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Tax Management
Transfer Pricing Report™

Will Border Adjustment Tax End Transfer Pricing as We Know It?

The House Republican blueprint for tax reform includes a destination-based cash flow tax that favors exporters over importers. In this article, the author discusses the benefits and drawbacks of the GOP proposal and its impact on trade and transfer pricing.

BY CLARK ARMITAGE, CAPLIN & DRYSDALE CHARTERED

Republicans in Congress are pressing forward with a corporate tax reform package that includes a ''border adjustment'' feature. The destination-based cash flow tax (DBCFT) is meant to encourage U.S. manufacturing, simplify the corporate income tax, and eliminate the benefits of abusive cross-border transfer pricing.

This article explains how the tax is meant to operate, summarizes how it would encourage manufacturing, explains its likely impact on international transfer pricing, and offers some thoughts on the likelihood of passage. In short, while the DBCFT could encourage U.S. manufacturing (by providing a comparative tax benefit), it would not eliminate transfer pricing controversy (rather, in some ways, controversy would expand), and its passage likely will be opposed by many U.S. and non-U.S. interests.

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How the DBCFT Would Work

The basic rules for calculating U.S. taxable income under a DBCFT are:[1]

- Revenues from U.S. sales are included in taxable income.
- Revenues from non-U.S. sales are not.
- Costs of U.S. inputs are deductible from taxable income.
- Costs of foreign inputs are not.
- Sales by foreign persons directly to U.S. consumers should be subject to the tax or some alternative.

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[1] Most of these items are specified or implied in the Republicans' ''A Better Way'' blueprint. See http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf. While the blueprint does not specify the rebate feature, it does praise the rebate feature of the typical value added tax: ''Today, all of our major trading partners raise a significant portion of their tax revenues through value-added taxes (VATs). These VATs include ''border adjustability'' as a key feature. This means that the tax is rebated when a product is exported to a foreign country and is imposed when a product is imported from a foreign country. These border adjustments reduce the costs borne by exported products and increase the costs borne by imported products.'' Also, summaries of the DBCFT often omit the fifth rule: that sales by foreign persons directly to U.S. consumers should be subject to the tax or some alternative. For reasons summarized below, applying the tax to direct inbound sales seems necessary to protect the DBCFT base.

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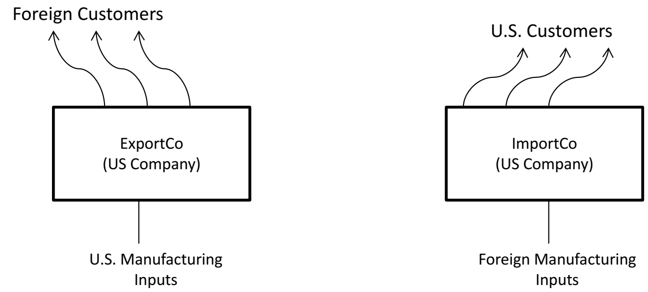
■ The resulting net would be subject to a tax rate of 20 percent.[2]

■ The negative DBCFT on a loss would be rebatable.

Slide A (below) illustrates how these rules might apply to a pure exporter and a pure importer.

■ The DBCFT would reduce U.S. taxes on exports. Theoretically, this reduced cost would be passed through to consumers in foreign countries through competition from other U.S. companies or to gain market share.

SLIDE A



Income Statements

ExportCo Income Statement		ImportCo Income Statement	
Foreign Net Sales (€100=)	$100	U.S. Net Sales	$100
U.S. COGS	- $80	Foreign COGS (Yuan 80=)	-$80
Operating Profit	$20	Operating Profit	$20

DBCFT Outcomes

ExportCo DBCFT Tax Return		ImportCo DBCFT Tax Return	
Includible Gross Revenue	$ 0	Gross Revenue	$100
Deductible U.S. COGS	-$80	Foreign COGS	$0
Taxable Income	-$80	Taxable Income	$100
Tax at 20%	$16	Tax at 20%	-$20
After-Tax Net Income	$36	After-Tax Net Income	$0

ExportCo generates 100 euros in foreign sales (assumed to be equal to $100), incurs $80 of U.S. COGS, and earns operating profit (OP) of $20. Under the DBCFT, ExportCo would have no includible revenue, and so report a taxable *loss* of $80 and receive a tax rebate of $16. Its after-tax net income would thus be $36 ($20 of OP + $16 of tax rebate). Conversely, ImportCo, with $100 of U.S. sales and 80 Yuan of foreign COGS (assumed equal to $80) would report taxable income of $100 and pay $20 of tax. Its after-tax net income would be zero ($20 of OP – $20 of tax).

In simple terms, exporters would be winners and importers losers.

Importance of Currency Exchange Rate Adjustments

But the backers of the DBCFT tell us that the above calculus won't hold. Instead, the U.S. dollar will immediately appreciate against all foreign currencies, eliminating the DBCFT's benefits to ExportCo and its costs to ImportCo. It is difficult to capture in a sentence or two the macroeconomic imperative that would cause the U.S. dollar to appreciate (see Martin Feldstein's analysis in the *The Wall Street Journal*),[3] but the following bullets summarize the basic tenets:

■ The DBCFT would increase U.S. taxes on imports. Theoretically, the cash-register prices of imported products would need to increase to cover the extra tax.[4]

■ Both of the above responses would tend to reduce the U.S. trade deficit (that is, more exports and fewer imports).

■ But the U.S. trade deficit cannot fall merely because of changes in the U.S. tax system. The U.S. trade

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[2] The blueprint indicates the rate would be 20 percent. As far as the author is aware, there has been no scoring of the DBCFT. Accordingly, there is no basis for determining whether a 20 percent rate would achieve revenue neutrality.

