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# Worries about NAFTA Take Back Seat to Potential "Border Adjustment Tax"

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Companies importing goods into the U.S. should pay very close attention to the serious discussions now taking place in Washington, D.C. regarding a major restructuring of the U.S. corporate income tax scheme to include a "border adjustment tax" feature. If such a proposal becomes law, which suddenly looks possible, it would have a radical effect on cross-border trade, mooting concerns about any threats to renegotiate NAFTA and other free-trade agreements.

***Basic Background***

Currently, U.S. companies pay a 35-percent income tax on their worldwide profits. In calculating its profits, a company subtracts its costs and expenses from its revenues and is able to take other deductions available in the U.S. tax code. Under the new proposal, under serious consideration by the Republican Congress and the incoming Trump administration, the income tax rate for U.S. companies would decrease to 20-percent and the tax would be not be assessed on worldwide income. Instead, a U.S. company would pay the 20-percent tax on the amount equal to the company's domestic revenues less its domestic costs. Therefore, because the tax scheme imposes a tax based on the place of the production and sale of the product, the proposed tax is also referred to as a "destination-based cash flow tax."

***Exports vs. Imports***

Pursuant to the proposal, a U.S. company would not be taxed on its export sales, but only for sales made within the U.S. On the other hand, the costs associated with any imported goods or supplies used in sales in the U.S. would not be deductible expenses. In other words, if a U.S. company imported component parts or raw materials, the costs of these imports would not be deductible, and the U.S. company would pay a 20-percent tax on these imports.

For example, consider the case where Company A sells a product for $100, which costs $80 for the company to produce in the U.S. (and all costs were incurred in the U.S.) In such a case, Company A would pay a tax of $4 (20 percent of $20, the difference between $100 and $80).

Next, consider the case where Company A sells a product for $100, but it imports that product into the U.S. at a cost of $80. In such a case, Company A would pay a tax of $20 (20 percent of $100), because it can only deduct domestic costs and not imported costs associated with the sale of the product.

Finally, in the case where Company A exports a product and sells it abroad, it would pay no income tax in the U.S. from the sale of that product (it's somewhat unclear how the costs for imported or domestic components of exported products would be treated).

***Stronger U.S. Dollar?***

In order for a U.S. company to continue to import goods and still make the same profit on its product sales in the U.S., it would seem that the company would need to raise the sale prices of its product. However, some noted economists (most recently, Harvard's Martin Feldstein, in a commentary written in the *Wall Street Journal* on Jan. 5, 2017) contend that this would not need to happen because the value of the dollar would rise dramatically as a result of such a new tax scheme. Accordingly, the relative cost of importing goods would be cheaper for the U.S. company. To achieve such an

offset, the dollar would have to appreciate by at least 25-percent. But other economists dispute the contention that the U.S. dollar would appreciate sufficiently in order to offset the non-deductibility of the import, and therefore lead to inflation.

***Trade Law Concerns***

The proposed "border adjustment tax" would almost certainly be challenged by other countries in the World Trade Organization on the grounds that it is a discriminatory subsidy. This is because it would allow U.S. wages to be deducted, which would not be available to foreign companies with respect to foreign wages. While the WTO allows border adjustments for consumption-based taxes ("indirect taxes," such as value-added taxes), it has objected to allowing border adjustments for income-style taxes ("direct taxes").

Notably, if the "border adjustment tax" was implemented and immediately challenged as violating WTO rules, it could likely take several years before it would need to be unwound. This is because, in most cases, formal responses by the WTO are imposed prospectively after a three-year litigation period. Moreover, many WTO rulings are implemented in the form of suspending concession or other obligations in amounts equivalent to the impairment of WTO rights resulting from the violating measures. Of course, what is most worrisome is that this could facilitate a breakdown in the WTO and trigger further trade wars.

***What Should Companies Do?***

At this time, no bill has been introduced in the U.S. Congress to change the corporate income tax scheme to a destination-based cash-flow tax with the border-adjustment features. Under the U.S. Constitution, such a bill must originate in the U.S. House of Representatives, and cannot be effectuated without the approval of both houses of Congress and the president's approval. However, more serious consideration and attention are being given to this proposal, as it seems to address two major campaign promises by the new president-elect: lower the corporate income tax rate and encourage U.S. based production of goods.

If a bill is introduced and approved, it is likely to happen quickly, and it will have a significant material adverse effect on contracts between U.S. companies and their foreign suppliers. It would be prudent for companies to review their current contracts. Miller Canfield will be continuing to monitor the situation and to advise clients accordingly.

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