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**MEMORANDUM**

May 22, 2017

**TO:** The Honorable Kevin Brady, Chairman
Committee on Ways and Means
U.S. House of Representatives

**FROM:** Timothy Keeler
Warren Payne
Mayer Brown LLP (On behalf of
Caterpillar, Inc.)

**RE:** House Republican Tax Reform Blue Print
and US WTO Obligations

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**Executive Summary**

The House Republican Conference's tax reform proposal, the Blueprint, has been criticized for violating US WTO obligations. In particular, commentators have asserted that the border adjustment mechanism in the Blueprint violates US WTO obligations. This analysis shows that such claims regarding the Blueprint, an untested question in WTO jurisprudence, are premature, and presents the arguments as to how the Blueprint is consistent with US WTO obligations. This analysis conducts a review of both the obligations in the key WTO agreements, and the relevant WTO jurisprudence, and shows how the Blueprint is consistent with US WTO obligations.

Specifically, with respect to U.S. obligations under the Agreement on Subsidies and Countervailing Measures (SCM), the border adjustment mechanism does not constitute a subsidy, as Article 1 of the SCM and relevant jurisprudence require that revenue "otherwise due" is "foregone" for a subsidy to exist. An analysis of that question, taking into account the WTO's decision in the FSC/ETI case, shows that no revenue otherwise due is forgone, because the Blueprint moves the US tax system to a destination-based system where revenue is taxed only where the consumption of the goods and services takes place. This is buttressed by a footnote in the SCM text which clarifies that "the exemption of an exported product from duties or taxes borne by the like product when *destined for domestic consumption*…shall not be deemed a subsidy."[1] In addition, it is also not a prohibited subsidy under the SCM, because it meets the definition of an indirect tax, and the exemption of tax for exports is not "in excess" of those

[1] Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, 1869 U.N.T.S. 14 (hereinafter SCM), at n.1 (emphasis added).

levied on the like product when destined for domestic consumption. Annex 1 to the SCM makes clear that a prohibited export subsidy exists only if any exemption from tax for exports is in excess of those levied on like products when sold for domestic consumption; the Blueprint does not appear to contemplate this.

With respect to U.S. obligations under the General Agreement on Tariffs and Trade (GATT) and General Agreement on Trade in Services (GATS), the border adjustment mechanism should not constitute a national treatment violation because both the domestic and imported like products are taxed under the Blueprint, taking into account the entire U.S. tax system. Where imports and domestic products are directly competitive the Blueprint meets the test that they are taxed similarly. For "like" products, as a practical matter, it also meets the national treatment test.

**Introduction**

On June 24, 2016 the House Republican Conference released a tax reform proposal entitled "A Better Way, Our Vision for a Confident America: Tax" also commonly referred to as the "Blueprint."[2] The Blueprint provides an outline of a proposal for the reform of the US tax code. Since its release, there has been debate about whether the Blueprint proposals violate US WTO obligations. However, the Blueprint provides only an outline of a reform proposal. There are many details of how the tax system outlined in the Blueprint would operate in practice that need to be developed. Without these details it is impossible to conduct a complete analysis of the compatibility of the Blueprint with US WTO obligations. That being said, this paper provides a high-level overview of how US tax policy and US WTO obligations would interact under the Blueprint. The paper describes: 1) the most relevant aspects of the Blueprint; 2) the most relevant WTO obligations; 3) a summary of how the decisions in the FSC/ETI cases impact any analysis; 4) an initial analysis of the WTO consistency of the new tax system under the Blueprint; and 5) a summary of how the WTO dispute settlement system operates. Based on this analysis, the Blueprint does not violate US WTO obligations.

As described by its Congressional supporters, the tax reform envisioned by the Blueprint "represents a dramatic reform of the current income tax system" and provides "focus on business cash flow, which is a move toward a consumption-based approach to taxation, will allow the United States to adopt, for the first time in history, the same destination-based approach to taxation that has long been used by our trading partners."[3] The fact that the Blueprint envisions a wholesale reform and restructuring of the basic approach to taxation by the United States is a critical factor when considering the potential interaction between the policies outlined in the Blueprint and US WTO obligations. This factor, along with others, significantly distinguishes

[2] House Republican Conference, "A Better Way, Our Vision for a Confident America: Tax" (2016), http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf
[3] *Ibid*. at 15.

the circumstances around the Blueprint from those that were central to the WTO analysis of the FSC/ETI cases.

**Overview of Key Features of the Blueprint**

Key components of reform of the US business and international tax regimes as outlined in the Blueprint include:

- Reduction in tax rates,
- Provision of full expensing,
- Elimination of most deductions and credits, including elimination of deductions for interest,
- Implementation of 100-percent exemption for dividends paid by foreign subsidiaries of US corporations to their US parent (i.e., a full territorial regime), and
- Implementation of border adjustability for the tax treatment of cross-border sales of goods, services, and intangibles.

