The Import Price Advantage Under the Border-Adjusted Tax

by Jonathan Van Loo and Rafi Mottahedeh

Jonathan Van Loo

Rafi Mottahedeh

Jonathan Van Loo is an associate at Dechert LLP in New York, and Rafi Mottahedeh is an associate with Jenner & Block in Chicago. They wish to thank Stephen Land for his helpful comments.

In this article, Van Loo and Mottahedeh discuss the proposal for a border-adjusted income tax, focusing on its possible unintended consequences.

I. The Popular Proposal of Border Adjustability

While the past few months have been a whirlwind of political activity, one item on our nation's agenda is tax reform. Although there are many disagreements about what tax reform should do, there is broad agreement that the system of taxation under the IRC is badly in need of fixing. This article analyzes one such proposal — namely, the provision for border adjustments in the tax reform task force blueprint that is part of the "Better Way" series of proposals from House Speaker Paul D. Ryan, R-Wis., and backed by House Ways and Means Committee Chair Kevin Brady, R-Texas.[1]

The blueprint proposes a cash-flow-based border-adjustable tax (BAT) that combines elements of a consumption tax and an income tax. The impetus for this approach is that the United States is at a disadvantage compared with countries that impose a VAT that is refunded or not applicable when items are exported. To bring parity with countries that have border adjustments for VAT, the corporate income tax as we know it would be repealed and replaced by BAT.

BAT would impose a tax on cash flows from sales to U.S. consumers and purchasers. This would be accomplished by (1) imposing the tax on a U.S. business's cash flow from an item's gross sales price to a U.S. buyer; (2) imposing no tax on the cash flow from an item's gross sales price to a foreign buyer; (3) allowing U.S. businesses to immediately expense domestic costs and investments in equipment, capital improvements, structures, and inventories; and (4) allowing a deduction for U.S. wages. Exporting would receive a tax subsidy, and importing and reselling goods in the United States would produce a marginal tax rate that is far higher than the headline 20 percent rate in the proposal.

The BAT is meant to promote exports and encourage the use of domestic goods and services while discouraging the use of imports. The allowed deduction of wages shows that BAT combines elements of a VAT and an income tax. Many economists claim that BAT would not result in any net change in the real price or volume of imports or exports.[2] At first, to be sure, there would be higher prices for imports, resulting in lower U.S. demand and thus fewer dollars leaving

[1] Tax Reform Task Force, "A Better Way: Our Vision for a Confident America" (June 24, 2016).

[2] *See, e.g.*, Alan D. Viard, "Border Adjustments Won't Promote Competitiveness," *Tax Notes*, Oct. 4, 2004, p. 122, explaining that in equilibrium a border adjustment would not affect trade flows, but instead would result in a higher value for the dollar.

the United States in purchases of imports. At the same time, the export subsidy would reduce prices for U.S. exports, increasing demand for dollars that non-U.S. customers would be sending back to the United States.

Assuming a flexible exchange rate, this shortage in the supply of dollars attributable to reduced purchases of imports, combined with the increase in demand for dollars by foreign purchasers of U.S. exports, would lead to an increase in the value of the dollar.[3] Under equilibrium conditions, the value of the dollar would increase to make the domestic price of imports equivalent to the pre-BAT price (the higher price resulting from the import tax would be offset by appreciation in the value of the dollar), and the price paid by foreign customers for U.S. exports would also be the same (the reduction in price for U.S. exports would be offset by the appreciation in the value of the dollar). In the end, consumers would pay the same price for imports in the United States, just as foreign customers would pay the same price (in their home currencies) for U.S. exports, and trade volumes would be unaffected.

It seems safe to predict that creative accountants and tax lawyers would likely find ways to mitigate the import tax and enhance the advantages of the export exemption. If for no other reason, it seems unlikely that BAT would have no impact on the "real" relative prices of domestically produced goods and services versus imports. Surely there would be some effect on prices, even if muted by an increase in the value of the dollar.

Regardless, BAT seems guaranteed to create massive losers. If the dollar appreciates in value, U.S. holders of foreign assets (such as public pension funds holding the retirement assets of millions of American workers) would experience a one-time decrease in the value of their foreign investments. If the dollar does not appreciate, U.S. consumers would pay higher prices for imports and BAT would effectively impose a regressive tax on U.S. consumers.

While neither scenario appears attractive, this article focuses on anticipating some of the unintended consequences of BAT, and their possible solutions.[4] Under BAT, the same good or service, regardless of where it is produced, would generally have a lower price as an "import" purchased from foreign seller (relative to a domestic seller). That is, under BAT, the price of imports would generally be discounted by the amount of the BAT liability. Therefore, all things equal, a U.S. business would often prefer to purchase a good or service as an import with a discounted price, regardless of where it was produced.

