The legality of the proposed U.S. "border adjustment tax" under WTO law

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1. This Memorandum addresses the legality under WTO law of the border adjustment tax proposed by a number of Republican representatives in the United States House of Representatives. After a short introduction to the border adjustment tax and its functioning, we will assess whether the envisaged tax can really be described as a border adjustment tax under the 1994 General Agreement on Tariffs and Trade (***GATT***) and whether its functioning respects the national treatment obligations of Article III GATT. We will then examine the legality of the border adjustment tax under the WTO Agreement on Subsidies and Countervailing Measures (***SCM Agreement***) and in particular whether some of its aspects constitute prohibited export or import substitution subsidies. Finally, we will address the remedies offered under WTO law to challenge the border adjustment tax.

1. INTRODUCTION

2. In June 2016, the House Republican Tax Reform Task Force published a "Tax Reform Task Force Blueprint" (***the Blueprint***).[1] The Blueprint proposes repealing the current corporate income tax, and replacing it with a 20% "flat tax" applied to "business cash flow." It would create a corporate tax based on the difference between taxable receipts and deductible amounts. Although it is not clear how the border adjustments would work exactly, the Blueprint explains the intended result which is that products, services and intangibles that are exported from the United States are exempt from U.S. corporate tax, while products, services, and intangibles that are imported into the United States would be subject to corporate tax.[2] Under the Blueprint, taxable receipts and deductible amounts which are effectively connected with the conduct of a trade or business within the United States will be included or deducted in the computation of net business income.[3] For example, if a company sells a domestically produced widget for $100 and it spent $70 on the domestic labour, raw materials and factory overhead necessary to produce the widget, only the remaining $30 will be subject to the 20 percent tax. That would produce a $6 tax bill. In contrast, the revenue generated by the sale of an imported version of the same product would be subject to the 20 percent tax on the entire $100 sale, producing a $20 tax bill. Likewise, if imported raw materials are used in the domestic production of a widget, the value of the imported components would not be deductible from the taxable revenue. Finally, if the company exports the widget abroad, it would not pay any tax on the export revenue. In the following analysis, the tax exemption of export revenue and the non-deductibility of non-domestic input costs will be considered in more detail.

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[1] A Better Way: our vision for a confident America, 24 June 2016, available at:https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf
[2] Blueprint, p. 28.
[3] Blueprint, p. 25; H.R.4377 - American Business Competitiveness Act of 2015.

2. BORDER ADJUSTMENT TAX

2.1 Border Adjustability

3. The first aspect of the Blueprint that must be assessed in light of the WTO Agreements is whether the proposed tax system is effectively a border adjustment tax. Indeed, the envisaged new tax system is routinely presented as a border adjustment tax, not unlike the value added tax (***VAT***) system applied in the EU, whereby VAT is levied on imports while export sales are exempted.

4. Under WTO law, WTO members are permitted by Article II:2(a) GATT to impose in addition to import duties "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." This Article thus allows for border adjustment taxes in order to levy on imported products taxes commensurate to the internal taxes levied on the domestic like products.

5. 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".[4] Therefore, only taxes on products, such as a value-added or a consumption tax can be the object of a border adjustment.

6. This conclusion has also been embraced by GATT/WTO jurisprudence. 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."[5]

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[4] GATT Working Party Report on Border Tax Adjustments, (1970) GATT Doc. Spec. (70) 121.

[5] GATT Panel Report, *United States – Taxes on Petroleum and Certain Imported Substances*, adopted 17 June 1987, para. 5.2.4.

7. One threshold question, therefore, is whether the Blueprint would actually replace the current US corporate income tax with a consumption tax, or whether the Blueprint would technically remain an income tax although mimicking certain features of a consumption tax. The Blueprint proposes repealing the current corporate income tax, and replacing it with a 20% "flat tax" applied to "business cash flow".[6] The Blueprint's "business cash flow" tax is not a VAT-style indirect tax. It is derived from legislation introduced by Rep. Devin Nunes of California, namely "the American Business Competitiveness Act".[7] Under this act, "net business tax income" is defined as "the amount by which the taxable receipts of the business entity for the taxable year exceed the deductible amounts for the business entity for the taxable year." The tax proposed in the Blueprint is thus a tax on the business cash flow of a business entity, calculated by reference to a simplified definition of net income, but a definition of net income nonetheless. It would therefore remain an income tax and not a tax on a product such as a VAT.

