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IS THE UNITED STATES' PROJECT TO INCORPORATE BORDER ADJUSTMENT CONSISTENT WITH WTO RULES OR THE BEGINNINGS OF A TRADE WAR?

HOW WOULD THIS NEW US TAX REFORM WORK?

Among the various controversial projects in the spotlight after the election of President Trump is the United States tax reform which may be conducted in line with the proposals of the House Republican blueprint released mid-2016.

The blueprint proposes the introduction of a border adjustment in accordance to which products, services and intangibles are taxed where they are consumed rather than where they are produced. This would result in taxing imports to the United States independently of the place of production of the product, while exempting US-produced goods from US taxes when they are exported. In other words, the reform would shift the US system to a "destination-based tax" in accordance to which the cost of all imports would no longer be tax-deductible while revenues resulting from all export sales would be exempted from taxation in the US.

One of the proposal's main objectives is to create a disincentive for US companies to delocalise their activities abroad since all their sales would be subject to US taxation once their products are imported for consumption in the US. The reform would also significantly raise Government revenues (*i.e*. the reform is estimated to raise approximately a trillion dollars over 10 years).

The specificities of how the system would be implemented have not been made public at this stage and are yet under discussion and negotiation within the GOP itself[1], but the proposal is already facing the scrutiny of a great number of discontents. The domestic US industries that significantly rely on imports of products/parts of products for their activities are worried as they would see their costs rise significantly. Foreign companies are naturally sceptical and concerned that their exports would become considerably less competitive if the proposal is implemented.

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[1] In terms of timing, Chairman Brady is pushing for tax reform in 2017, aiming to have the bill passed in the House of Representatives by the August recess. However, this timing may be too ambitious for a bill with such an important reform.

WOULD THIS NEW US TAX REFORM BE WTO-COMPATIBLE?

It is also already raising a big question mark: is the proposed border adjustment tax WTO-consistent? The WTO system allows border adjustments to be made by its Members but limits such adjustments to "indirect" taxes, which include taxes on sales, excise and value-added taxes. On the other hand, it precludes the use of border adjustments on direct taxes, which is the case of income taxes.

Supporters of the US proposed border adjustment argue that it would be equal to an indirect tax, very similar to the VAT system already applied by various countries around the world and which is authorised by the WTO.

On the other hand, the proposal appears to differ from the classic VAT system in a very important aspect: it seems to favour domestic products in as much as wage costs would be deductible for US-produced goods (whether destined for domestic consumption or export), while imports into the US would be fully taxed without such a wage cost deduction.

In this sense, particular WTO concerns raised by the border adjustment as per the blueprint's current proposal are the following:

- Would this border adjustment, coupled with a wage cost deduction for US-produced goods destined for internal or external consumption, **amount to discrimination in the sense of GATT Articles II and III?**

  This would be the case if the adjustment is such that the tax on imported products is levied at a rate higher than the rate/amount levied on domestically produced "like products".

  The fact that domestically produced goods would benefit from a tax exemption on wage costs while imported goods would no longer be deductible from taxable income raises at least a doubt on the arguably non-discriminatory nature of the system. Denying the same deductions applicable to domestically produced goods from imported products would certainly raise concerns under GATT II and III.

- Would the exemption of exports from taxation in the US **amount to an export subsidy in the sense of article 3.1 of the SCM Agreement?**

  Note Ad of GATT Article XVI provides that "the 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 accrued, shall not be deemed to be a subsidy."

  At this stage, it is difficult to make definitive assessments on the outcome of potential WTO litigation on the matter, but it is clear that the new US tax reform could theoretically be considered a direct tax instead of an indirect tax "borne by the product", and consequently be qualified as a prohibited export subsidy in the terms of the SCM Agreement.

  A relevant aspect to consider is that the deductibility of wage costs from the envisioned "consumption-based" tax is an element that may lead to its qualification as a direct tax. Wage costs cannot be individualised and attributed to the consumption of a specific unit of the product. Such an element makes it harder to qualify the tax as an indirect tax "borne by the product" and increases the likelihood that it is considered a direct tax–and more specifically an income tax–and consequently that its deduction from exports is qualified as an export subsidy if challenged at WTO level.