Perhaps the most significant example of this "import advantage" involves sales by a foreign seller directly to a U.S. consumer. The proposals for BAT have not yet been fleshed out, and the issues identified in this article may be anticipated and addressed in future legislation. Yet given the heightened prospects for some kind of border-adjustable tax, it is worth identifying some of the unanticipated consequences of BAT, however tentative this may be.

II. Consumers Purchase Imports Directly

As long as a foreign seller remains outside the U.S. taxing jurisdiction, sales by foreign sellers to U.S. consumers would apparently be exempt from BAT. Indeed, BAT would only be indirectly imposed on imports by denying U.S. businesses a deduction. Moreover, because BAT is a cash flow tax imposed on revenue rather than net profit, the disparity in the taxation of foreign and domestic sellers of imports would provide a big advantage to foreign retailers.

For example, assume a 20 percent BAT rate[5] and that the domestic retailer and foreign retailer pay the same price ($80) for an imported good. As shown in Table 1, to cover the BAT liability, a domestic retailer would have to charge a price that is 25 percent greater than the price charged

[3] *See* Alan J. Auerbach et al., "Destination-Based Cash Flow Taxation," Oxford University, Saïd Business School, Working Paper 17/01 (Jan. 27, 2017). This paper focuses on financial transactions and considers the impact of BAT on exchange rates, domestic prices, as well as a variety of policy considerations. For a summary, see Martin A. Sullivan, "The Finance Industry Under a Cash Flow Tax," *Tax Notes*, Feb. 6, 2017, p. 651.

[4] *See* Bill Parks, "To Catch a Thief," *Tax Notes*, Jan. 2, 2017, p. 141 (calling for more attention to solutions to problems of a destination-based corporate tax).

[5] All examples in this article assume a 20 percent BAT rate.

directly by the foreign seller. Moreover, consumers would be indifferent between purchasing from foreign or domestic retailers because, regardless of who is the seller, they cannot deduct the expense of their purchases. The foreign retailer may have to pay an income tax in its home jurisdiction, but it would presumably be far lower than BAT.[6] The foreign seller would have higher shipping and logistics costs. However, in many cases the greater shipping and logistics costs as well as the foreign retailer's income tax could fail to erode the 25 percent price difference created by BAT.

While that is probably the simplest shortcoming of BAT, it is also arguably the most serious issue discussed in this article. A serious proposal would have to address this disparity in treatment between foreign and domestic retailers. Otherwise, BAT would create a tremendous incentive for foreign retailers to establish platforms to sell directly to consumers in the United States.

Not only would this threaten the U.S. retail industry, including (perhaps principally) online retailers, it may also result in increased tensions with our major trading partners — especially Canada and Mexico. One could imagine a new foreign retailer — let's call it Canazon — establishing warehouses on the border with the United States, ready to service U.S. consumers. Moreover, in the case of California and other states with high sales taxes, the price disparity between Canazon and a California retailer would be all the greater, as Canazon would not charge any sales tax. At the highest California sales tax rate of 9.75 percent, the California retailer would charge about $110 for the imported good, increasing the price difference between the domestic and foreign retailer by nearly 50 percent.

Ways to address this shortcoming may include imposing the import tax on individuals, and subjecting foreign sellers to U.S. tax.

A. Imposing the Tax on Individuals

It has been observed that the use tax imposed by states on individuals is a tax on honesty.[7] Sales taxes are, in almost all cases, technically taxes on the consumer. The retailer or service provider (for states in which services are subject to the sales tax) is merely obliged to collect and remit the sales tax. If the seller of property or services does not have nexus for sales tax purposes under *Quill*,[8] the state cannot impose a collection obligation on the seller. In such cases, the end consumer or purchaser must remit that tax, which is typically termed a "use tax."

Use taxes apply equally to property purchased online, through the mail, and even through the old-fashioned method of driving over the border to a neighboring state. For example, consumers in the Boston area sometimes make a quick drive over the border to New Hampshire (a state without any sales taxes) to buy goods, and then promptly drive home with a trunk full of alcohol, electronics, or anything else that will fit in their car. Despite hopes of diligence and honesty, very few of those individuals file use tax returns and report what they bought in New Hampshire to the authorities in Massachusetts.

While it is hard to determine exact figures, the rates of compliance with use tax obligations are widely acknowledged to be abysmally low. More than half of the states have a line item on their state income tax returns where individuals who have not filed a separate use tax return (which is extremely rare) can report the amount of use tax owed to their state of residence. In California, less

[6] Assuming a 10 percent after-tax margin and a 20 percent corporate income tax, the foreign retailer may have to increase its price by $2 (*i.e.*, it would charge $82, earning $10 in income, resulting in $8 of after-tax earnings, for a 10 percent margin), narrowing the price difference to $18.