8. It is common ground in GATT and WTO jurisprudence that an income tax is not a tax on a product and cannot be border adjusted.[8] Therefore, the proposed tax, when imposed on imported goods, would not be covered by Article II:2(a) GATT.

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[6] Blueprint, pp. 23, 28

[7] H.R.4377 - American Business Competitiveness Act of 2015.

[8] GATT Panel Report, *United States – Taxes on Petroleum and Certain Imported Substances*, adopted 17 June 1987, para 5.2.4*; United States – Restrictions on Imports of Tuna*, unadopted, para. 5.13.

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2.2 Non-Discrimination Principle

9. Any domestic tax levied on imported products must, regardless of whether it is border adjustable, be levied at a rate no higher than the rate levied on domestically produced "like" products. The Panel in *US – FSC (Article 21.5 – EC)* has clarified that the national treatment disciplines for internal taxes under Article III GATT apply not only to "indirect taxes" like VAT, but also to "direct taxes" like corporate income taxes.[9] Furthermore, even a border adjustable tax under Article II:2(a) GATT must be imposed consistently with the "national treatment" principle of Article III GATT.[10]

10. The imposition of an internal tax at the border will therefore be inconsistent with the GATT non-discrimination rules under Article III:2 GATT where the imported products are taxed in excess of the domestic products.

11. According to the proposed tax: "only taxable receipts and deductible amounts which are effectively connected with the conduct of a trade or business within the United States shall be included or deducted in the computation of net business income."[11] However, "products, services and intangibles that are imported into the United States will be subject to U.S. tax regardless of where they are produced".[12] Thus, the cost of imported inputs would not be deductible from the company's revenue when calculating the company's net business income that will be used as the taxable base. In contrast, the cost of domestic inputs such as domestic labour, raw materials and manufacturing overheads will be deductible and reduce the taxable base. Therefore, the envisaged tax system clearly discriminates against imported goods in violation of GATT Articles II:2(a) and III:2. Indeed, the use of imported products will lead to higher taxes on domestic business revenue than when domestic products are used.

3. SUBSIDY

3.1 Export Subsidy

12. According to the Blueprint, "products, services and intangibles that are exported outside the United States will not be subject to U.S. tax regardless of where they are produced".[13] As export revenue will be tax exempt, the proposal is likely to constitute a prohibited export subsidy.

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[9] Panel Report, *US – FSC* (Article 21.5 – EC), paras. 8.142 and 8.144.
[10] Article II:2(a) of the GATT.
[11] H.R.4377 - American Business Competitiveness Act of 2015. Emphasis added.
[12] Blueprint, p. 28.
[13] Blueprint, p. 28.

13. Under Article 1 of the SCM Agreement, an actionable subsidy exists when there is a financial contribution by a government that confers a benefit and is specific. Article 1.1(a)(1)(ii) of the SCM Agreement stipulates that there is a financial contribution when “government revenue that is otherwise due is foregone or not collected”. The border adjustment tax is a tax on companies’ cash flow which is foregone by the government when the revenue results from exports. It therefore constitutes a financial contribution under Article 1 of the SCM Agreement. It also confers a benefit on the exporting producer.

14. In addition, the measure would also be specific as the subsidy is contingent upon exportation under Article 3 of the SCM Agreement. Indeed, specificity is deemed to exist where the subsidy is an import substitution or export subsidy.

15. Under Article 3 of the SCM Agreement, an export subsidy is a subsidy “contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I”. The Appellate Body in *US — FSC (Article 21.5 — EC)* stated that “contingent” means that the grant of the subsidy must be conditional or dependent upon export performance.[14]

16. The "Illustrative List" of prohibited export subsidies in Annex I to the SCM Agreement expressly includes under point (e): "[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".[15] 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”.[16]

17. As the border adjustment tax comes closest to an income tax, it would be a direct tax falling under point (e) of the Illustrative List. This is confirmed by the WTO jurisprudence arising from the *US-FSC* dispute, where the Appellate Body found that exemption of foreign source income is a prohibited export subsidy.[17] Likewise, since the exportation of the products is a necessary condition for the tax exemption under the Blueprint, it would clearly be a subsidy contingent upon exportation under Article 3 of the SCM Agreement.

