PREPARED FOR THE BORDER ADJUSTMENT TAX? A U.S. AND GLOBAL PERSPECTIVE

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K&L Gates' Global Tax Group has been monitoring the potential impact of the Border Adjustment Tax (BAT) across a number of jurisdictions.

In our 14 February 2017 update, we commented that issues regarding the legality of BAT and the serious and significant international implications of its application meant that the introduction of BAT was uncertain.

In this further update we consider further the issues being raised in the United States about the BAT, look at potential challenges to the BAT by the World Trade Organization (WTO) and consider what the BAT may mean for jurisdictions outside the U.S. trading with U.S. business.

U.S. CONCERNS

The BAT is part of a comprehensive tax reform plan that would shift the U.S. system from an income tax to a cash-flow destination based consumption tax. It would operate by exempting gross receipts from exports from U.S. federal income tax, and denying any deductions for the cost of imports. The BAT would apply to sales and imports of products, services and intangibles, and affect all forms of businesses, including corporations, "pass-throughs" and sole proprietorships.

The blueprint is vague as to whether the BAT applies to financial transactions and advice. The expectation is that financial transactions will be exempted from the BAT base in some form, but that investment management services would be included in the base.

The policy of the BAT is to incentivize business activity in the U.S. by effectively penalizing imports and subsidizing exports. It is intended to discourage corporate inversions and erosion of the U.S. tax base by making transfer pricing issues moot. It also is estimated to pay for one-third of the cost of the overall tax reform bill.

The U.S. business community is pushing for tax reform in order to make U.S. companies more competitive in a global marketplace. However, because the BAT rewards exporters and punishes importers, the proposal has ironically divided the very business community that is driving reform. While importers could potentially have a larger tax liability than book income, exporters could potentially experience a negative tax situation, since their costs would remain fully deductible (assuming they were not imported). The controversy extends beyond the business community. Consumer groups fear the BAT will result in higher prices. Importers fear U.S. consumers

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would work around the tax by buying directly from offshore vendors. The BAT could spur increased mergers and acquisitions, as net exporters seek companies with income sufficient to offset negative taxable incomes.

House Republicans, who proposed the BAT, say the value of the U.S. dollar will increase concomitantly with the tax increase, effectively increasing the buying power of importers and thus mitigating the impact of the BAT. Economists and other analysts are mixed in their reaction as to how the dollar will react. Since many international contracts are denominated in the U.S. dollar and because many currencies are not free floating, it is unclear to what extent any fluctuation in the dollar will offset the impact of the BAT.

Further, it is unclear whether the Trump Administration will endorse the BAT. There have been mixed messages from the White House, but President Trump has made it clear he would like to impose some sort of levy on imports to level the playing field for U.S. businesses and to bring jobs back to the U.S.

WTO IMPLICATIONS

While the focus has been on the impact on U.S. businesses and consumers, there are significant and serious international implications of the BAT. It is unclear whether the BAT would violate WTO protocols and a challenge from the WTO seems almost certain.

The WTO's Agreement on Subsidies and Countervailing Measures (**SCM Agreement**) only allows border adjustability for taxes imposed on products, the most common of these being value added taxes, sales tax and stamp duties. Whilst there seems to be some argument that a BAT is similar to a value added tax as it is focused on destination based consumption, the majority of commentators disagree with this analysis saying that the proposed BAT is a true corporate tax which in effect imposes a discriminatory subsidy in favour of net exporters. Further, the SCM Agreement prohibits the subsidizing of exports and of the use of domestic over imported goods.

Article II of the General Agreement on Tariffs and Trade (GATT) prohibits charging tariffs in excess of those in each country's tariff schedule. The denial of deductions for the cost of imports could be considered equivalent to a tax on the imports themselves. In WTO terms, this could be viewed as the imposition of tariffs in excess of those provided for in the U.S. schedule or might violate the Article II requirement not to impose "other" duties or charges on imports. Article III of the GATT, which sets forth what are known as "national treatment" principles, generally requires that imports be treated no less favorably than domestically-produced goods. To the extent the BAT permits certain deductions (such as the cost of domestic wages), and thus generates lower tax rates for domestically-produced goods, while denying the same deductions for the same imported products, it would seem to violate the basic national treatment rules of the WTO.