[3] In ''The House GOP's Good Tax Trade-Off,'' *Wall St. J.*, Jan. 5, 2017, Feldstein explains:

> If the exchange rate remained unchanged, the higher prices of U.S. imports [necessary to pay the additional tax] would reduce the U.S. demand for imports and the lower dollar price of U.S. exports [permitted by the newly reduced tax and forced by competition] would raise the foreign demand for American exports. That combination would reduce the existing U.S. trade deficit.
>
> But as every student of economics learns, a country's trade deficit depends only on the difference between total investment in the country and the saving done by its households, businesses and government. This textbook rule that ''imports minus exports equals investment minus savings'' is not a theory or statistical regularity but a basic national income accounting identity that holds for every country in every year. That holds because a rise in a country's investment without an equal rise in saving means that it must import more or export less.
>
> Since a border tax adjustment wouldn't change U.S. national savings or investment, it cannot change the size of the trade deficit. To preserve the original trade balance, the exchange rate of the dollar must adjust to bring the prices of U.S. imports and exports back to the values that would prevail without the border tax adjustment. With a 20 percent corporate tax rate, that means that the value of the dollar must rise by 25 percent.

[4] This is theory. In practice, U.S.-based manufacturers may be able to undercut prices, depending on relative costs of production.

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deficit does (and must) equal the difference between actual investment in the U.S. and actual U.S. savings. Since U.S. persons save less than is invested in the U.S., and this fact would not be changed by the DBCFT, the U.S. trade deficit must persist.

■ To preserve the trade deficit, the theoretical price changes described in the first two bullets above cannot occur. Instead, the U.S. dollar must appreciate against foreign currencies to prevent those changes.

Assuming that exchange rates move as predicted,[5] what happens to ExportCo and ImportCo? As shown on Slide B (below), both companies end up earning after-tax net income of $16 (that is, what they would have earned pre-DBCFT under a typical corporate income tax system with a 20 percent rate). Here's why:

■ Due to the change in exchange rates, both companies leave their local-currency prices unchanged. ExportCo continues to generate 100 euros in foreign sales and ImportCo $100 of U.S. sales.

■ For ExportCo, the U.S. dollar equivalent of 100 euros of sales is now only $80. ExportCo therefore earns no OP ($80 - $80 = $0), but receives a tax rebate of $16 to earn after-tax net income of $16.[6]

■ For ImportCo, the U.S. dollar equivalent of its Yuan costs is $64 (that is, 80 percent of $80). ImportCo therefore earns $36 of OP ($100 - $64), pays tax of $20, and earns after-tax net income of $16 ($36 - $20).

Because of the change in exchange rates, import and export prices should remain unchanged and taxpayers should not be harmed or helped by the DBCFT.

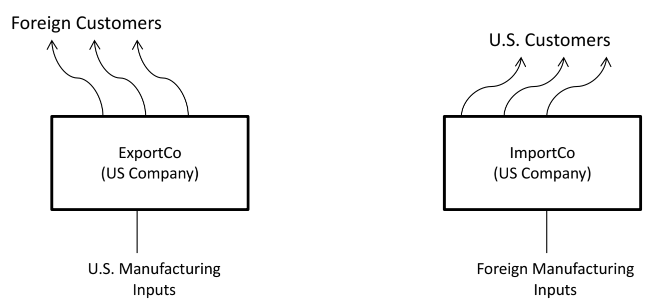
But if the expectation is that the DBCFT will increase U.S. manufacturing, the anticipated change in exchange rates would seem to defeat that policy purpose. So, what would the DBCFT achieve? The answer seems to be that, provided U.S. trading partners do not respond in a way that defeats the effects of the DBCFT (more on that below), the DBCFT would allow U.S. companies that manufacture in the U.S.—either for domestic or foreign consumption—to pay only one country's tax, while companies manufacturing offshore would pay two. Slides C and D (below) illustrate how this would work.[7]

[5] No view is expressed here on whether exchange rates would change as predicted. There is, however, great doubt on this front, which has implications (as discussed below) for whether U.S. taxpayers would be willing to support a DBCFT.

[6] Note 1 quotes the blueprint's apparent analogy of this rebate to the VAT rebate. One may question whether the two are truly analogous. The DBCFT rebate is attributable to the deduction for the expenses of the export, while such expenses are not deductible under a VAT and, instead, the VAT rebate returns taxes previously paid that relate to foreign value added.

[7] In order to isolate the tax effects of the DBCFT, Slides C and D assume, probably unrealistically for most situations, the same level of pre-DBCFT U.S. dollar domestic and foreign production costs.

SLIDE B



Income Statements

ExportCo Income Statement		ImportCo Income Statement	
Foreign Net Sales (€100 =)	$80	U.S. Net Sales	$100
U.S. COGS	- $80	Foreign COGS (Yuan 80 =)	-$64
Operating Profit	$0	Operating Profit	$36

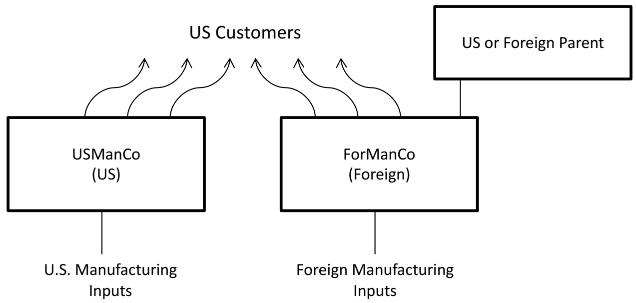
DBCFT Outcomes

ExportCo DBCFT Tax Return		ImportCo DBCFT Tax Return	
Includible Gross Revenue	$ 0	Gross Revenue	$100
Deductible U.S. COGS	-$80	Foreign COGS	-$0
Taxable Income	-$80	Taxable Income	$100
Tax at 20%	$16	Tax at 20%	-$20
After-Tax Net Income	$16	After-Tax Net Income	$16