As noted in the Blueprint itself, the intent is for the US to adopt a destination-based, cash-flow tax regime. The proposal therefore makes a fundamental break from the current structure of the US tax regime that taxes income regardless of where it is earned to one that taxes revenues only when those revenues are generated from the sale of goods and services in the US. Thus, the Blueprint's structure acts as a proxy for consumption. This approach is common in a number of different forms of tax regimes that have developed over many years, including the "X-Tax," the "Growth and Investment Tax" and of course common to all value-added tax regimes.[4] This is a substantial break from the deferral of income and depreciation of expenses that is fundamental to an income tax regime.

Under a destination-based regime tax is levied on revenues generated from the consumption of goods and services in the US while all revenues associated with the consumption of goods and services outside of the United States would be exempt from US tax. Additionally, the changes outlined in the Blueprint are mandatory and permanent upon all taxpayers.

Revenues associated with the consumption of goods and services outside the US would be exempt from tax through either a 100 percent exemption established under the territorial regime or the border adjustment mechanism. Revenues associated with the consumption of goods and services abroad where those goods and services are provided through a foreign subsidiary of a US corporation are exempt from tax through the 100 percent territorial exemption. Such revenues could be repatriated (or returned) to the US parent of the foreign subsidiary without

[4] *See* David Bradford, "The X Tax in the World Economy," AEI Press (2004); The President's Advisory Panel on Federal Tax Reform, 2005; Itai Grinberg, "Where Credit is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT," Georgetown University Law Center (2010).

additional tax liability. Revenues associated with the consumption of goods and services abroad where those goods and services are provided through exports is exempt from tax through the application of the border adjustment policy. Under a border adjustment mechanism, revenues from the direct export of goods and services would be excluded from tax.

Similarly, revenues arising from the consumption of goods and services in the US would be subject to tax regardless of whether such goods and services are provided through an entity in the United States (whether a domestic entity or the subsidiary of a foreign entity) or through the direct importation of those goods and services. In the case of goods and services provided through an entity in the United States, the revenues earned by the provider would be subject to US tax. In the case of goods and services provided through direct importation, tax equivalence is achieved by denying the importer the ability to deduct the costs associated with those imported goods and services when determining its taxable revenues. Thus in an analogous manner just as revenue is taxed based on where it is generated, costs or expenditures are deductible based on where production takes place.

This structure is similar to how value-added taxes (VATs) typically operate. Broadly speaking, under a VAT regime when a good is exported the exporter is not subject to the VAT tax on the export price and also receives a tax rebate equal to the amount of VAT already paid. In particular, "taxpayers subtract from their VAT liability an amount of input credit that is calculated from aggregate amounts, based on total purchases from *domestic* entities."[5] Imported goods are subject to the full VAT at the time of importation.[6]

Commentators may attempt to distinguish a VAT system from the Blueprint by arguing that a VAT is a tax on a product while the Blueprint is a tax on an entity. Such an argument reveals a fundamental misunderstanding of the actual mechanics of VAT regimes. In the case of both a credit-invoice VAT and a subtraction method VAT the taxpayer does not net the tax for each individual product sold. In both cases, and as presumably contemplated by the Blueprint, the taxpayer nets the total amount of input credits against the total amount of tax liability.[7] Furthermore it ignores that the Blueprint fundamentally changes the structure of the US tax system to a destination based system, which is analogous to an indirect tax system. Thus, there is no meaningful distinction in the basic operation of the netting of input credits to tax liability under any of these forms of indirect taxation.

**Relevant WTO Obligations**

[5] Itai Grinberg, "Where Credit is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT," Georgetown University Law Center (2010), at 316 n.13 (emphasis added).
[6] Tuan Minh Le, "Value Added Taxation: Mechanism, Design and Policy Issues," World Bank (2003).
[7] *Ibid*. at 315.

The following sections outline and explain what US obligations are relevant to any analysis of the WTO compatibility of the reforms outlined in the Blueprint and provides an analysis of how such obligations have been previously interpreted in past disputes over US tax policy.

There are three core WTO agreements which contain obligations relevant to analyzing the consistency of any tax policy with US WTO obligations: 1) Agreement on Subsidies and Countervailing Measures (SCM); 2) General Agreement on Tariffs and Trade (GATT); and 3) General Agreement on Trade in Services (GATS).

*Agreement on Subsidies and Countervailing Measures (SCM)*

The SCM contains obligations that WTO member countries have adopted to discipline government subsidies. The SCM provides a general definition for the term "subsidy" and divides subsidies into two categories: prohibited subsidies and actionable subsidies.[8] Article 1 defines what constitutes a subsidy, which most relevantly includes circumstances when "government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)."[9] A footnote regarding this definition clarifies that "*the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption…**shall not be deemed a subsidy***. (emphasis added)"[10] Further, Article 3 of the SCM defines prohibited, or *per se* WTO-inconsistent subsidies, as: "the following subsidies, within the meaning of Article 1…: (a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex 1;" and "(b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods."[11] Thus, Article 3 further defines tax policies that can be prohibited subsidies provided such policies first meet the definition contained in Article 1.