18. Article VI:4 GATT prohibits the application of countervailing duties for rebates or exemptions upon exportation of taxes "borne by the like product." The Ad Note to Article XVI GATT similarly 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 or 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 "Illustrative List" of prohibited export subsidies (Item (g) and Footnote 60).

[14] Appellate Body Report, *US — FSC (Article 21.5 — EC)*, para. 111.
[15] Emphasis added.
[16] Emphasis added.
[17] Appellate Body Report, *US — FSC (Article 21.5 — EC)*, para. 117.

19. This raises the question of whether the tax is "borne by a product" and is therefore exempted under Article VI:4 GATT or the SCM Agreement. As discussed in the previous section dealing with Article II:2 GATT, the envisaged border adjustment tax is not directly "borne by a product" and has characteristics similar to those of an income tax. It is therefore highly unlikely that it would fall under that exemption.

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3.2 Import substitution subsidy

20. As defined in Article 3.1(b) of the SCM Agreement, import substitution subsidies are subsidies contingent upon the use of domestic over imported goods. According to the Appellate Body in *Canada – Autos*, both *de jure* and *de facto* contingency falls under Article 3.1(b).[18]

21. The border adjustment tax would allow for the deduction of domestic input costs from the company's taxable revenue, but would not grant a similar deduction for non-domestic input costs. The tax deductibility of input costs would thus be conditional upon the use of domestic over imported goods. Since the use of local production inputs result in a lower tax burden for the company, there is manifestly an incentive for firms to purchase US inputs instead of imported products. This constitutes an import substitution subsidy which is prohibited under Article 3.1(b) of the SCM Agreement.

4. REMEDIES

22. A WTO Member whose domestic industry is injured by subsidized imports can challenge the subsidy concerned both multilaterally at the WTO and unilaterally by imposing countervailing duties on the subsidized imports.

23. There can be little doubt that several key features of the border adjustment tax constitute prohibited subsidies under Article 3 of the SCM Agreement. Should a WTO Member decide to challenge this new tax system before the WTO, the fast-track dispute settlement procedure foreseen in Article 4 of the SCM Agreement applies. Pursuant to Article 4.1, consultations may be requested with any Member believed to be granting or maintaining a prohibited subsidy. If such consultations fail to resolve the dispute, the dispute may be referred to a WTO dispute settlement panel. The rules applicable are primarily those of the Dispute Settlement Understanding (***DSU***). However, Article 4 sets out a number of special additional rules and procedures which prevail over the DSU rules. Under Article 4 of the SCM Agreement, the timeframes are half as long as the timeframes provided for under the DSU. For example, panel proceedings concerning prohibited subsidies must be concluded within three months, while proceedings before the Appellate Body may not exceed 60 days. In addition, if a panel finds a measure to be a prohibited subsidy, Article 4.7 provides that the panel shall recommend that the subsidizing Member withdraw the subsidy without delay and specify the time period within which the measure must be withdrawn.

[18] Appellate Body Report, *Canada – Autos,* para. 139.

24. If a recommendation to withdraw a prohibited subsidy is not followed within the time period set by the panel, the Dispute Settlement Body must, upon request by the original complainant, authorise appropriate countermeasures pursuant to Article 4.10 of the SCM Agreement. The level of appropriate countermeasures may be the amount of the prohibited subsidy rather than the level of any trade effects or the nullification or impairment that has been caused.[19]

5. CONCLUSION

25. The proposed US border adjustment tax is likely to violate Articles II and III GATT and constitute a prohibited import substitution and export subsidy under the SCM Agreement. A WTO Member wishing to challenge the new tax system could also make use of the accelerated dispute settlement procedure available under the SCM Agreement in disputes involving prohibited subsidies.

26. If the challenge is successful, WTO Members could retaliate by imposing additional import duties on US products equivalent to the amount of the prohibited subsidy. Considering that the prohibited subsidy would potentially consist of the exemption of all export revenue obtained by US companies, it is clear that the amount of retaliation could be huge.

[19] Decision by the Arbitrator, *Brazil – Aircraft (Article 22.6 – Brazil),* paras. 3.28, 3.29 and 3.33-3.40.