Slide C (below) compares the DBCFT outcomes for domestic and foreign manufacturers selling to U.S. consumers. As in Slide B, the non-deductibility of foreign COGS exactly offsets the reduction in the U.S. dollar value of the foreign COGS that results from the change in exchange rates. Both USManCo and ForManCo thus earn $16 of post-DBCFT net income. The foreign producer is worse off, however, because it must also pay a foreign tax on its manufacturing profits (in this case to China where its manufacturing is located). ForManCo is worse off than USManCo by the amount of that foreign tax.[8] This is true whether the foreign tax rate is 5 percent or 40 percent.

[8] Slides C and D assume that ForManCo is subject to the DBCFT. The exact incidence of the tax depends on the corporate structure. The tax may be assessed directly on ForManCo if it has a U.S. presence, or indirectly when paid by a related or unrelated U.S. business or consumer. In the latter case, ForManCo notionally bears the tax (that is, it must adjust its prices to allow the U.S. person to pay the tax).

SLIDE C



Income Statements

USManCo Income Statement		ForManCo Income Statement	
US Net Sales	$100	US Net Sales	$100
US COGS	- $80	Foreign COGS (Yuan 80 =)	-$64
Operating Profit	$20	Operating Profit	$36

DBCFT Outcomes

USManCo DBCFT Tax Return		ForManCo DBCFT Tax Return	
Includible Gross Revenue	$100	Gross Revenue	$100
Deductible U.S. COGS	-$80	Foreign COGS	-$0
Taxable Income	$20	Taxable Income	$100
Tax at 20%	-$4	Tax at 20%	-$20
After-Tax Net Income	$16	After-Tax Net Income	$16
		Chinese Tax	-¥X

Analogously, Slide D (below) shows that, where the target market is foreign, the DBCFT favors U.S. manufacturing over foreign manufacturing (at least for U.S.-parented companies). In this case, the reduced U.S. dollar value of USManCo's foreign sales (from $100 to $80) is offset by the DBCFT's reduction in U.S.ManCo's tax (from $4 to a tax loss rebate of $16). USManCo thus earns $16 of post-DBCFT net income. Under a territorial system, ForManCo is not subject to the DBCFT on foreign sales of foreign-manufactured products, so it pays $0. It does, however, pay tax in China, where the goods are manufactured. Again, the foreign producer is worse off than the domestic producer by the amount of foreign tax paid.[9]

The real benefit of the DBCFT is in effect a kind of tax arbitrage. U.S. companies that produce in the United States pay only one tax. U.S. companies that manufacture abroad pay two. It's worth stopping at this point to note an irony: the United States is attempting to prevent taxpayers from engaging in tax-rate arbitrage by creating a system that provides for permanent tax arbitrage in favor of the United States.[10]

[9] Unlike Slide C, which holds true for both foreign and U.S. parents, the Slide D fact pattern is likely relevant only to U.S. parents, which will account for and eventually repatriate the foreign manufacturing company's post-tax earnings.

[10] A VAT has similar characteristics, but other countries have adopted VAT in addition to a corporate income tax system rather than in lieu of one.

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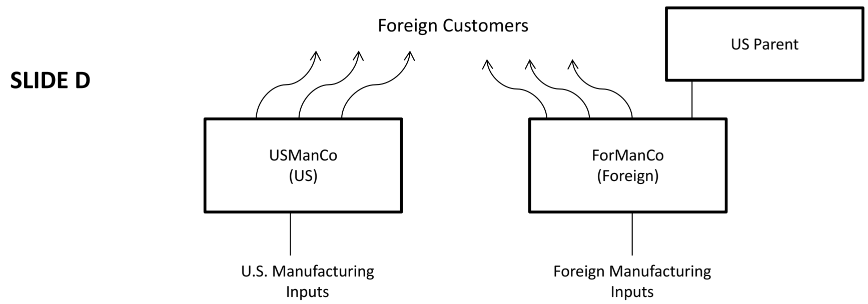

Income Statements

USManCo Income Statement		ForManCo Income Statement	
Foreign Net Sales	$80	Foreign Net Sales	$80
U.S. COGS	- $80	Foreign COGS (Yuan 80 =)	-$64
Operating Profit	$0	Operating Profit	$16

DBCFT Outcomes

USManCo DBCFT Tax Return		ForManCo DBCFT Tax Return	
Includible Gross Revenue	$0	Gross Revenue	$0
Deductible U.S. COGS	-$80	Deductible Foreign COGS	-$0
Taxable Income	-$80	Taxable Income	$0
Tax Loss Rebate at 20%	$16	Tax at 20%	-$0
After-Tax Net Income	$16	After-Tax Net Income	$16
		Chinese Tax	-¥X

Is International Transfer Pricing A Dead Letter Under DBCFT?

In a paper released Nov. 30, 2016,[11] Alan Auerbach and Douglas Holtz-Eakin assert that ''[b]order adjustments eliminate the incentive to manipulate transfer prices in order to shift profits to lower-tax jurisdiction.''[12] The author thinks this is an overstatement and probably the wrong way for U.S. tax executives to think about the DBCFT. While transfer pricing planning to avoid or reduce U.S. tax would be reduced, it likely would not end, and foreign countries would likely be more interested than ever in international transfer pricing into and out of the U.S. The article here addresses how the DBCFT may affect transfers of tangible goods, services and intangibles into and out of the U.S.,[13] special considerations regarding direct foreign purchases by U.S. consumers, and the potential implications for existing and potential future IRS advance pricing agreements.

