abandon the border adjustment aspect of the Republican tax proposal, or that a WTO Member will challenge it. All policy measures of all Members, including the United States, are considered to be fully consistent with WTO rules until found otherwise in a WTO panel or Appellate Body ruling that is adopted by the WTO Dispute Settlement Body. Many WTO Members therefore adopt measures that they suspect – or know – to be problematic under WTO rules, but determine that such policies likely will not be challenged, including for diplomatic reasons, or that the legal risks are outweighed by political or economic considerations.

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[19] *See*, *e.g.*, Ryan Ellis *Tax Reform, Border Adjustability, and Territoriality*, Forbes, Jan. 5, 2017 http://www.forbes.com/sites/ryanellis/2017/01/05/tax-reform-border-adjustability-and-territoriality/#7d5a015f73d1 ("[A] VAT only allows deductions for business to business purchases. The House GOP tax reform plan, however, does allow for a business to deduct labor compensation paid (wages are then taxed on the individual level.").