THE EFFECTS OF THE BAT WILL EXTEND FAR BEYOND THE U.S. BORDER

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The European Union (**EU**) has already clarified it will not stand by without taking responsive action. Officials from jurisdictions like Canada, Mexico and Germany, have indicated their disapproval and concerns about the BAT. The impact on tax treaties, intended to prevent double taxation, is unclear. Many think a U.S. exemption from taxation of exports will result in a shift of the location of taxation, with non-U.S. jurisdictions taking custody of the income and taxing it. Countries around the world are concerned about how the denial of a deduction for the cost of imports and the strengthening of the U.S. dollar will affect the demand for their products, and their ability to afford products from the U.S.

Being a destination based cash flow tax, the BAT is not consistent with a corporate tax system, it goes against current principles of international taxation underlying the double tax treaties, and is not in alignment with the more recent global Base Erosion and Profit Shifting Rules (**BEPS**) initiatives launched by the Organisation for Economic
Co-operation and Development (**OECD**), Australia and the European Union.

Initial observations as to the BAT:

- Granting a corporate income tax exemption on income derived from exports leads to a reduction of the income tax base and qualifies economically as a subsidy.
- Disallowing a deduction for expenses relating to imports from the U.S. corporate tax base is effectively an increase of the tax base.
- Due to its nature as a destination-based (cash-flow) tax, it is often compared to the European style value added tax (VAT) or the Australian goods and services tax (GST). However, the proposed BAT substantially differs from VAT and GST, e.g., in that:
  - VAT and GST is typically economically neutral for most businesses; and
  - end-consumers bear the same VAT burden irrespective of whether the services and supplies originate from the domestic market or from abroad.
- Materially, the BAT appears to be a customs duty collection tool dressed in an income tax garment.

Economically, it has been said that BAT will eventually be trade neutral, due to the expected increase of the value of the U.S. dollar, however the value of a currency is also influenced by many other factors. In addition, it may be questioned whether (potential) effects on the exchange rate can be taken into consideration when analyzing and discussing the application of existing domestic and international tax law.

It is too early to finally assess the potential reaction of other countries on a potential enactment of the BAT by the U.S. In case of an enactment, many details will have to be better understood such as whether and how cross-border income payments from outside the U.S. (e.g., interest, royalties, dividends) will be subject to tax but exempted or rather be excluded from tax. In case of substantial frictions with the current tax systems, the reaction

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in Europe for example, may be a combination of both, a reaction at EU level as well as consequences drawn by individual member states.

Some states may question the income tax nature of the BAT or deny certain benefits such as treaty benefits based on applicable "subject-to-tax" clauses or alike. Whether or not certain states will go beyond that by requesting changes to the existing Double Taxation Treaties or their interpretation remains to be seen. Why for example should a country apply reduced withholding tax rates on royalties or alike if the respective income is not taxed in the U.S. for reasons of impeding the free trade between the U.S. and that particular country?

BAT may well also impact the current approach to globally harmonize the common understanding of fair international taxation, including the battle against the so-called BEPS which was triggered by biased rules governing international taxation.

Australia

Australia has been an early adopter for many of the OECD BEPS measures. It has recently passed legislation to implement a diverted profits tax, similar to that in the United Kingdom, a "Netflix" tax being a GST on intangible supplies via a digital platform operator by non-resident suppliers to Australian consumers. It has also introduced the Multinational Anti Avoidance Law to combat tax avoidance by multinational companies operating in Australia.

These measures show an increasing focus on cross border flows of business, and a move toward a destination model of taxing rather than an origination model. That is consistent with the BAT principles. However, given that the U.S. is Australia's biggest trading partner and a destination of choice for many Australian companies seeking to expand globally, the impact of the BAT for Australian business cannot be underestimated.

While much of the focus in the U.S. has been on the impact of BAT on the import and expect of manufactured goods and products, cross border utilisation of intellectual property, intangibles, and management and head office charges are likely to be an area of ongoing focus as the BAT works its way through the legislative agenda.