As noted, an illustrative list of prohibited export subsidies is contained in Annex 1 of the Agreement and includes "the 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."[12] Direct taxes are defined as "taxes on wages, profits, interests, rents, royalties, and all other forms of income and taxes on the ownership of real property."[13] Indirect taxes are defined 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."[14]

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[8] Actionable subsidies are not relevant for this analysis.
[9] SCM, Art. 1.1(a)(1)(ii).
[10] SCM, n.1. The footnote in full reads: "In accordance with the provisions of Article XVI of GATT 1994 (Note to Article XVI) and the provisions of Annexes I through III of this Agreement, 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."
[11] SCM, Art. 3.
[12] SCM, Annex 1(e).
[13] SCM, Annex 1(e), at n.58.
[14] SCM Annex 1(e), at n.58.

In each case, however, for tax policy to constitute a subsidy that violates WTO obligations, revenue that is "otherwise due" would need to be foregone, per the definition in Article 1. In addition, the SCM also provides an exception to the definition in Annex 1(e) for "measures to avoid the double taxation of foreign-source income."[15]

*General Agreement on Trade and Tariffs (GATT) and General Agreement on Trade in Services (GATS)*

Both GATT and GATS contain the same fundamental obligations intended to prevent countries from implementing discriminatory policies: National Treatment and Most Favored Nation Treatment. The National Treatment obligation is most relevant for this analysis.

a) National Treatment

The premise of National Treatment is that the laws and rules in a country should treat foreign interests no worse than domestic interests. Thus, imported and domestically produced or provided goods and services should be effectively subject to the same laws, rules, regulations, standards and practices. National Treatment is articulated in Article 3 of the GATT,[16] which covers trade in goods and Article 17 of the GATS, which covers trade in services.[17]

Specifically, Article III of the GATT[18] provides in Paragraph 1:

> The contracting parties recognize that internal taxes and other internal charges, laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products … should not be applied to imported or domestic products so as to afford protection to domestic production.

[15] SCM, Annex 1(e), at n.59.

[16] General Agreement on Trade and Tariffs, Oct. 30, 1947, 55 U.N.T.S. 154 [hereinafter GATT], at Art. II:1(b), regarding border measures that are duties or charges other than ordinary customs duties, is not the relevant analysis, because, as will be shown below, the Blueprint system is a destination-based indirect tax. Thus, the proper framework is GATT III:2, pertaining to internal measures enforced at the border.

[17] General Agreement on Trade in Services, Apr. 15, 1994, 1869 U.N.T.S. 183 [hereinafter GATS], at Art. I:2 defines "trade in services" as the supply of a service through four "modes":

(1) from the territory of one Member into the territory of any other Member;
(2) in the territory of one Member to the service consumer of any other Member;
(3) by a service supplier of one Member, through commercial presence in the territory of any other Member; and,
(4) by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member.

Modes (1) (cross-border) and (3) (via commercial presence within the importing country) are most relevant here.

Further paragraph 2 expands on this principle, stating that:

> The products of the territory of any contracting party imported into the territory of any other contracting party shall not be 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. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.

An annex to the agreement clarifies that a tax that is consistent with the terms of the first sentence of Paragraph 2 would nonetheless be considered inconsistent with the second sentence when "competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed." In sum, where products are similar enough to be considered "like", the tax rate on imported goods must not exceed that of the domestic good, while goods that are not like but compete in the marketplace or are substitutes for one another must be taxed "similarly."

Article XVII of the GATS provides in Paragraph 1:

> In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.

The GATS National Treatment obligation only applies when the imported and domestic services and service suppliers are "like"; *i.e.*, in general, when there is a sufficiently competitive relationship between the domestic and foreign services and service suppliers.

**Relevant WTO Jurisprudence**

The WTO Dispute Settlement Body ("DSB") has addressed questions as to whether tax regimes violate a country's WTO obligations, and the most relevant decisions are the series of cases brought against the United States for a sequence of tax regimes, the Foreign Sales Corporation (FSC) and the Extraterritorial Income Exclusion Act (ETI).[19] The FSC regime provided US tax exemptions for the export-related foreign-source trade income of Foreign Sales Corporations. The ETI replaced the FSC and was passed by Congress in an effort to comply with the DSB decision regarding the FSC regime. The WTO Appellate Body ("AB") found that both of the tax regimes violated US WTO obligations because they were prohibited export subsidies under Article 3 of the SCM Agreement that exempted the remission of taxes otherwise due. Moreover,

[19] The FSC/ETI cases were brought against the US by the European Union. Consultations were first requested in November of 1997 and the final AB report was issued in February 2006.

the AB found that the regimes did not fall within the exception to the definition of prohibited export subsidies as measures to avoid the double taxation of foreign-source income. There are several aspects of these decisions that are relevant to any analysis as to whether aspects of the Blueprint are inconsistent with WTO obligations.