Tangible Property Transfers

Referring to Slide A, under DBCFT, the IRS does not care what price ExportCo charges to a foreign subsidiary (Country A Sub) for goods. Because foreign sales are excluded from ExportCo's revenue, its U.S. taxable income under the DBCFT would be the same whether its pricing to Country A Sub results in $100 or $200 of revenue. The Country A tax administration, on the other hand, will care because Country A Sub presumably gets a tax deduction or other benefit for the price paid to ExportCo. A price of $100 may leave Country A Sub with some taxable income, while a price of $200 may push it into the red.

ImportCo's foreign purchases involve a similar dynamic. Because those purchases are non-deductible in the U.S., ImportCo has every incentive to minimize the price it pays to its foreign manufacturing subsidiary (Country B Sub). A lower price reduces Country B income and so reduces Country B tax. The Country B tax administration will want to watch closely.[14]

The Auerbach report identifies the potential incentive for U.S. taxpayers to maximize export prices and minimize import prices, but without acknowledging the transfer pricing tension it creates: ''Thus, the multinational would have no incentive to use transfer prices to shift profits away from the United States . . . . Indeed, it would benefit by shifting profits *to* the United States to reduce the taxes it pays in the low-tax country.'' While the DBCFT creates this incentive for low-tax countries, the incentive is even greater where the foreign country is relatively high-taxed. It is this reality that creates the largest vulnerabilities for the DBCFT.

[11] ''The Role of Border Adjustments in International Taxation,'' www.americanactionforum.org/research/14344.

[12] The Auerbach report acknowledges that the purported trade benefits of a border adjustment feature are not real: ''border adjustments, in themselves, should not influence international trade, either by discouraging imports or encouraging exports.''

[13] One conceivable iteration of the DBCFT would deny deductions for U.S. costs incurred in connection with foreign sales. This iteration is unlikely since one purpose of the DBCFT is to encourage U.S. activity. If such a rule were enacted, it would require companies to allocate costs between U.S. and foreign sales, which could involve application of transfer pricing principles.

[14] The author considered whether application of the DBCFT to a value chain with goods manufactured partly within and partly outside the U.S. would alter these basic outcomes and concludes that it would not. For example, if a U.S. company manufactures components, sells them to its Mexican subsidiary for assembly, and imports the finished product back into the United States for sale to unrelated U.S. persons, the DBCFT would allow a deduction for U.S. inputs and tax the revenue from sales to unrelated U.S. persons. The other transactions would effectively be ignored for U.S. purposes and taxed for Mexican purposes.

Transfers of Services and Intellectual Property

The above discussion concerns transfers of tangible property—goods. The application of the DBCFT to services transactions and intellectual property (IP) licenses likely would be more complicated. While the place of consumption of tangible goods typically is known—they either left the country on a ship (and were consumed overseas) or arrived in the U.S. on a ship (and were consumed domestically)—the consumer of services and IP is more difficult to ascertain.

For example, if a U.S. contract research organization provides R&D services to a multinational pharmaceutical company, is the consumer the U.S. distributor (in which case the sales are includible under DBCFT), the foreign parent (excludible), or both (partially includible)? This determination could involve the application of transfer pricing or like principles.[15]

Exports and imports of IP would involve similar and perhaps amplified considerations. The DBCFT would create incentives for U.S. companies to ''produce'' IP in the United States for export since the royalty income presumably would be exempt from U.S. taxation and deductible overseas. The IRS would seem to have little incentive to police what it means for IP to be produced in the United States, while foreign countries would have every incentive.

Effect of the DBCFT on APAs

The DBCFT also raises intriguing questions about the long-term viability of APAs, which are subject to cancellation in the event of material changes in the law or governing regulations.[16] Rev. Proc. 2015-41 provides that: ''If controlling U.S. case law, statutes, regulations, or treaties change the federal income tax treatment of any matter covered by the APA, the new case law, statute, regulation, or treaty provision supersedes any inconsistent terms and conditions of the APA.''[17] Would enactment of the DBCFT constitute such a change? The author believes some APAs would survive this analysis, others would not, and that the determination would need to be made on a case-by-case basis.

An APA that relies on a comparable uncontrolled price (CUP) likely would be canceled. For example, a CUP based on the pre-DBCFT U.S. dollar price paid by a U.S. distributor to an unrelated third party would seem no longer to provide a reliable benchmark for post-DBCFT prices paid by the U.S. distributor to its foreign parent. The CUP could not capture (absent an agreed adjustment among the parties to the APA) the reduction in price accompanying enactment of the DBCFT.

An APA that relies on a comparable profits method (CPM) might survive, however. Since the CPM assesses compliance based on the tested party's financial-statement operating profit, adoption of the DBCFT may not change the outcomes.

Also important to this inquiry is whether an APA is unilateral or bi/multilateral. For bi/multilateral APAs, since the IRS will have less incentive to monitor post-DBCFT transfer prices, the question of continued enforceability likely would be more relevant to the foreign tax administration(s) (assuming those tax administrations accept continued enforceability of the APA after DBCFT).

Many U.S. unilateral APAs may simply cease to be relevant since no foreign tax administration is bound by their terms. The IRS generally should not care.