[7] *See, e.g.*, Adam Thimmesch, "Taxing Honesty," 118 *W. Va. L. Rev.* 148 (2015).

[8] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) (holding that a seller with no physical presence in a state did not have sufficient nexus for the state to require such seller to collect and remit sales taxes).

than 1 percent of returns in 2012 reported any such amount, and the average use tax reported was $154.[9] New York had the highest rate of reporting, but still only 33.5 percent of state income tax returns reported any use tax liability in 2012.[10] When studies have been conducted to try to determine the exact amount of tax lost to noncompliance, the numbers have been stark. In California, the lost revenue was estimated to be more than $1 billion annually in 2014-2015.[11]

While states attempt to bridge the compliance gap,[12] in focusing on individuals with extremely high incomes or trying to enlist common carriers as sales tax enforcers,[13] their attempts to enforce compliance demonstrate that there is no realistic way for such a rule to be imposed on most consumers. It would require far too much labor to control all international mail and packages and search the vehicles of everyone at a border crossing for goods (and then determine whether the tax had been paid on those goods).

Because BAT is a federal tax, cross-border shopping by consumers may be a manageable problem only affecting border cities such as El Paso or Detroit. The real issue is purchases over the internet, or any other method of purchasing by mail. Moreover, in the digital age there is no need to drive over the border or receive something in the mail. With a few clicks, one can purchase software, music, movies, and much more. If poorly crafted and nearly impossible to enforce cloud taxes signal how the federal government could try to tax digital transactions, there is little doubt how unsuccessful any attempt to bridge the gap would be for digital "goods."[14]

B. Imposing Import Tax on Foreign Sellers

Under current law, gain or income from the sale or exchange of inventory property that is produced outside the United States is U.S.-source only if the sale or exchange takes place within the United States.[15] This is known as the "title passage" rule, which was adopted by Treasury regulations in 1947 and continues today.[16] Under the current regulations, a sale takes place when the "rights, title and interest" of the seller are transferred to the buyer. When the seller retains bare legal title, the location of the sale is the place and time where the buyer acquired the risk of loss and benefits of ownership.[17] If the sale has been arranged for the primary purpose of tax avoidance, the sale would be considered to take place in the location where the "substance" of the sale occurred based on all factors of the transaction, including negotiations, execution of the agreement, location of the property, and place of payment.[18]

It would not be difficult for a foreign retailer to comply with those rules to ensure they did not earn any U.S.-source income. The sale should produce foreign-source income as long as the foreign retailer delivers goods to a common carrier, ensures that title passes to the purchaser at the time of shipment, and the risk of loss and benefits of ownership shifts to the purchaser in the seller's country of residence.[19]

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[9] Minnesota House of Representatives, "Use Tax Collection on Income Tax Returns in Other States" (Apr. 2015). Note, however, that the data is from 2012, when many states had not yet managed to get Amazon to collect and remit sales taxes. While one can assume that the rates of noncompliance have decreased since large online retailers now collect sales taxes, the 2012 data show how profound the noncompliance was, given the success of Amazon when it was not yet collecting sales taxes.

[10] *Id.* Although beyond the scope of this article, the enormous difference in use tax compliance levels between states is fascinating to observe. However, even the highest level of compliance still appears to leave a massive compliance gap.

[11] California Board of Equalization, "Revenue Estimate: Electronic Commerce and Mail Order Sales."

[12] For example, Connecticut routinely audits those with incomes exceeding $1 million for use tax compliance.

[13] *See, e.g.*, *State of New York v. United Parcel Service*, 1:15-cv-01136 (S.D.N.Y. 2015), in which New York brought suit against UPS claiming $872 million in penalties and damages for making illegal deliveries of untaxed cigarettes from Native American reservations.

[14] Matthew Adam Susson, "Thinking Out Cloud: California State Sales and U.S.E. Taxability of Cloud Computing Transactions," 17 *Chap. L. Rev.* 295 (2013); Michael J. Wynne, "The Staggering Breadth of Chicago's New 'Cloud' Taxes" (June 24, 2015).

[15] Sections 865(b), 861(a)(6), 862(a)(6), and 863(b).

[16] Reg. section 1.861-7(c).

[17] *Id.*

[18] *See, e.g.*, *Philipp Bros. Inter-Continent Corp. v. United States*, 17 A.F.T.R. 2d 1072 (S.D.N.Y. 1966). Note, however, that tax avoidance exception is almost never applied.

[19] Reg. section 1.861-7(a), (c).