First, in each case the AB addressed the question as to whether the FSC and ETI regimes actually resulted in the US foregoing revenue otherwise due in a manner that constituted a subsidy. In the FSC case the AB held that as long as a Member's WTO obligations are respected, "[a] Member, in principle, has the sovereign authority to tax any particular categories of revenue it wishes. It is also free *not* to tax any particular categories of revenues."[20]

More specifically, the AB found that "[T]he SCM Agreement does not prohibit a Member from foregoing revenue that is otherwise due under its own rules of taxation, even if this also confers a benefit under Article 1.1(b) of the SCM Agreement. However, if a Member's rules of taxation constitute or provide a subsidy under Article 1.1 and this subsidy is specific under Article 2, the member must abide by the obligations set out in the SCM agreement with respect to that subsidy, including the obligation not to 'grant [] or maintain' any subsidy that is prohibited under Article 3 of the Agreement."[21]

In conducting its analysis, the AB noted that in theory a country could tax all revenue but such an abstraction cannot be the basis for any analysis. Rather, the AB found that "[t]here must, therefore, be some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised 'otherwise.'"[22] Moreover, "panels should seek to compare the fiscal treatment of legitimately comparable income to determine whether the contested measure involves the foregoing of revenue which is 'otherwise due', in relation to the income in question."[23] The AB then went to great lengths in its decision to describe the prevailing US tax regime with a particular focus on describing how the US tax regime took a worldwide approach and that the specific language of the tax code was that the US normally taxes "all income from whatever source derived."[24]

Further, the AB focused on the provisions allowing a taxpayer to elect into ETI treatment, and the presumption that a taxpayer would elect into whichever treatment (ETI or "otherwise") that would result in the lowest possible tax burden.[25] These provisions led the AB to conclude that

[20] Appellate Body Report, *United States – Tax Treatment For "Foreign Sales Corporations"*, WTO Doc. WT/DS108/AB/R (adopted Mar. 20, 2000), at¶ 90.
[21] Article 21.5 Appellate Body Report, *United States – Tax Treatment for "Foreign Sales Corporations,"*, AB-2001-8, WTO Doc. WT/DS108/AB/RW (adopted Jan. 14, 2002), at ¶ 86.
[22] *Ibid*. at ¶ 87.
[23] *Id*. at ¶ 91. *See also*, Appellate Body Report, *United States – Measures Affecting Trade in Large Civil Aircraft - Second Complaint*, WTO Doc. WT/DS353/AB/R (adopted Mar. 12, 2012), at ¶¶ 806-815.
[24] *Ibid*. at ¶ 99.
[25] *Ibid*. at¶¶ 93, 99 and 103.

the proper analysis as to whether any tax was foregone was to compare the tax burden under ETI to what that tax burden would be for the same income absent the opportunity to elect into the ETI regime. In addition, the Panel in the ETI case made clear that when analyzing such questions, the substance of tax provisions must be what is analyzed, and not the form.[26]

Thus, the FSC/ETI case, which requires any analysis to address the substance of how tax is imposed relative to a representative benchmark, is key to any analysis of the WTO consistency of the Blueprint.

**Compatibility of the Blueprint with US WTO Obligations**

The analytical framework established by the AB, namely, that any analysis of the compatibility of US tax policy with US WTO obligations must focus on how the specific tax policy in question operates relative to a benchmark of how the tax regime more broadly taxes similar income, is critical. The Blueprint outlines a *fundamental* change in approach in tax policy - away from the worldwide system and the attendant presumption that the US would tax all income from whatever source derived. As noted above, what drove the AB decision in the FSC and ETI cases was the belief that absent the taxpayer's voluntary decision to participate in the FSC and subsequent ETI regimes, such income was subject to tax.

In contrast, the Blueprint establishes a system under which revenues earned from the consumption of goods and services outside the US is exempt from US tax regardless of whether those goods and services are provided via direct export or through a US subsidiary operating in a foreign market. Likewise, the Blueprint would subject revenue earned from goods and services consumed in the US to tax regardless of whether such goods and services are provided through a US entity or through direct importation. This destination based approach to taxation is a significant contrast to the worldwide approach to taxation the US currently maintains and was central to the Appellate Body's analysis. The shift to a destination based system with border adjustment would match the destination-based approached utilized in VAT taxes.[27] Moreover, an important motivation for border adjustability in the context of a destination-based system is to mitigate the risk of base erosion, such as inversions and profit-shifting, a traditional feature of any tax system. The consequences of this fundamental shift are analyzed for each agreement below.

*Compatibility with Obligations of the SCM Agreement*

[26] Article 21.5 Panel Report, *United States – Tax Treatment for "Foreign Sales Corporations,"* WTO Doc. WT/DS108/RW (Aug. 20, 2001), at ¶¶ 8.36, 8.41.
[27] For example, "[e]very country in the OECD imposes a VAT on the destination basis with respect to cross-border transactions." Itai Grinberg, "Where Credit is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT," Georgetown University Law Center (2010), at 344 n.139.