For all types of APAs, U.S. taxpayers may choose to opt out. This could be accomplished by altering the structure of the covered transactions in a manner that undermines one or more critical assumptions. Such changes may be desirable in light of enactment of the DBCFT (for example, where the APA involves IP that the taxpayer decides to transfer (back) to the United States).

Going forward, it seems likely that fewer U.S. APAs of any kind would be sought. The IRS would have little incentive to engage on its own behalf and foreign competent authorities would understand that the IRS is operating only on behalf of the taxpayer.

Direct Foreign Purchases, Including by Exempt Organizations

As noted at the beginning of this article, where a foreign producer sells directly to an ultimate U.S. consumer, the DBCFT likely must be applied to the purchase. Absent this rule, U.S. persons purchasing goods for personal consumption could avoid the tax by purchasing directly from foreign sellers that lack U.S. taxable presence (for example, through a foreign website).[18] Given the lack of nexus of the foreign seller, Congress will either need to apply the tax to the U.S. purchaser (likely creating collection issues), or tax at the border (which will more closely resemble a tariff, creating potential trade issues). This challenging problem is even more difficult in the case of U.S. consumers' direct purchases of foreign services (for example, legal or accounting services for individual consumption). For all types of transactions, it seems likely that collection of the tax from U.S. consumers will create significant controversy, exceeding even the battle over collecting state sales taxes from remote sellers.

Would the rule about foreign producers apply if the consumer were an exempt organization (EO)? The an-

[15] If the U.S. contract research organization treats the sales as foreign (and excludes them), the U.S. distributor would lose a deduction. But this may be preferable to the parties on the whole if the foreign tax rate is higher than the U.S. rate or if the U.S. distributor is in a loss position. Unrelated companies may want a contractual understanding regarding the identification of the consumer. For example, while the U.S. contract research organization may want the consumer to be the foreign parent, the multinational may want the U.S. distributor to be the consumer and receive the deduction. The IRS would undoubtedly closely review such understandings.

[16] Unless the parties agree to revise an APA, the Advance Pricing and Mutual Agreement (APMA) program of the IRS ''will cancel an APA in the event of a failure of a critical assumption or a material change in governing case law, statute, regulation, or applicable treaty.'' See Rev. Proc. 2015-41, 2015-35 I.R.B. 263, §7.06(3).

[17] *Id.* at §7.07.

[18] As another example, think of IKEA switching from its current format to having a showroom, with a warehouse in Canada that ships directly to consumers. The showroom receives a cost-plus payment. U.S. purchasers benefit from the stronger dollar. And IKEA does not suffer from the nondeductibility of its goods, because the individual U.S. purchasers are not deducting the cost anyway.

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swer likely must be ''yes.'' Otherwise, exempt organizations, like other consumers, would have every incentive to purchase directly from abroad. Also, exempting direct EO purchases from the tax while applying the tax to for-profit importers that sell to EOs would result in like situations being taxed differently. Assuming a DBCFT does tax direct purchases by EOs, the tax looks more like a consumption tax than an income tax (because EOs are generally exempt from income tax), which likely is more consistent with the backers' intent, but seems at odds with its basic construction as an income tax.

Customs Pricing

The DBCFT also would have consequences for customs pricing of goods. As explained above, under DBCFT, U.S. importers would have a tax incentive to minimize prices paid to related foreign parties. Lower import prices would reduce customs duties (which typically are assessed as a percentage of the import price). The U.S. Customs and Border Patrol can no longer rely on taxpayers policing themselves by keeping prices up to ensure the largest possible income tax deduction. Section 1059A of the Code, which generally prohibits taxpayers from claiming a tax basis in excess of their customs basis, would become a dead letter, even if the same is not true for Section 482.

How Other Countries Might Respond to a DBCFT

ExportCo in Slide A achieves a positive return of $16 only as a result of the tax loss rebate of $16. Its actual OP is $0. Foreign governments thus see a U.S. company exporting goods at break even and being subsidized to do so by the U.S. government. The optics are bad and perhaps unacceptable to U.S. trading partners. Foreign governments may respond through a variety of policy measures. The article here focuses on two potential responses that would affect the existing system of international taxation.

First, a foreign government that has a U.S. tax treaty may treat the DBCFT as not covered.[19] The implications of non-coverage may include:

- the DBCFT may be viewed as a non-income tax;
- making the concept of double taxation a non-sequitur (for example, if the DBCFT is viewed as a consumption tax and not an income tax, a foreign tax on the same ''income'' can't produce double taxation); and
- making MAP relief unavailable for foreign-initiated adjustments.

The absence of MAP access may not be terribly important, since foreign competent authorities would understand that the IRS lacks any stake in the outcome (that is, the foreign competent authorities would understand that the IRS is fronting for taxpayers). On the other hand, the taxpayer would have no choice but to pursue relief through local audits and litigation.[20]

Second, the DBCFT could be viewed as the world's largest hybrid tax scheme. U.S. export sales would be non-includible by the U.S. seller and typically deductible by the foreign buyer.[21] While the BEPS Report on Action 2 likely would not specifically sanction countries to deny deductions in these circumstances, it is conceivable that individual-country legislation implementing Action 2 would do just that (whether intentionally or inadvertently). Countries also could change their law to deny the local deduction, perhaps on trade grounds, but possibly on the basic premises of the Action 2 Report.[22] Non-deductibility of foreign companies' purchases from the U.S. would of course stymie the DBCFT's effectiveness at encouraging exports.

Consequences of Eliminating Loss Rebate

An obvious change to address foreign government concerns would be to eliminate the DBCFT's loss rebate feature. But can a DBCFT without a loss rebate feature achieve the anticipated beneficial effects? The author believes (for the most part) that the answer is no, and that the absence of a loss rebate feature could produce significant administrative complexity.