Table 1. Impact of Import Tax on Domestic Retailer and Foreign Retailer				
Seller	**Sale Price**	**Cost of Imported Good**	**BAT Liability**	**Price Difference From Domestic**
Domestic retailer	$100	$80	$20	$0
Foreign retailer	$80	$80	$0	-$25

Foreign-source income earned by a foreign person is usually not subject to U.S. tax. However, at least in some limited cases, foreign-source income earned by a foreign corporation may be subject to U.S. tax if it is effectively connected to a U.S. trade or business conducted by the foreign seller.[20] If Canazon was found to be engaged in a U.S. trade or business, the IRS could argue that at least part of its foreign-source sales income should be subject to federal income tax.

Although lacking a comprehensive or specific definition under statutory law or the regulations, case law has defined a U.S. trade or business as profit-oriented activities conducted in the United States that are "considerable, continuous and regular."[21] As long as the foreign seller does not conduct any business activities in the United States, it should not be at risk of being a U.S. trade or business. Moreover, an inadvertent mistake or occasional trip by the foreign seller to the United States should not create a U.S. trade or business as long as the presence is not considerable, continuous, and regular.

If the foreign seller is a resident of a country with a double tax treaty with the United States and satisfies the conditions for qualifying for benefits under the treaty — which seems likely given that it would be conducting an active retailing business in its country of residence — it would obtain additional protection from U.S. taxation.[22] Residents of foreign countries that qualify for treaty benefits are only taxable in the United States if they carry on a business in the United States through a permanent establishment and the profits are attributable to that PE.[23] While a PE is generally defined as a place of business that is "fixed" in a specific building or physical location used by the enterprise for the conduct of its business,[24] many tax treaties have generous determinations for what constitutes a PE, so this is a real concern.

For example, the Japan-U.S. double tax treaty provides: "A building site, a construction or installation project, or an installation or drilling rig or ship used for the exploration of natural resources, constitutes a permanent establishment only if it lasts or the activity continues for a period of more than twelve months."[25] Similarly, like many treaties, the Japan-U.S. tax treaty provides that storage and display facilities are not a PE.[26] Therefore, a Japanese electronics seller may be able to maintain a display room and a warehouse in the United States and use the services of independent agents, without being stuck with BAT liability on sales of its imports.

While each treaty is different, the Japanese treaty is not unique in offering generous exceptions to the normal understanding of what constitutes a PE. Analyzing in any real depth the application of BAT to tax treaties is a theoretical exercise at this point with unclear results, but concerns as to how it would not be effective in

[20] Section 864(c)(4) and (c)(5). While Canazon would not be subject to tax under current U.S. tax rules on its foreign-source income even if it were engaged in a U.S. trade or business (given what it would be selling and how), it is easy to imagine provisions like section 864(c)(4) and (5) that could tax Canazon's foreign-source income for sales into the United States.

[21] *See, e.g.*, *De Amodio v. Commissioner*, 34 T.C. 894 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962) (holding that property management, collection of rents, paying taxes, managing insurance, and other matters regarding property constituted activities that were "considerable, continuous, and regular").

[22] *See* Section VIII below for further discussion of treaty considerations.

[23] *See* Treasury, "Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006," article 7 of model treaty.

[24] *Id.*, at article 5.

[25] Article V, para. 3 of the Japan-U.S. tax treaty.

[26] *Id.*, at Article V, para. 4(a).

achieving its goals are real for treaty partners. Changing these rules would require, as a starting point, changing tax treaties to allow the taxation of foreign corporations regardless of a PE.[27] Far more fundamentally, it would require modifying sourcing rules to allow the United States to tax foreign corporations that sell to U.S. consumers, regardless of whether they have any physical presence in the United States, and regardless of the source of the sale proceeds based on long-standing case law and regulations.

If the tax could be imposed on foreign sellers to U.S. consumers based on the location of the purchaser, it would equalize foreign and domestic sellers of imports. Foreign sellers would pay a tax of 20 percent on all sales to U.S. consumers, which would effectively be a federal sales tax (collected by foreign retailers). Such a rule would not be the first example of the extraterritorial extension of U.S. taxing authority, but it's difficult to imagine how this tax could ever be effectively collected, regardless of whether it's imposed on the U.S. consumer or the foreign retailer. Therefore, sales that take place directly between end consumers and foreign importers would not be subject to BAT, providing an unintended advantage to foreign retailers and distributors selling directly to U.S. consumers.