The first question is whether the Blueprint's border adjustment meets the SCM's definition of a subsidy. As noted, the SCM definition of a subsidy includes "government revenue that is otherwise due is foregone."[28] The test is to "compare the fiscal treatment of legitimately comparable income to determine whether the contested measure involves the foregoing of revenue which is 'otherwise due', in relation to the income in question." The answer is clearly no, there is not revenue foregone which would otherwise be due. As detailed earlier, the Blueprint establishes a destination-based system of consumption taxation, under which the revenue earned from the consumption of goods and services outside the US are not subject to US tax, while those earned from consumption within are; at the same time, capital and other expenses are deducted relative to the location of production. This fundamental shift makes the analysis radically different from the worldwide system at issue in the FSC/ETI cases. The relevant benchmark for comparison is the corporate tax base as outlined in the Blueprint which exempts all revenue generated from the consumption of goods and services outside the US from tax; there are no special exemptions.[29] Moreover, this is buttressed by a footnote to the "revenue foregone" portion of the definition of a subsidy, which clarifies that "the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption…shall not be deemed a subsidy."[30] The Blueprint clearly would institute a destination based corporate tax system, thus meeting the terms of what the footnote clarifies is not a subsidy.

The second question is whether the Blueprint's border adjustability is a prohibited subsidy. As noted, prohibited subsidies are: "the following subsidies, within the meaning of Article 1…: (a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex 1;" and "(b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods."[31] Again, the answer is no. A policy must be a "subsidy" to be prohibited; as shown above, the Blueprint does not create a subsidy because it does not result in the foregoing of revenue otherwise due. The Blueprint's destination-based structure exempts all revenue from taxation where consumption of the provided goods and services occur outside the United States and footnote 1 of the SCM clarifies such a tax system is not a subsidy.

The Annex 1 illustrative list of prohibited export subsidies follows these implications of the Article 1 definition of subsidy. Footnote 1 of the SCM begins by stating "[i]n accordance

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[28] SCM, Art. 1.1(a)(1)(ii).
[29] Many commentators have compared the destination based cash flow tax to a subtraction method VAT, which is currently in place in Japan. One difference is the deductibility of domestic wages. However, there is no reason why a subtraction method VAT must be the benchmark to determine if there is foregone revenue; the destination based cash flow tax stands on its own principles of taxation and methods of defining the tax base. Moreover, many VAT systems routinely exempt products or industries, based on their social utility or political sensitivity. Indeed, some exempt small businesses as a class.
[30] SCM, at n.1.
[31] SCM, Art. 3.

with…the provisions of Annexes I through III of this Agreement…" before clearly excluding from the definition of "subsidy" the exemption of export income from taxation in destination-based systems. Annex 1 examples of what are prohibited export subsidies include "the 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."[32] Direct taxes are subsequently defined (through examples as opposed to a substantive definition) as "taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property."[33]

However, with respect to indirect taxes, Annex 1 also makes clear that a prohibited export subsidy exists only if any exemption from tax for exports is in excess of those levied on like products when sold for domestic consumption; the Blueprint does not appear to contemplate this. Indirect taxes are defined (again, through examples) 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). The Blueprint does not create a prohibited export subsidy, as it is not a direct tax. The Blueprint fundamentally changes the structure of the US tax system from an income tax system to a cash flow tax system – a destination-based, consumption-proxy tax regime. The non-taxation of revenue generated from the consumption of goods and services outside the US and the taxation of cash-flow generated from the consumption of goods and services inside the US does not - as a formal, textual matter - squarely fall within the examples listed under the definition of a direct tax in Annex 1; therefore, at a minimum, it falls into the catchall language for indirect taxes of "all taxes other than direct taxes and import charges."[34] Such an interpretation is also the only way to read all three SCM provisions in harmony and not render any of them a nullity: destination-based taxes clearly fall within the footnote, and thus do not meet the Art. 1 definition of a subsidy; destination-based taxes also do

[32] SCM, Annex 1(e).
[33] SCM, Annex 1(e), at n.58.
[34] Even without the catch-all language for indirect taxes, the Blueprint would still fit more comfortably with the examples listed in the indirect tax definition. Indeed, some commentators have noted that in a similar situation, a recent Appellate Body holding was based upon non-formalistic arguments regarding the commonality of criteria with an example provided in a list:

> In sum, the particular characteristics of the NASA procurement contracts and USDOD assistance instruments before us are such that, in our view, they are most appropriately characterized as being akin to a species of joint venture. Furthermore, these joint venture arrangements between NASA/USDOD and Boeing have *characteristics analogous* to equity infusions, one of the examples of financial contributions included in Article 1.1(a)(1)(i) of the *SCM Agreement*. We recall that, under subparagraph (i), there is a financial contribution where "a government practice involves a direct transfer of funds". Several examples of direct transfers of funds are provided. These examples are not exhaustive. Where, as here, there are *measures that have sufficient characteristics in common with one of the examples* in subparagraph (i), this *commonality* indicates to us that the measures fall within the concept of "direct transfers of funds" in Article 1.1(a)(1)(i).

