Hogan Lovells

House Proposal for Border Adjustability and Relevant WTO Rules

2 February 2017

On June 24, 2016, on behalf of the House Republican Caucus, House Speaker Paul Ryan, R-Wis., and House Ways and Means Chairman Kevin Brady, R-Tx., proposed sweeping reforms of the U.S. income and corporate taxes. The "Better Way" Blueprint (Blueprint) would change the U.S. corporate tax system to a consumption-based, territorial tax system[1] with the following elements:

(1) a flat corporate income tax rate of 20 percent;
(2) reductions in double taxation;
(3) immediate write-offs of business investments;
(4) limits on deduction of interest expenses; and
(5) border adjustability.

Border tax adjustability is also an important component to the Blueprint because it could provide a basis for the Congress to slash U.S. corporate tax rates, while minimizing revenue losses or avoiding offsetting tax increases elsewhere in the U.S. tax code. But, border adjustability also will be scrutinized closely to see if the proposal conforms to U.S. WTO obligations.

As Chairman Brady explained at a Heritage Foundation event: "We propose to take taxes off of Made-in-America products being sold around the world, and put them on imports coming into the United States."[2] This goal reportedly would be achieved by ending the current deduction of the cost of imported materials, products, services, and intangibles against corporate income taxes. In short, increased taxes on imported goods would offset the revenue losses arising from reduced corporate tax rates, benefiting U.S. manufacturers and U.S. exporters of goods and services.

Because the full details regarding how border adjustability would work are not yet available, it is impossible to provide definitive answers regarding its World Trade Organization (WTO) consistency. However, the materials released thus far suggest that the Blueprint may raise WTO issues and therefore potential risks to both U.S. importers and exporters.

Under WTO rules, the United States and other WTO Members are permitted to impose charges on importation that are equivalent to <u>indirect</u> taxes imposed on domestic goods, and to rebate on

---

[1] The current U.S. corporate tax system taxes worldwide income.

[2] Ways and Means Committee Blog - "Brady at The Heritage Foundation: Ending Tax on "Made in America" Goods Will Unleash U.S. Economic Growth" (December 1, 2016) at https://waysandmeans.house.gov/brady-heritage-foundation-ending-tax-made-america-goods-will-unleash-u-s-economic-growth/ and https://www.c-span.org/video/?419355-1/ways-means-committee-chair-kevin-brady-discusses-tax-code-overhaul

exportation indirect taxes paid on such products. GATT Articles II and III authorize WTO Members to collect “a charge equivalent to internal taxes or charges imposed in respect of the like domestic product or in respect of an article from which the domestic product has been manufactured or produced” when a product is imported, as long as the border tax or charge does not exceed the level of internal taxes “applied, directly or indirectly, to like domestic products.” In addition, GATT Article VI and the WTO *Agreement on Subsidies and Countervailing Measures* (SCM Agreement) permit WTO Members to rebate prior-stage cumulative indirect taxes on exported products, thus providing a tax advantage to exports.

In combination, the WTO’s adjustments for imports and exports are commonly referred to as “border tax adjustments.” The Blueprint seeks to incorporate border tax adjustments into the current U.S. corporate income tax system and thus level the international playing field.[3]

The Blueprint aims to move U.S. corporate tax policy toward a more consumption-based system with the corollary benefit of qualifying U.S. exports for border tax adjustments under the GATT/WTO rules:

> Movement toward a consumption-based system need not involve a shift to an explicit consumption tax, such as a retail sales tax, but instead could result from reforms which exclude certain features of the income tax base. These changes would achieve similar economic results albeit through different administrative rules.

However, as the Blueprint makes clear, it would not represent a fundamental shift in U.S. corporate tax policy to a true indirect tax system, e.g. a sales or value added tax (VAT) on products,[4] but instead would reconfigure the existing U.S. corporate income tax system into a flatter, territorial-based system that is more closely tied to consumption.

As a result, based on the limited information available to date, the Blueprint appears to remain fundamentally an income or direct tax on corporate entities, as opposed to an indirect tax on products, which would qualify for border adjustments under WTO rules. This has important WTO implications, as a U.S. characterization of a new corporate tax system as “consumption-based” or a “consumption tax” will face scrutiny under WTO rules and prior decisions (including some pertaining to previous U.S. tax measures).