III. Exports From the U.S. Are Re-Imported

Under BAT, goods purchased directly from a foreign seller would bypass BAT and therefore be sold at a 20 percent discount. The same holds true for goods produced in the United States and then re-imported. Assume a U.S. business sells a good or service for $100 that cost $70 in deductible U.S. expenses to produce. If sold domestically, the producer would have a net tax of $6 (20 percent of $100 revenue less $70 in deductible expenses), resulting in after-tax profit of $24. The producer gets the same after-tax profit of $24 if it sells the good or service as an export for $80 ($80 of tax-free revenue, less $70 in expenses, plus a tax refund of $14).[28] This difference is identical to the import price difference shown in Table 1.

If Canazon (a foreign retailer exempt from BAT) purchases the product for $80, it can then sell this "exported" good back into the United States at a price lower than the $100 offered by the producer. While a U.S. business that purchases the product from Canazon would be unable to deduct the expense, U.S. consumers would be indifferent to deductibility. Moreover, as discussed in detail below, U.S. businesses with net operating losses would be able to use their NOLs by purchasing from Canazon.

Because both the sale by the domestic producer to Canazon and the sale by Canazon to the U.S. purchaser are at arm's length, this does not appear to be aggressive tax planning. Two different ways to address this include imposing a tax on Canazon (as discussed above) or restricting the export exemption by requiring the exporter to obtain a certification from the foreign purchaser.

For the second solution, it may be possible to require a foreign purchaser of a domestic product to certify that it is either an end user or that it will track and collect BAT on all its sales into the United States. However, requiring such a certification from foreign purchasers of U.S. goods and services would represent a significant compliance burden on U.S. exporters wishing to qualify for the export exemption.

IV. Price Discount on Imports

Assume a good or service sold by a multinational corporation is partly produced in the United States and partly outside the United States. If the product is sold as an import by a foreign subsidiary, the U.S. customer will not be able to deduct the expense, but the foreign seller will not pay BAT. The foreign seller will pay the U.S. affiliate for its contribution, which will qualify as excludable export revenue for the U.S. affiliate. The U.S. affiliate will deduct the expense of wages and other domestic inputs.[29]

[27] The need to amend or even abandon tax treaties because of BAT has been widely acknowledged. *See* Reuven S. Avi-Yonah, "Back to 1913? The Ryan-Brady Blueprint and Its Problems," *Tax Notes*, Jan. 4, 2017, p. 1367.

[28] This example assumes the producer has sufficient other sources of income to reduce its tax liability by $14.

[29] This assumes the domestic subsidiary would have sufficient other sources of income to use the deduction.

Table 2. Price Charged by Multinational for Import Versus Domestic Good						
	Price	Domestic Expense	Foreign Expense	U.S. Tax Benefit for Domestic Expense	BAT Liability	After-Tax Profit
Foreign Subsidiary	$80	-$30	-$40	$6	$0	$16
U.S. Subsidiary	$100	-$30	-$40	$6	-$20	$16

If the U.S. affiliate sells the product, it will pay BAT on sales revenue and deduct the expense of wages and other domestic inputs. For the multinational to offset the BAT liability and earn the same after-tax profit, the U.S. affiliate will charge a higher price than the foreign seller will. As shown in Table 2, the foreign affiliate will charge a price that is 20 percent lower than the U.S. affiliate, resulting in the same price difference as in Table 1.[30]

In theory, a U.S. customer would be indifferent between paying for a nondeductible import from the foreign subsidiary versus a deductible good or service from the U.S. affiliate. The higher price paid to the U.S. affiliate creates a tax benefit for the U.S. customer equal to 20 percent of the price.

However, from a practical perspective, the foreign affiliate arguably has the upper hand because the U.S. customer would not have to claim or track a deduction on its tax return. Moreover, domestic purchasers that have NOLs would prefer purchasing from the foreign affiliate. Finally, the multinational may prefer to route the sale through the foreign affiliate to reduce or eliminate any future tax on the distribution of earnings from the United States.[31]

This scenario raises the concern that multinational corporations may seek to help their customers use their NOLs by providing U.S. customers with the option of purchasing goods or services from a foreign affiliate at a 20 percent discount relative to purchases from a U.S. affiliate. One way to address this would be to restrict the export exemption when export revenue is earned from a foreign affiliate that then sells to the United States. While this type of restriction and rule seems feasible in principle, it would be very complex in practice because it would require tracking and tracing sales revenue along the entire supply chain, potentially including production chains that take place entirely outside the United States.

V. Use of NOLs to Offset Import Tax

Although BAT allows an immediate deduction for capital goods, it does not permit a corporation with a net loss to claim a refund. Thus, NOLs would increase for U.S. businesses with high levels of export revenue as well as businesses in capital-intensive industries. Presumably, BAT would restrict taxpayers from transferring the tax benefit associated with an immediate deduction of capital equipment purchases through leasing and financing arrangements.[32] However, even with such restrictions, BAT would create new opportunities for monetizing NOLs.