Appellate Body Report, *U.S. – Measures Affecting Trade in Large Civil Aircraft - Second Complaint*, WTO Doc. WT/DS353/AB/R (adopted Mar. 12, 2012), at ¶ 624 (emphasis added).

not fall into the definition of direct tax, and thus fall into the catch-all definition of indirect tax.[35] Any attempt to read the Annex definitions as cramming a destination-based tax into the definition of direct tax, and thereby bootstrapping it into being a prohibited export subsidy, would render the text of footnote 1 a legal nullity.[36]

Moreover, some commentators have taken the overly narrow view that to be an indirect tax the tax must be applied directly to a specific product. This approach flips the fundamental nature of defining an indirect tax on its head, is contrary to the destination basis principle set forth in footnote 1 of the SCM, and would sweep in as a direct tax value added taxes that are not imposed directly on a product (thus contradicting the SCM definition of indirect tax). Well established analysis shows that direct taxes are those that are levied in the country where the producer resides (residence) or where the production is performed (origin).[37] Indirect taxes are those levied based on where the goods and services subject to taxation are consumed.[38] Therefore, a tax levied on a specific product is simply one approach to achieving the principle of destination-based consumption taxation. It does not preclude other approaches to taxing consumption. As already noted the Blueprint is structured to levy tax based on where goods and services are consumed. Thus, the legal and economic concepts of what constitutes a direct tax are consistent in showing that a destination-based tax system is not a direct tax system.

With the understanding that the Blueprint is an indirect tax, some may argue that it still runs afoul of the obligations in the SCM that the exemption or remission of taxes may not be "in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption."[39] In the case of the Blueprint, the exemption of exports from tax is not "in excess" of those levied in respect of the production and distribution of like products when sold for domestic consumption. The "excess" question is answered by analyzing the tax rate and tax base applied to the revenue from the sale of the domestically produced and distributed like product when destined for export, versus when destined for sale in the domestic market. In the

[35] With respect to SCM Article 3.1(b), which prohibits "subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods," the same analysis holds. This question focuses on the lack of a deduction for imported products versus the deductions available to domestic firms. Again, there is no subsidy because there is no revenue foregone. Moreover, as shown in the next section on GATT, when the total US tax system is taken into account, there is, in practice, no differential between the amount of taxes on imports versus domestic goods.

[36] It is well-established that an interpreter is not free to adopt a reading that would reduce whole clauses of a treaty to redundancy or inutility. ***See***, for example, Appellate Body Report, ***Brazil - Export*** *Financing Programme for Aircraft*, WTO Doc. WT/DS46/AB/R (adopted Aug. 20 1999), at ¶ 179 and note 110.

[37] See Joint Committee on Taxation, *Destination-Based Taxation and Border Adjustments*, JXC-20-17, May 22, 2017, which states: "Indirect taxes that are imposed based on the place where production of goods or services occur, irrespective of the location of the persons who own the means of production, and where the goods and services go after being produced, are examples of origin-based taxation. If, instead authority to tax a transaction or service is dependent on the location of use or consumption of the goods or services, the tax system is an example of a destination-based tax."

[38] Andrew Guzman & Joost H. B. Pauwelyn, "International Trade Law" 250 (Wolters Kluwer 2nd ed. 2008).

[39] SCM, Annex 1(g).

case of the Blueprint, the tax rate and tax base are identical (other than the exemption for export revenues). The same deductions apply in each case and the same tax rate is applied in each case.[40] As already noted, countries are free to determine what revenue is subject to tax and all destination based tax regime exempt export revenue from tax. Commentators who fixate on examples in which the final-stage exporter has less tax liability or generates a tax loss as a result of the exemption of export revenue conflate the existence of a tax loss with the existence of a remission of tax "in excess," when those are two different analyses.[41] In fact, VAT tax systems routinely result in rebates when the product is exported.[42] The Blueprint, which provides the taxpayer with a net operating loss carryforward (NOL) that can be applied against future tax liability, is arguably less generous in this context than VAT regimes where the taxpayer receives a rebate (cash) from the government.

It should also be noted that the exemption from tax for exports under the Blueprint is not a countervailable subsidy (i.e., subject to anti-subsidy duties). That is, there is not revenue foregone, as this is a destination-based tax system, and it does not fall within the SCM Article 1 definition of subsidy; thus, it cannot be countervailed.[43]

*Compatibility with GATT and GATS National Treatment Obligations*

The Blueprint does not violate the National Treatment obligation of the GATT and GATS. As noted above, the National Treatment obligations, when applied to tax policy, require that when the imported and domestic products are similar enough to be considered "like" the tax rate on imported goods must not exceed that of domestic goods (Article III:2, first sentence), while goods that are not like but compete in the marketplace or are substitutes for one another must be taxed "similarly" (Article III:2, second sentence). Commentators have fixated on the presumption that the Blueprint maintains the deductibility of wages as an allowable expense deduction when entities subject to US corporate tax (regardless of whether they are a US entity or the subsidiary of a foreign entity) determine their tax liability, but an analogous deduction is

[40] The question of whether a rebate from indirect taxes for exports is a countervailable subsidy has been examined many times by the US Department of Commerce. When determining whether the exemption from VAT taxes is "in excess" the Department has focused its analysis on whether the exported product and the like product destined for the domestic market are taxed at the same rate and on the same base. See for example, Pasta from Turkey, "Preliminary Results of Countervailing Duty Administrative Review," 81 FR 52825 (Aug. 10, 2016) and Certain Oil Country Tubular Goods from China, "Final Affirmative Countervailing Duty Determination, Final Negative Critical Circumstances Determination," 74 FR 64045 (Dec. 7, 2009).