Indeed, the WTO has historically taken a skeptical view of a WTO Member’s characterizations of its own measures. Instead, WTO Panels and the Appellate Body typically conduct a detailed examination of a challenged measure’s “design, structure, and operation” in order to probe beneath a WTO Member’s characterization and to assess independently whether the measure is consistent with WTO rules.[5]

WTO rules permit border tax adjustments for indirect taxes imposed on goods or service, but border adjustments are not permitted for direct taxes, *e.g.*, income or social welfare taxes paid by a person or corporate entity. [6] [7] [8] The U.S. has long objected to the GATT/WTO system’s disparate

---

[3] “A Better Way,” p. 28.

[4] *Id.*

[5] *See, e.g.*, Panel Report, *Australia — Automotive Leather II* paras. 9.56–9.57 (export subsidy); AB Report, *US — Shrimp*, paras. 141–142 (GATT Article XX exception for *natural resource conservation* measures); AB Report, *Korea — Alcoholic Beverages*, para. 150. (GATT Article III); AB Report, *US – FSC* (Article 21.5), para. 215 (GATS national treatment).

[6] This has been a longstanding sore point for the U.S. Indeed, since the Trade Act of 1974, one of a U.S. negotiating objective for the Tokyo and Uruguay Rounds was to address the differential treatment of direct and indirect taxes under GATT and WTO rules. See e.g., Omnibus Trade and Tariff Act of 1988, Sec. 1101 ((b)(16), 102 Stat. 1121 (1988); Report of the Committee on Ways and Means on the Trade Reform Act of 1973, 93 Cong., 1st Sess, H. Report No. 93-571, p. 27 (1973).

treatment of direct and indirect taxes,[9] but has twice run afoul of GATT/WTO rules after similar efforts by Congress to exempt export income from U.S. corporate income taxes in order to replicate the effects of border tax adjustments.[10]

If a WTO Panel or the Appellate Body examines the Blueprint's new U.S. corporate tax system closely, there is a high likelihood it will find that it is an income tax system—unless the Blueprint goes further and fundamentally changes the U.S. corporate income tax to a true sales, VAT, or turnover tax.[11] Notwithstanding the Blueprint's characterization of its proposed reforms as consumption-based, details to date suggest that the new approach would continue to impose taxes on corporate income and retain the design, structure, and key features of an income tax. The Blueprint's new U.S. system would still (1) tax corporate income, as opposed to a good's sales price or value-added, and (2) allow deductions and credits for interest, labor costs, investments, R&D, etc.,[12] which would not be allowed in a sales tax or VAT system.[13] In short, the reforms would make U.S. corporate taxes more consumption-based, but would not necessarily alter its underlying status as an income or (in WTO terminology) a "direct" tax.

If so, the proposed border adjustability tax could run afoul of several WTO principles, including:

1. To the extent, border adjustability taxes would be collected as additional charges on imports at the U.S. border, they likely would be challenged as inconsistent with GATT Article II:1(b), which prohibits ordinary customs duties in excess of those set forth in the U.S. Tariff Schedule and all other duties or charges of any kind imposed on or in connection with importation.

2. The deduction of domestic materials, products, and services for corporate tax purposes, but not the deduction of imported materials, products, and services, likely would be challenged as inconsistent with GATT Article III:2, which prohibits discriminatory "internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products."

3. Finally, to the extent the Blueprint would provide a tax exemption for corporate income derived from exports of U.S. goods or services abroad, it likely would be challenged as a prohibited export subsidy under SCM Article 3.1 and the *Illustrative List of Export Subsidies*. Importantly, contrary to the assertions of some that a WTO challenge will

---

[7] The distinction between direct and indirect taxes for purposes of border tax adjustment dates back to the original U.S. draft of the Havana Charter and U.S. commercial treaties from the 1930s. GATT Analytical Index, pp. 141, 150 (1995).

[8] GATT, *Report by the Working Party on Border Tax Adjustments*, L/3464 para. 14, BISD 18S/97 (20 Nov. 1970).

[9] *See e.g.*, Section 121 of the Act of 1974, 88 Stat. 1986.