A corporation (Loss Corp.) could monetize its NOLs simply by importing goods and services and selling them to domestic businesses. Assume that a domestic customer wishes to purchase a nondeductible import that costs $80. It would be willing to pay up to $20 more for the same deductible product sold by Loss Corp. Loss Corp. would earn $100 in gross revenue, which it would offset with $100 in NOLs, leaving it with $20 in

[30] This example assumes the foreign subsidiary will be earning $40 in revenue regardless of the location of the sale — if it sells the product, it remits $40 to the U.S. subsidiary for its contributions, leaving the foreign subsidiary with $40. If the U.S. subsidiary sells the product, it will pay $40 to the foreign subsidiary.

[31] Presumably, under BAT, non-U.S. persons would continue to be taxed on U.S.-source income such as dividends.

[32] *See* David P. Hariton, "Financial Transactions and the Border-Adjusted Cash Flow Tax," *Tax Not*es, Jan. 17, 2017, p. 239 (arguing that, under BAT, preventing taxpayers from using financial transactions to transfer tax benefits would require extensive rulemaking by Treasury and the IRS).

after-tax profit. Loss Corp. would therefore monetize an NOL of $100 for $20 in after-tax earnings.

Conceivably, the government could prohibit the use of NOLs to offset gross revenue from the resale of imported goods. However, there would have to be exceptions for revenue earned from the sale of goods and services that are materially different from any imported inputs. Otherwise, NOLs would be effectively eliminated for domestic manufacturers and producers that use imports in their production process.

This exception would, in turn, open the door for exporters to monetize their NOLs by purchasing imports. As discussed above, regardless of the location of production, the same product can be sold for a 20 percent price reduction as a nondeductible import. An exporter with an NOL would therefore seek to use nondeductible imports purchased at a lower price. Thus, BAT would create an unintended incentive for U.S. businesses with high levels of exports to purchase such "imported" goods.

VI. Importers Absorb Import Tax

If a foreign multinational producer is based in a country with an anti-deferral tax system similar to that in the United States, it may be able to absorb the U.S. import tax. For example, assume the foreign producer's home jurisdiction allows the deferral of taxation of foreign active income until repatriated, and allows a foreign tax credit for foreign taxes incurred on that repatriated income. The foreign producer earns substantial active income in countries outside of its residence that is taxed at a lower rate than its domestic tax rate. The foreign producer has a U.S. subsidiary to sell its products in the United States, and a non-U.S. subsidiary to sell its products everywhere else in the world outside the United States and its home jurisdiction. Under this example, we assume that BAT is a creditable tax in the foreign multinational's home jurisdiction.

Assume the U.S. tax rate is 20 percent, the tax rate in the foreign producer's country of residence is 25 percent, and the foreign producer's other subsidiary has a 15 percent tax rate. It charges $70 to its subsidiaries for products that sell for $100 to the consumer. (One benefit of BAT is that from the U.S. perspective, the price the foreign producer charges to its U.S. subsidiary for imported products is irrelevant.) The U.S. subsidiary sells $100 and the non-U.S. subsidiary sells $500 in the rest of the world.

As shown in Table 3, assuming all earnings are repatriated, on a consolidated basis, the foreign producer does not pay any incremental tax under BAT because the higher U.S. tax liability merely offsets the foreign producer's income tax liability on distributions from its other subsidiary. In the real world, this example seems unlikely because few if any countries tax dividends that multinationals receive from foreign subsidiaries in the same way as the United States.[33]

Regardless, the example illustrates the more general proposition that non-U.S. multinationals may be able to absorb or mitigate the import tax in ways that are unappreciated or unanticipated. If true, the import tax would not necessarily end the incentive to invert because foreign producers able to absorb the import tax would continue to enjoy an advantage over U.S.-based multinationals unable to plan to mitigate the cost of BAT.

That problem is less serious than many others are. After all, worldwide systems of taxation are generally less competitive than territorial systems that exempt active foreign earnings from taxation.[34] Indeed, the example above simply illustrates that a multinational subject to tax on its repatriated earnings may be able to effectively bring its domestic tax rate on its worldwide income close to zero by using foreign tax credits generated by BAT. In any case, it seems safe to predict that BAT would not create any rush by our trading partners to embrace worldwide taxation.

[33] Although foreign corporations generally operate in the United States through U.S. subsidiaries, some, particularly banks, operate through branches. To the extent a foreign corporation has a branch or PE in the United States that is earning U.S.-source business income, as opposed to a subsidiary remitting dividend income, the tax will often reduce the home jurisdiction taxes of that foreign corporation regarding the branch income. However, because it is unclear how BAT would apply to banks and financial transactions, the effect on U.S. branches of foreign banks is uncertain.