Absent a loss rebate feature, the upward pressure on the value of the U.S. dollar should be reduced because the exporter has no tax benefit to pass through to its foreign customers. Since the absence of a loss feature would not affect importers, the DBCFT should nonetheless cause some appreciation in the U.S. dollar (for example, assuming equal imports and exports, it may hypothetically increase by 12.5 percent rather than 25 percent). In this environment, both exporters and importers would seem to suffer: exporters because any appreciation in the dollar would hurt them in the absence of a loss rebate feature; importers because they need full (25 percent) appreciation to offset the cost of the DBCFT.

Could taxpayers collaborate to avoid these negative consequences? The answer is likely yes, and that their collaboration would have the effect of eliminating or greatly reducing the upward pressure on the U.S. dollar. Slides E and F, discussed below, illustrate two potential solutions.[23]

[19] Article 2 of the U.S. Model Income Tax Treaty, provides that ''1. This Convention shall apply to taxes on income imposed on behalf of a Contracting State irrespective of the manner in which they are levied. 2. There shall be regarded as taxes on income all taxes imposed on total income, or on elements of income.'' Is the DBCFT an income tax on certain ''elements of income''? This point likely would be debated. Article 2 also provides ''4. This Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes.'' Same question.

[20] Not all tax treaty provisions are necessarily affected. Provisions reducing withholding rates, for example, arguably should be unaffected by U.S. adoption of the DBCFT.

[21] The non-deductibility of foreign inputs would not be an objectionable hybrid situation since it would impose a double cost on taxpayers rather than a double benefit.

[22] Such rules have generally been permitted under European Union (EU) law. In Case C-403/03, Schempp v. Finanzamt Munchen, 2005 E.C.R. I 6435, the Court of Justice of the European Union (ECJ) upheld a German law denying German residents a deduction for alimony paid to a non-resident former spouse unless the amount was taxable to the recipient spouse. The Court concluded that the treatment was not discriminatory, but rather the result of natural ''disparities in the tax legislation of the Member States,'' opining that the EU ''is not concerned with any disparities in treatment which result from divergences existing between the various Member States, so long as they affect all persons subject to them in accordance with objective criteria and without regard to their nationality.''

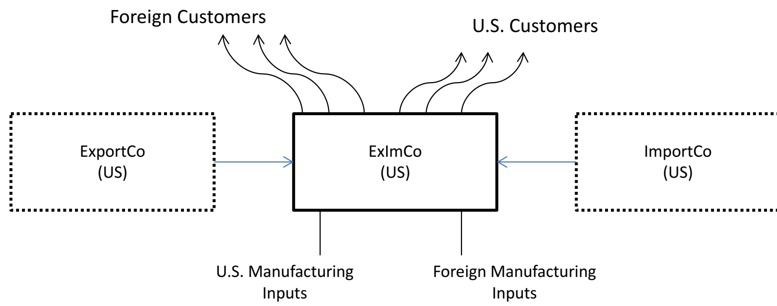
[23] The slides assume that there is no material change in exchange rates, and therefore use pre-DBCFT costs, and implic-

In Slide E (below), ExportCo merges with ImportCo and the resulting ExImCo generates combined sales, COGS and OP of $200, $160 and $40, respectively. Under DBCFT, ExImCo's includible sales are $100, its deductible COGS are $80, it earns $20 of DBCFT taxable income, and it pays $4 of DBCFT. This is an effective rate of only 10 percent, giving both companies incentives to merge.[24]

itly, exchange rates. This thinking is explained immediately after the examples.

[24] The 10 percent effective tax rate does not represent an advantage over other companies paying the DBCFT. Instead, any company with ExImCo's sales and inputs profile would have a comparable effective tax rate.

SLIDE E



ExImCo Income Statement	
US Net Sales	$100
Foreign Net Sales	$100
U.S. COGS	- $80
Foreign COGS	- $80
Operating Profit	$40
DBCFT Tax (from right)	-$4
After-DBCFT Net Profit	$36

DBCFT Outcome	
Includible Gross Revenue	$100
Deductible COGS	- $80
Operating Profit	$20
DBCFT Tax at 20%	$4

The facilitation arrangement in Slide F (below) achieves the same outcomes as a merger, but without the attendant costs and commitments. ExportCo and ImportCo enter into a facilitation contract, pursuant to which ExportCo purchases what were previously ImportCo's foreign inputs and resells them to ImportCo at $80 plus a $2 fee for its service. ExportCo has $2 of DBCFT taxable income, pays $.4 of tax, and earns $21.6 after tax ($22 - $.4). ImportCo generates $100 of taxable U.S. sales, incurs $82 of deductible U.S. inputs, earns $18 of DBCFT taxable income, pays $3.6 in tax, and earns after-tax income is $14.4. The companies together pay tax of $4 and earn after-tax net income of $36 (like the merged entity in Slide E).[25]

[25] The split of economics between the two companies would be subject to negotiation.

Slide F seems to present an abusive arrangement, particularly if beneficial ownership of the foreign inputs remains at all times with ImportCo. But since the economics of a facilitation contract can be achieved through merger,[26] it's hard to understand why there should be a serious objection. Also, to prevent a facilitation contract from being effective, a DBCFT likely would need to include tracing provisions that treat ImportCo's purchases from ExportCo as foreign inputs. Tracing provisions would complicate the tax, defeating its attractive simplicity.

[26] It is possible that an enacted DBCFT would preclude the merger benefits shown on Slide E, which would require companies merging for purely business reasons to somehow maintain separate pools of inputs and sales. This seems both impractical and unlikely.