[10] AB Report, *US – FSC*, WT/DS108/AB/R (Feb. 24, 2000) and GATT Panel Decision, *US – DISC*, L/4422, BISD 23S/98 (Nov. 2, 1976).

[11] A VAT or sales tax likely would be a political non-starter for many Republican Members of Congress, since it makes it easy to raise taxes to support increased government spending. Such taxes are also highly regressive, and thus likely to be an anathema for many Democrats.

[12] In a VAT, the tax is typically calculated as a percentage of the sales price less the cost.

[13] Economists have long argued whether the effects of direct taxes on income and indirect taxes on goods and services are equivalent, or can be equivalent in certain circumstances. This debate remains unresolved and is unlikely to change the WTO's view of "border adjustability" as a "direct" tax for WTO purposes. Instead, under the rules of treaty interpretation set out in the *Vienna Convention on the Law of Treaties*, the WTO is likely to focus on the text of the WTO Agreement and on past interpretations by WTO Members, e.g. the GATT *Report by the Working Party on Border Tax Adjustments.* See *Vienna Convention on the Law of Treaties,* Article 31.

take 3-5 years, such a challenge would be adjudicated under the WTO's expedited provisions applicable to challenges pertaining to prohibited subsidies.[14]

Border adjustability remains politically attractive because it would allow Congress to sharply reduce corporate income taxes, without ballooning the budget deficit or raising taxes elsewhere in the U.S. tax code, always a difficult and unhappy proposition. Nevertheless, the relevant WTO issues also should be considered carefully at the outset. This is because, as noted in point three above, the timeframe for resolving a WTO challenge to U.S. border adjustability could be much shorter than is normally the case for most WTO disputes, and lead to the expeditious imposition of WTO-sanctioned retaliatory duties on U.S. exports.[15]

WTO-authorized retaliation would hand the issue back to Congress, which would face a set of unpalatable choices, including: (1) raising taxes elsewhere in the U.S. tax code; (2) eliminating important reductions in U.S. corporate income tax rates; or (3) allowing the U.S. budget deficit to increase significantly.[16] Moreover, if this were to lead to a political impasse, then retaliatory duties (the most likely form of WTO-authorized retaliation) could remain in effect on U.S. exports for a protracted period, causing serious damage to U.S. corporate incomes and jobs, U.S. exports, and U.S. international competitiveness.

---

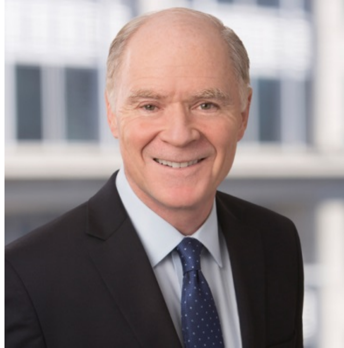
[14] WTO challenges to prohibited export subsidies are subject to an accelerated schedule under Article 4 of the SCM Agreement, including issuance of a Panel report within 90 days of the establishment of a Panel. Moreover, WTO export subsidy disputes typically do not present difficult factual or legal issues, since any government benefit that is contingent on exportation is on its face a prohibited "export subsidy" under Article 3 of the SCM Agreement. In other words, the time frame for resolving a WTO challenge to U.S. border adjustability could be shorter than is normally the case for most WTO disputes, and lead to the accelerated imposition of WTO-sanctioned retaliatory duties on U.S. exports.

[15] The Tax Foundation has estimated that border adjustability would raise approximately $1.1 trillion of revenue over 10 years, so the retaliation amount could be significant and affect a broad range of U.S. industrial and agricultural exports.

[16] Id.

Contacts

Warren Maruyama
Partner, Washington, D.C.
Tel +1 202 637 5716
warren.maruyama@hoganlovells.com



Robert Kyle
Partner, Washington, D.C.
Tel +1 202 637 5494
robert.kyle@hoganlovells.com

Jonathan Stoel
Partner, Washington, D.C.
Tel +1 202 637 6634
jonathan.stoel@hoganlovells.com

Kyle Simpson
Senior Advisor, Washington, D.C.
Tel +1 202 637 3652
kyle.simpson@hoganlovells.com

Jared Wessel
Counsel, Washington, D.C.
Tel +1 202 637 6472
jared.wessel@hoganlovells.com