[34] Even Congress has admitted that the system is uncompetitive. *See* H.R. Rep. No. 108-548, pt. 1, 108th Cong., 2d Sess. (2004).

Table 3. Impact of Import Tax on Foreign Multinational						
	Sale Price	Import Price	Ceditable Subsidiary Tax	Gross Distribution To Foreign Producer	Tax on Distribution Before Tax Credit	Foreign Producer Net Tax
U.S. sales	$100	$70	$20	$30	$7.50	-$12.50
Rest of world	$500	$350	$22.50	$150	$37.50	$15
Total	$600	$420	$42.50	$180	$45	$2.50

As unlikely as it appears, the effect would be detrimental. Under these circumstances, the import tax may fail to increase the price of a product that is produced by the multinational outside the United States. Indeed, to the extent the dollar rises in value following BAT, such imports may actually become cheaper because of BAT and further encourage multinationals to shift production outside the United States. Because this is driven by tax policy in foreign countries, there is very little that the United States can do about it.

VII. Repatriate Intellectual Property

U.S. businesses that charge royalties for intellectual property licensed for use in goods and services sold outside the United States will generate tax-exempt export revenue.[35] Under BAT, some U.S. multinationals would likely repatriate IP that generates such export revenue.

It is possible that there is no need to address this issue because it doesn't appear to lead to any results that are necessarily inconsistent with the stated policy goals. While repatriating IP is not expected to generate U.S. manufacturing jobs and may be a windfall for some multinationals that use this as a means of tax-free repatriation, it's unclear that exempting royalty revenue earned from exported goods and services is contrary to policy intent. If policy makers believe it is inappropriate, it should be possible to restrict any tax benefit from repatriated IP through regulations that would restrict the export exemption.

VIII. Is BAT a VAT or Income Tax?

However BAT applies to dealing in goods and services, it remains unclear and difficult to imagine how such a tax would apply to financial transactions or other situations in which there is no "good" or traditional service being sold or transferred. Perhaps the most likely scenario is the preservation of an income tax, but only for financial transactions.[36] This would require delineating financial versus "real" transactions. Perhaps BAT would draw on the case law and regulations determining when transactions like hedging using futures are ordinary versus capital, when there is, at least in theory, tangible personal property underlying the hedge.[37] However, case law often makes such determinations based on the purpose of holding an investment, which by no means would provide a simple solution for determining when to apply the cash flow tax or the income tax.

Alternatively, others have suggested that BAT should apply equally to financial and nonfinancial transactions.[38] This is important, because it would affect to what extent BAT would resemble an income tax. Previous attempts to provide a corporate income tax benefit for exports have been struck down as noncompliant with international trade rules.

The first attempt was the original domestic international sales corporation, which was added to the code in 1971.[39] When the original DISC

[35] IP licensed to foreign licensees that use IP for goods and services sold in the United States raises the question whether the royalty income should qualify as an "export" when used in goods and services ultimately sold in the United States.

[36] Hariton, *supra* note 32.

[37] *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955); *see also Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988).

[38] For a discussion of one such recent proposal by a group of prominent economists, see Sullivan, *supra* note 3.

[39] Revenue Act of 1971, P.L. 92-178. Note that the DISC is different from the more recent IC-DISC that is still in use today.

provisions were generally regarded as an illegal export subsidy, the United States attempted to fix the problem by creating foreign sales corporations.[40] However, FSCs were then explicitly held to be illegal export subsidies by the newly constituted WTO in 2000.[41]

DISCs and FSCs essentially operated to defer export income and exempt some of it from taxation in the United States, thereby affecting the sourcing of income using ratios. Although the United States argued that these provisions brought it on level footing with territorial-based tax systems, that argument proved to be of little avail.

The United States tried once again to exempt portions of export income from taxation through an export cash flow exemption that previously was available under former sections 114 and 941-943.[42] The extraterritorial income exclusion had a brief life before also being ruled against by the WTO as an illegal export subsidy, and it was repealed in 2004.[43]

The blueprint argues that border adjustability is a consumption tax like VAT, and therefore does not violate WTO rules. However, there are important differences between a traditional VAT and BAT. For example, it has been widely observed that, in contrast to a border-adjustable VAT like a credit-invoice VAT, domestic wages are deductible under BAT.[44] If, as has been widely suggested, an income tax on financial transactions was layered on top of BAT, this would arguably make it less likely to survive WTO challenge.[45]

Of course, changes to the proposed law could move it further from or closer to a VAT. One proposal worth considering is to restrict the availability of the export exemption to prevent domestically produced goods from being sold at a discount into the United States as "imports." Such a restriction may reduce the extent to which BAT results in an impermissible export subsidy. However, such a restriction may also make BAT appear more akin to an income tax and further from a VAT.