[41] It should be noted that if the analysis of "in excess" were to extend to circumstances where a taxpayer may face different gross tax liabilities on exports versus sales of the like product in the domestic market it would call into question the ability of exporters to receive rebates under VAT regimes.

[42] "In a well functioning VAT, a registered trader with more input credits than VAT liability (for example, an exporter or firm that makes large capital investments) can obtain a refund for VAT paid in excess of input credits." Itai Grinberg, "Where Credit is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT," Georgetown University Law Center (2010), at 314.

[43] *See* SCM, Art. 1, ¶ 2, and Art. 10. Moreover, a non-prohibited (i.e., actionable) subsidy must also be found to be "specific" in order to be countervailed. SCM, Art. 1, ¶ 2, and Art. 2.

not imputed to imported goods. More specifically, commentators suggest that the tax base for imported goods and services is broader than the tax base for US produced goods and services, and therefore the total amount of tax imposed on the imports is greater than the total tax imposed on domestically produced goods and services. However, under a complete analysis, when the total tax impact is analyzed, imported and domestically produced goods and services are taxed the same, and many domestically produced goods and services are likely taxed at higher rates than their imported counterparts. Thus, the Blueprint does not run afoul of the National Treatment obligation contained in either the GATT or the GATS.

An analysis of the National Treatment provisions requires 1) a determination of the total amount of taxes paid, and 2) a comparison of those amounts between like imported and domestically produced goods and services. In the context of the second part of the analysis, as noted above the WTO obligations require that the imported products not be subject to tax "in excess" of the domestic like product. For purposes of imported products that are directly competitive with the domestic like product the imported product must be taxed "similarly." Therefore, the analysis must be applied in a manner that is specific to a comparison between like products or directly competitive products. A broad claim against the tax system as a whole does not meet this prerequisite.

When comparing the total tax burden on either like or directly competitive products for purposes of the National Treatment analysis, taxes imposed elsewhere in the US regime that contribute to the total amount of tax imposed in the course of the production of the good or service in question must be included. Therefore, it is necessary to incorporate in the first part of the analysis a determination of how much tax is raised both from the taxation of revenue under the destination-based regime and how much revenue is raised through the imposition of taxes on labor factors of production in the form of wage and income taxes on individuals. It is the combination of those taxes imposed on the domestic like or directly competitive product that ultimately determines the total tax burden imposed on the good or service in question.

The Blueprint makes no changes to the current law payroll tax system. Under the payroll tax system wage income is subject to two different payroll taxes: Medicare taxes and Old Age, Survivors and Disability Insurance (OASDI). In combination these two taxes impose a total of 15.3 percent on domestic wages.[44] Thus, all domestic wage income is taxed at a minimum of 15.3 percent. This tax is applied to all wage income when such wages are earned in the US. The US does not apply it to wages earned in a foreign country that are a component of the total costs of production of a good or service imported into the US. Thus, such foreign wage costs avoids imposition of the tax while US wage costs are subject to tax. If the US were to deny a deduction for wages paid while also continuing to subject wages to payroll taxes, the US would in effect be

[44] The Medicare portion is 1.45 percent for employer and employee and the OASDI portion is 6.2 percent for employer and employee. In addition, the total amount of wage income subject to payroll taxes may increase under the Blueprint if all income generated by pass through businesses that does not qualify for the business tax rate is subject to payroll taxes.

subjecting that wage costs to double taxation and thereby increasing the total tax burden imposed on the production of the good or service in question.

In addition to the payroll tax, most wage costs paid by the producer is also subject to individual income tax. Under the Blueprint, wage costs are subject to tax at the individual level at one of three tax rates depending on the total amount of income of the taxpayer: 12, 25, or 33 percent. Thus, for wage costs subject to even the lowest of the three tax brackets the total tax rate is 27.3 percent, which is higher than either the 20 or 25 percent tax rates applied to businesses in the Blueprint and therefore is the proxy for the burden that would be imposed as a result of the loss of the expense deduction for imported goods and services. For wage costs subject to higher income tax rates, the total tax is even higher.

Thus, a significant share of labor costs would be subject to significantly higher levels of tax for domestic entities than the actual tax equivalent would be when a wage deduction is not provided in the border adjustment for imports. Thus, for purposes of the second part of the analysis, comparison of the relative amounts of tax paid, it is clear that domestically produced goods and services are subject to similar and likely often higher levels of tax than competing imported goods and services. Therefore, a potential national treatment violation could occur only when the labor costs of the domestic like product are so low as to avoid the imposition of any individual income tax at all. Without a corresponding low-wage based (i.e., where no individual income tax is owed) like product there can be no Article III:2, first sentence, National Treatment violation. With respect to directly competitive or substitutable products (Article III:2, second sentence), the outcome is the same. While this may capture a broader swath of products to be compared, the test is that the products are taxed "similarly" and cannot be imposed for the purpose of providing protection to domestic production. As shown above, looking at the US tax system as a whole, imported and domestically produced goods are taxed similarly. Moreover, the design, architecture, and structure[45] of the Blueprint's tax rates and tax base (including border adjustability), as applied, are for the purpose of legitimate and recognized sovereign tax policy considerations, and not for protective purposes.