France

The BAT could jeopardise the application of the tax treaty entered into by the U.S. and France. According to the most recent case law of the French high administrative court (Conseil d'Etat), treaty benefits must only be granted where there is an effective double taxation. If a French company pays a royalty to a U.S. company, such royalty will be exempt in the U.S. and the French revenue may take the view that the treaty does not apply. French domestic withholding tax of 30% may apply accordingly.

The BAT would clearly contradict some of the provisions of this treaty. By way of example, Article 7 provides that in determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are reasonably connected with such profits, whether incurred in the State in which the permanent establishment is

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situated or elsewhere.

Germany

Germany has also been an early adopter of the BEPS rules – to the extent such rules were not already enacted before as German rules fighting cross-border base erosion and profit shifting were already rather sophisticated.

A mere reduction of the U.S. corporate income tax rate itself should generally not be of a concern from a German tax perspective. However, for purposes of the application of the Controlled Foreign Corporation (CFC) and Passive Foreign Investment Company (**PFIC**) rules pursuant to the German Foreign Tax Act, there will be an issue where the effective corporate income tax burden in the U.S. drops below 25%, measured by German tax standards.

However, Germany would certainly not welcome substantial single-sided impediments on the free trade imposed by BAT or other means.

United Kingdom

For United Kingdom businesses that export to the U.S., the introduction of a BAT could have far reaching consequences for sales, FX strategy and business organisation.

One area of particular difficulty relates to cross-border financial services (UK outbound and inbound): it is not yet clear how a BAT would deal with these (VAT systems are themselves complex in this area). Useful practical strategies may be drawn by U.S. businesses in conjunction with advisers both in the U.S. and jurisdictions with VAT systems, like the United Kingdom, as and when any BAT reform is rolled out in detail.

On a more general level, tax issues have gained a higher profile in the UK over the last few years. Like many other jurisdictions the UK is actively adopting the recommendations of the OECD's BEPS initiative and actively encouraging EU policy to endorse the same. The UK's implementation of these OECD recommendations has resulted in the UK seeking to tax profits created in UK, and trying to ensure that where value has been created in the UK that value is not artificially diverted for tax purposes to offshore jurisdictions.

The current UK Government's enthusiasm for these OECD initiatives (and the automatic exchange of tax information including private tax rulings) is a continuation from the previous administration, faces little or no political opposition and is not in any way contaminated by BREXIT.

It can be noted that the OECD BEPS initiative's overarching economic goal to ensure that value is taxed where it is created (not located) in fact, with increased attribution to human resource (rather than capital or IP), is not necessarily incompatible with the political objective of the Blueprint to increase value creation in the U.S. (and

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taxing it there).

Global high brand value service and product suppliers, and other businesses which are head-quartered outside of the UK, argue that the value of their sales derives from their domestic jurisdictions where their global high value brand products or IP was developed and where their technicians, designers, board etc. are based. As a result, value is not derived from a UK based sales centre, the services of which, if outsourced, would only cost a small amount in fees or commissions. It will be interesting to see how the lobby groups for U.S. based multinationals and a post-BREXIT UK each respond to the EU Commission's state aid challenges, which were aimed at preventing low EU tax on EU sales. It may prove harder to resist greater taxation in the EU if there is no domestic tax in the U.S. in relation to the EU operations.

In addition to the policy arguments there are also technical issues with how the UK's value based approach will sit with the proposed destination based approach in the US. For example, the U.S.-UK double tax treaty currently deals with direct taxes (such as federal profits, income and gains taxes) and is predicated on traditional tax bases such as residence and source and does not address indirect taxes (like VAT) at all. How this will be applied in the context of the U.S.-UK double tax treaty is not clear.

CONCLUSION

Given both the uncertainty regarding the intricacies and workings of the BAT as well as how it will interact with existing Double Tax Treaties, the introduction and operation of the BAT remains unclear.
The impact of the proposed tax on net importers vs net exporters divides the business community and creates further uncertainty in an already uncertain economy. The same applies to the consequences on the application and interpretation of domestic tax and international tax law outside the U.S. It is hoped that detailed legislation as well as commentary addressing the concerns of the U.S. domestic and international community will go some way in resolving these issues in a time efficient manner.

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