This being said, the WTO-consistency of this future border adjustment plan remains uncertain and dependent on how it would be implemented. Other provisions than the one mentioned above could also be relevant. What is clear is that if the current question marks remain on its (i) potentially discriminatory character and/or (ii) potential qualification as an export subsidy, affected countries and foreign industries will not hesitate to resort to the different international trade mechanisms available to address such concerns and re-establish a level playing field.

WHAT REMEDIES MAY BE AVAILABLE FOR EUROPEAN BUSINESSES?

Various types of actions may be considered by the European Commission and/or European industries/associations, as per the illustrative examples below.

At WTO level, the European Union could try to neutralise the potential negative impacts of this border adjustment mechanism on the exports of the European industry into the US (*i.e.* offensive action), as well as any negative impacts on its domestic industry resulting from an increase of US imports into Europe (*i.e.* defensive action). This could be done in particular via a **WTO action** filed by the European Commission challenging the border adjustment on the basis of GATT Articles II and III (discriminatory treatment/violation of the national treatment principle) and of Article 3.1 of the SCM (prohibited export subsidy). The ultimate goal of the action would be that the US government removes the border adjustment or reforms the system in such a manner as to remove from its features any discrimination against European products and/or remove the illegal subsidies resulting from it.

Should the US decide not to comply with a WTO ruling, the European Commission could resort to **retaliatory tools** allowed by the WTO rules. The EU has not hesitated in the past to impose retaliatory measures when it found that WTO decisions in favour of its industries were not complied with. It has done so against the US, for instance, in the Foreign Sales Corporation (FSC) system which was a type of tax device allowed under the United States Internal Revenue Code that provided a significant illegal export subsidy to more than half of total US exports, to the direct detriment of European companies. The EU and the US finally found an agreement after the EU requested the WTO to authorise trade sanctions on the United States up to a maximum amount of USD 4.043 billion.

The potential negative effects resulting from the US border adjustment tax could also be tackled on the basis of the European Trade Barrier Regulation, via an action known as a **TBR action**. The EU industry, for instance, could resort to the TBR to counter the negative effects of the US border adjustment if it can demonstrate that it constitutes a discriminatory taxation system. A TBR action can be defensive, when it aims to help EU businesses overcome trade barriers and thereby develop their activities overseas; but it can also be offensive, when it aims to tackle unfair foreign trade practices that cause injury within the EU internal market. The instrument has been successfully used in the past by the EU industry in a variety of situations to remove trade obstacles. For instance, in the early 2000’s, a TBR action was brought by Volkswagen against Colombia’s VAT system, which had been designed in such way as to discriminate against certain foreign cars and to unfairly protect local manufacturers. At the time, the Commission raised the issue with the Colombian authorities, which agreed to eliminate the tax discrimination. In the present case, the main advantage of a TBR action against the US would be to provide for a threat escalation with a view to limiting, as early as possible—without going up to WTO litigation—, the damaging effect of US measure and/or to influence the current legislative process in the US.

Finally, **trade defence instrument (TDI) actions such as anti-subsidy and anti-dumping actions could be filed with the European Commission to compensate for the injury caused.**

An **anti-subsidy TDI action** could be filed, for instance, with the DG Trade at the EU Commission at the request of a given branch of EU industry that is suffering from a surge of imports of US products as a result of the financial advantage conferred to the US producers of the "like product" through the tax exemption of exports implemented with the border adjustment plan. A relevant recent example of the successful use of the anti-subsidy instrument to counter the negative impact of US tax policies is the anti-subsidy complaint filed in 2008 by the EU biodiesel industry with the EU Commission against tax credits provided to US biodiesel producers. Since there were no minimum restrictions on the biodiesel share for the tax credit to be applied, by adding just “one drop” of biodiesel, subsidies of up to approximately USD 300 per tonne could be obtained by producers when putting the blend out for consumption. Furthermore, the US policy imposed no limits on exports, meaning that the US biodiesel first benefited from both the US subsidies and, after being exported to Europe, from the higher tax-free price of biodiesel in the EU. Duties of significant levels were then imposed on US imports of biodiesel.

An anti-dumping TDI action could also be used to capture potential trade distortions caused by dumping practices that cannot be directly tackled through an anti-subsidy complaint (*i.e.* exports by US companies at prices lower than the like product’s domestic price/normal value). All the more so since the European Commission has recently agreed to make the necessary adjustments when calculating dumping margin, and therefore the level of the antidumping duties, in order to reflect any significant distortions resulting, for example, from State interference.

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