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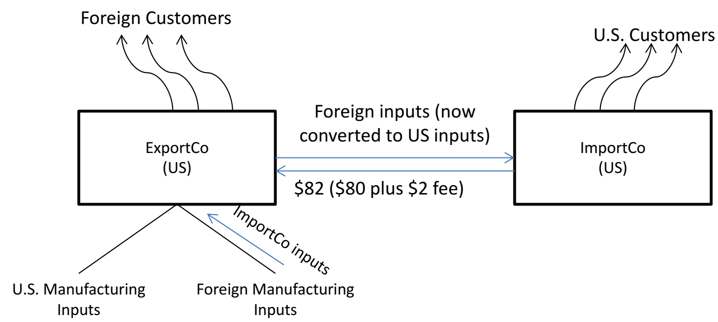
SLIDE F



Income Statements

ExportCo Income Statement		ImportCo Income Statement	
Foreign Net Sales	$100	U.S. Net Sales	$100
U.S. Net Sales	$82	U.S. COGS	-$82
U.S. COGS	-$80	Operating Profit	$18
Foreign COGS	-$80		
Operating Profit	$ 22		

DBCFT Outcomes

ExportCo DBCFT Tax Return		ImportCo DBCFT Tax Return	
Includible U.S. Gross Revenue	$82	Includible U.S. Gross Revenue	$100
Deductible U.S. COGS	$80	Deductible COGS	$82
Taxable Income	$2	Taxable Income	$18
Tax at 20%	$.4	Tax at 20%	$3.6

Slides E and F show that companies can get around any dislocative effects of a DBCFT that lacks a loss rebate feature. The anticipated costs of these efforts may, however, be significant. Congress might address this by allowing trading in DBCFT loss rebates, or even establishing an exchange.

Assuming all of the above comes to pass (that is, no loss rebate causes companies to collaborate), the anticipated upward pressure on the U.S. dollar is likely largely eliminated. Absent the loss rebate feature, exporters can no longer drop their foreign prices. Absent the tax cost on imports (eliminated through merger or facilitation), importers no longer need increase their U.S. prices. Once taxpayers collaborate to respond to a DBCFT without a loss rebate feature, they effectively neutralize its exchange rate implications. Some net impact would remain since the U.S. does have a trade deficit (that is, the excess of imports over exports can't be offset through merger or facilitation),[27] and because some exporters may not be able or may be unwilling (for example, for regulatory reasons) to offset their foreign sales against foreign inputs.

The downside to a DBCFT without a loss rebate feature is that it likely would not retain as much preference for U.S. manufacturing. On Slide F, the U.S. tax on imports is effectively negated as long as the foreign inputs can be offset against export sales. To the extent ExportCo's foreign inputs exceed its foreign sales, the excess would be taxed twice—once by the U.S. at 20 percent and again by the country of manufacture. The size of the U.S. trade deficit may be about the right measure of this excess across all companies (assuming import-export collaboration is largely effective).

What if Exchange Rates Don't Adjust as Anticipated?

If exchange rates don't change, the Slide A fact pattern would hold. U.S. exporters would likely be benefitted and U.S. importers harmed. More goods presumably would then be manufactured in the United States, both for export and for local consumption.

There likely would, however, be collateral consequences if exchange rates don't adjust. If U.S. substitutes are either unavailable or uncompetitive (after accounting for DBCFT), prices at Walmart, the gas station, and anywhere else where foreign goods are purchased will increase. Even when U.S. goods can be substituted for foreign goods, less competition and higher U.S. production costs likely will increase cash-register prices for many goods.

Other Key Features of the DBCFT

The excludability of exports and non-deductibility of imports are the key ''border adjustable'' aspects of the Republicans' blueprint for corporate tax reform. Other key aspects of the blueprint could be part of any corporate income tax system, and are not specific to border adjustability. These include the treatment of capital investment, net interest expense, and wages.

Capital Investment

The DBCFT would allow immediate deductions for ''cap-ex,'' an acceleration of deductions compared to existing law. The ability to deduct cap-ex is designed to encourage capital expenditures.

[27] The 2016 U.S. trade deficit in goods and services was $502.3 billion on exports of $2.2094 billion, and imports of approximately $2.7117 billion. ''*U.S. International Trade in Goods and Services*,'' U.S. Bureau of Economic Analysis (Feb. 7, 2017).

Net Interest Expense

However, the DBCFT would disallow deductions for net interest expense. The logic is that, if companies can deduct cap-ex, they should not be permitted to deduct expenses associated with carrying cap-ex (that is, interest expense). Another policy reason for non-deductibility of net interest expense may be to encourage use of equity.

Non-deductibility of interest likely has far-reaching implications (far too extensive to address in depth here). Examples include:

- U.S. companies may shift third-party borrowings offshore (perhaps with U.S. parent guarantees),[28] where interest will remain deductible and presumably irrelevant to a U.S. territorial tax system. Such a response undoubtedly would harm the U.S. banking sector.
- Companies acquired through leveraged buyouts or with otherwise heavy debt burdens may not be able to survive under the additional tax burden (even with a reduced tax rate). Private equity investors and advisors may be particularly hard hit.
- The trade-off of being able to deduct cap-ex, but not net interest expense seems to disfavor services businesses, which likely have lower cap-ex-to-debt ratios than manufacturers.

A potential solution to these concerns would be to allow companies to elect either the old regime—permitting net interest deductions, but amortizing cap-ex – or the new. Like other fixes, this would increase the complexity of the tax.