Some commentators have asserted that payroll and individual income taxes should not be included in the GATT national treatment analysis because they are not border adjustable or applied directly to a product.[46] Similarly to the SCM definition of an indirect tax, an overly

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[45] Appellate Body Report, *Japan – Taxes on Alcoholic Beverages*, WTO Doc. WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R (adopted Nov. 1, 1996), at 29.

[46] Some cite to a 1970 GATT Working Party Report on Border Tax Adjustments, which stated that "certain taxes that were not directly levied on products were not eligible for tax adjustment. Examples of such taxes comprised social security charges whether on employers or employees and payroll taxes." Working Party Report, *Border Tax Adjustments*, L/3464, BISD 18S/97 (adopted Dec. 2, 1970). However, the Working Party Report has not been followed in other aspects (such as its guidance on determining "likeness" among products), it has not been adopted by WTO panels or the Appellate Body, and the text itself of the GATT national treatment provisions on tax is what should govern. Namely, "[t]he products of the territory of any contracting party imported into the territory of any

narrow view of permitting border adjustability for taxes based on how clearly they apply to a product would disallow many forms of VAT taxes that are generally considered GATT consistent. Moreover, proposals to address this include removing the wage deduction (which would make the cash flow tax more similar to a subtraction method VAT), but providing a tax credit to businesses and individuals to offset payroll taxes. But this merely elevates form over substance; it is the same effective tax base subject to the same tax rates. As noted, the FSC/ETI jurisprudence counsels against elevating form over substance.[47] Many commentators argue disallowing the deduction for wages but providing a credit for wage taxes would be WTO consistent. If such a construction is WTO consistent then the current construction of the Blueprint should also be WTO consistent as it is the same tax base taxed at the same rates.[48]

**Background on WTO Dispute Settlement System**

Even if another country were to reject the analysis that the Blueprint does not violate US WTO obligations and chooses to pursue a WTO challenge, the process of the WTO challenge does not require the US to change its laws. Specifically, "[w]here a U.S. law or regulation is at issue in a WTO case, the WTO's adoption of a panel and, if appealed, AB report finding that the U.S. measure violates a WTO agreement does not give the WTO decision direct legal effect in this country. Thus, federal law is not affected until Congress or the executive branch, as the case may be, takes action to remove the offending measure."[49]

First, the WTO dispute settlement process is a multistage process that begins with consultations before any formal dispute resolution begins.[50] If the process proceeds beyond the consultation phase then a Panel to hear the dispute is formed. Countries may, and often do, appeal decisions of the Panel to the AB. Decisions are issued more quickly by the AB than a Panel.[51] Once a final decision is issued, WTO member have a reasonable period of time to comply, generally 15 months.[52] The dispute settlement process further provides for the adjudication of differences of opinion between parties as to whether the country found to violate its WTO obligations has properly remedied any violation.[53] Countries may in the event of an impasse seek permission to retaliate against another WTO member if it is ultimately determined that the country violating its

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other contracting party shall not be 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).

[47] Moreover, WTO members may show some caution before seeking to use WTO obligations to require, in effect, that another WTO member make their tax code more regressive (i.e., less progressive), for purely formalistic reasons.

[48] The same analysis holds for the national treatment analysis of services under the GATS.

[49] Congressional Research Service, "Dispute Settlement in the World Trade Organization (WTO): An Overview" (Nov. 26, 2012), https://fas.org/sgp/crs/misc/RS20088.pdf.

[50] Dispute Settlement System Training Module, "The Process – Stages in a Typical WTO Dispute Settlement Case," https://www.wto.org/english/tratop_e/dispu_e/disp_settlement_cbt_e/c6s1p1_e.htm.

[51] WTO Analytical Index, "Dispute Settlement Understanding" [hereinafter DSU], at Art. 17.5.

[52] DSU, Art. 21.3.

[53] DSU, Art. 21.5.

WTO commitments has not sufficiently remedied the violation.[54] Retaliation takes the form of suspension of trade concessions against the non-compliant country and applies until the losing country comes into compliance with its WTO obligations and any retaliation is prospective in nature only.[55] The losing country has the ability to challenge a winning country's proposed level of suspension of trade concessions through an arbitration before the original Panel that heard the case.[56]

**Conclusion**

As shown in the analysis above the Blueprint does not violate US WTO obligations. It is neither a countervailable nor prohibited export subsidy and therefore does not violate US obligations under the SCM Agreement. It is not a violation of US obligations under the SCM because there is no tax foregone that is otherwise due, it is a destination-based indirect tax, and the exemption of exports from tax is not in excess of the indirect tax imposed on the like product when sold in the US market.

The Blueprint does not violate National Treatment obligations because where domestic and imported products are directly competitive the tax burden on them is similar, due to the imposition of wage and income taxes on the labor costs faced by the domestic product. For "like" products, as a practical matter, it also meets the national treatment test.

[54] DSU, Art. 22.5.
[55] DSU, Arts. 22.3, 22.8.
[56] DSU, Art. 22.6.