As discussed above, other countries may regard BAT as a creditable tax under their own income tax system. Presumably, other countries would require BAT to be covered by a tax treaty because otherwise the treaty would fail to protect their residents from double taxation. To ensure that its own residents would continue to benefit from tax treaties, the United States may agree that BAT is covered. Therefore, as discussed above in Section II.B, it appears likely that BAT would be considered an income tax under tax treaties. To the extent BAT is considered an "income tax" for treaty purposes, this would also make it more difficult to defend against WTO challenges. However, given the novelty of BAT, the absence of specific legislation, and its unclear status under tax treaties, there is no easy way to predict the likelihood of success.[46]

IX. Conclusion

On its face, BAT seems to combine a radical simplification of the tax code with a system that promotes exports and, by making imports more expensive, purports to create U.S. manufacturing jobs. Although a traditional credit-invoice VAT may better achieve those goals, it is inconceivable in the current political environment that Republicans would propose a traditional VAT as a federal sales tax that would *supplement* the income tax. Moreover, a VAT would be very complex to coordinate with state and local sales taxes, but BAT does not give rise to the same issues because it replaces the corporate income tax. At the same

[40] Deficit Reduction Act of 1984, P.L. 98-369 (1984).

[41] Appellate Body Report, "United States – Tax Treatment for 'Foreign Sales Corporations,'" WT/DS108/AB/RW, at 1619 (Jan. 14, 2002).

[42] P.L. 106–519 (Nov. 15, 2000).

[43] WTO, *supra* note 41, provisions repealed by the American Jobs Creation Act of 2004 (P.L. 108-357). For a good description of DISCs, FSCs, the extraterritorial income exclusion, and a review of the history of the GAAT and WTO disputes, *see* David L. Brumbaug, "A History of the Extraterritorial Income (ETI) and Foreign Sales Corporation (FSC) Export Tax Benefit Controversy," Congressional Research Service (Nov. 9, 2004).

[44] *See, e.g.*, Jim Nunns et al., "An Analysis of the House GOP Tax Plan," Tax Policy Center (Sept. 16, 2016).

[45] Hariton, *supra* note 32.

[46] Some commentators appear to believe there would not be significant barriers to implementing the plan. *See, e.g.*, "The House Republican Blueprint: A Destination-Based Cash-Flow Tax," Washington National Tax Services (Jan. 18, 2017). Others, including many economists, take a much dimmer view of the proposal. For an excellent summary of the dispute over the optics and economic effects of border adjustability, see Alan Reynolds, "First Doubts About Border Adjustability," Cato At Liberty (Jan. 30, 2017).

time, because it is purportedly a *consumption* tax, proponents of BAT are hopeful it would withstand challenge under the WTO.

In spite of those benefits, BAT would also create unanticipated opportunities for creative tax planning that may undermine BAT's policy goals. At the extreme, BAT would create a system in which U.S. sellers and purchasers could elect to treat a sale of a good or service either as an import for the purchaser, resulting in tax-exempt export revenue for the producer but no deduction for the purchaser, or as a domestic item for the purchaser, resulting in a BAT liability for the seller but a deduction for the purchaser. The "import" would be offered at a 20 percent price discount, regardless of where it was produced.

This import price advantage would be most pernicious in the context of consumer sales directly to U.S. consumers. It appears to be difficult to address, and has the effect of increasing foreign jobs in the retail sector at the expense of U.S. jobs. Indeed, the relevant U.S. tax rules would require foreign retailers to go out of their way to avoid any U.S. presence. Because BAT does not provide for an immediate tax deduction for net losses, exporters would have a strong incentive to use goods or services classified as "imports" in their production process, even if those imports were produced in the United States. To the extent the exporter purchases an "import" that was originally produced in the United States, the exporter would essentially be transferring its export tax subsidy to the domestic producer of that "import." More generally, BAT would produce massive tax benefits for exporters and producers in capital-intensive industries, and those taxpayers have a wide variety of methods available to transfer these tax benefits to other taxpayers, which may result in a far greater erosion of the tax base than anticipated.

The blueprint argues that the United States is at a disadvantage because VAT is not imposed by many countries on their exports. It's unclear whether the VAT operates to the disadvantage of U.S. producers as much as it operates to the disadvantage of consumers in countries with VAT. Moreover, President Trump has been claiming the dollar is already valued too high, making exports too expensive — yet BAT threatens to further increase the value of the dollar. We hope that as the tide shifts toward tax reform that rewards exports and domestic production, any future reform will adequately account for unintended consequences. ■