Deductibility of Wages

One major difference between the DBCFT and a typical VAT is that the DBCFT would allow companies to deduct compensation.[29] Whether allowing wage deductions causes the DBCFT not to qualify as a VAT, and so to run afoul of World Trade Organization (WTO) rules for indirect taxes is under fierce debate.[30] While WTO rules allow border adjustments for indirect taxes, wage deductions are usually deductible only under corporate-income-tax regimes. Corporate income tax regimes, on the other hand, are not permitted to establish preferences for export sales or local production.[31] Proponents of the DBCFT argue that wage deductions are economically equivalent to a payroll tax reduction and are therefore compliant with WTO rules for indirect taxes.[32] Whether or not the wage deduction runs afoul of WTO rules is beyond the scope of this paper, but adds uncertainty to the consequences of adopting DBCFT.

Chances the DBCFT Will Become Law

The author sees several impediments to the DBCFT becoming law. Aside from the technical and economic issues identified above – WTO compliance, foreign government reactions, unintended economic consequences, taxpayer work-arounds, etc.—several U.S. constituencies likely would oppose border adjustability, either because it can only harm them, because they aren't confident that the U.S. dollar will appreciate as predicted, or for other reasons.

U.S. persons who own material assets denominated in foreign currencies may oppose enactment of the DBCFT. The proponents of the DBCFT claim it would increase the value of the U.S. dollar by 25 percent, resulting in a concomitant decrease of 20 percent in the value of foreign currencies relative to the dollar. U.S. persons owning assets overseas should be concerned since their foreign assets will drop in value (in U.S.$ terms) by 20 percent. The opponents may include:

- private investors (anyone with a 401(k)), mutual funds, banks and other investors and investment managers;
- technology companies, many of which own material non-U.S. manufacturing assets;
- natural resource companies, which may own significant overseas reserves; and
- other investors in overseas' assets.

U.S. retailers that source products from overseas likely will oppose DBCFT. If the dollar fails to appreciate as anticipated, the dollar price of U.S. retailers' foreign-sourced goods likely will rise, reducing U.S. retail spending. It seems unlikely that U.S. retailers would accept as an article of faith that the U.S. dollar's appreciation will fully compensate for the increased tax on their foreign-sourced products.

Financial institutions that engage in U.S. lending likely would oppose. Non-deductibility of net interest likely would reduce U.S. lending for reasons summarized above.

U.S. companies that import services from overseas, such as companies that outsource R&D, IT services, and call center operations may also be harmed and so oppose the DBCFT. The DBCFT would make those imported services non-deductible.

If DBCFT does become law, there also would be numerous transitional issues. For example:

- Should the DBCFT be retroactively effective to 2017 taxable years? Given the potentially damaging application of the DBCFT to many taxpayers, a retroactive effective date seems unwise.
- Should there be transitional provisions to address long-term contracts? A long-term cross-border contract priced in U.S.$ may become non-economic for one

[28] The guarantee revenue may even be excludible under border adjustability.

[29] Allowing wage deductions has the beneficial effect of preserving some of the balance in the tax code between the treatment of capital and labor. Overall, the DBCFT tips that balance in favor of capital by accelerating deductions for cap-ex, while leaving the treatment of labor costs unchanged.

[30] The DBCFT has characteristics of an income tax (for example, it is not paid if the taxpayer has losses and allows a deduction for wages), and a sales tax (for example, it is applied on U.S. inputs and not on foreign inputs). The VAT is a sales tax, payable regardless of whether the seller has losses, and not permitting a deduction for wages. It seems unlikely that other WTO members would simply accept VAT characterization of the DBCFT. Accordingly, adoption of the DBCFT may require the United States to either dramatically amend its terms, or to think seriously about whether it wants to remain in the WTO.

[31] Michael Daly, *The WTO and Direct Taxation* 4-5, World Trade Organization, Discussion Paper No. 9 (2005), https://www.wto.org/english/res_e/booksp_e/discussion_papers9_e.pdf ("remission, calculated in relation to exports, of direct taxes or social welfare charges on industrial or commercial enterprises are considered as [impermissible] export subsidies, whereas tariff or consumption tax refunds on exports are not") (Internal quotations omitted).

[32] *See* Auerbach report.

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party or the other. This seems a particularly thorny problem.

■ Should an immediate deduction be allowed for existing, partially amortized cap-ex? The answer likely should be yes, assuming net interest expense becomes immediately non-deductible.

These transitional issues add uncertainty and reduce the chances that the DBCFT becomes law.

Conclusion

The DBCFT proposal faces an uphill battle in order to become U.S. law, but it is the leading proposal under consideration and merits close attention. Its key challenge is that too many taxpayers are likely losers under the tax. If the tax does pass, its effectiveness at encouraging U.S. manufacturing and other activities may be reduced or eliminated through the reactions of foreign governments. Its treatment of U.S. exporters in particular resembles an export subsidy that likely would invite reciprocal action. While the DBCFT could be revised to address some foreign concerns—for example, by eliminating the loss rebate feature—the benefits of the DBCFT to the U.S. economy would be substantially reduced.

The DBCFT, if enacted, would result in material changes to IRS and foreign tax administrations' sensitivities to transfer pricing into and out of the United States. In general, the IRS would become less, and foreign tax administrations more, concerned about ensuring arm's-length pricing. U.S. pricing/valuation issues would not, however, be eliminated. Particularly in the areas of services and IP transfer pricing, the IRS may often need to determine whether sales are for U.S. consumption (and subject to tax) or for foreign consumption (and exempt).

Most U.S. companies will need to evaluate the application of evolving DBCFT proposals and should monitor legislative developments closely.