CRS Reports & Analysis

Legal Sidebar

Border-Adjusted Taxes and the Rules of the World Trade Organization: The Distinction Between Direct and Indirect Taxes (Part I)

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In the coming months, Congress may consider tax reform proposals that provide for adjustment "at the border" of a federal tax imposed on a U.S. business' cash flow. Such proposals may raise questions about the interplay of federal tax policy with the United States' international obligations under the World Trade Organization (WTO) agreements. Determining whether a proposed border-adjusted tax (BAT) is consistent with WTO rules may be complicated by the distinction that some provisions of WTO agreements draw between a direct tax imposed on a person or business entity (e.g., a corporate income tax) and an indirect tax imposed on a transaction involving a product or service (e.g., a value-added tax (VAT), sales tax, or excise tax).

Part I of this two-part sidebar post provides general background on border-adjusted taxes and the interplay between the WTO agreements and tax measures. Part II of this sidebar explores how WTO agreements on trade in goods distinguish between direct and indirect taxes and discusses the implications that this distinction may have for whether a BAT is consistent with U.S. WTO obligations. These sidebar posts do not analyze a specific tax proposal. For information on the economic and trade effects of a BAT, see this CRS In Focus product.

Border-Adjusted Taxes

As commonly understood, a BAT is a fiscal measure that imposes a charge on goods or services in accordance with the destination principle of taxation. Under this principle, a government taxes products based on the location of their sale to the final consumer rather than on the location of their production or origin. Thus, to adjust a tax "at the border," a country: (1) taxes imported products and domestically produced products sold on its market on the same basis and at the same rate; and (2) exempts from this tax products exported for sale to foreign consumers. Generally, a BAT seeks to promote "equal conditions of competition" for foreign and domestic companies supplying products or services within a taxing jurisdiction.

Many countries apply a border adjustment to their VAT—a general consumption tax levied on the value added to a good or service at all stages of production and distribution. However, unlike most other countries, the United States does not have a VAT. The federal government relies primarily upon income taxes and payroll taxes for revenue rather than taxes imposed on transactions involving products or services (e.g., a VAT or excise tax). Various bills introduced in past Congresses would have applied a border adjustment to the corporate income tax or sought a renegotiation of provisions in the WTO agreements that may prohibit the United States from taking such action.

The WTO Agreements and Tax Measures

The WTO Agreements set forth internationally binding rules for a wide variety of government practices that affect international trade in goods and services. Thus, it is unsurprising that WTO rules may apply to a WTO Member's tax policies to the extent that such policies act as barriers to trade. After all, tariffs—the traditional subject of trade negotiations—are taxes on imported products. In addition, to regulating tariffs, WTO rules apply to other tax measures that could undermine tariff concessions or negatively impact competitive opportunities for the products of WTO Members. These measures include internal taxes that discriminate against imports and tax policies that distort trade by subsidizing exports or domestic production.

If a WTO Member believes that a U.S. BAT violates one or more of the WTO agreements, it could potentially challenge the tax law in a dispute settlement proceeding. If the WTO panel ultimately rendered an adverse decision to the United States, the United States would be expected to remove the offending measure, generally within a reasonable period of time, or face the possibility of paying compensation to the complaining Member or being subject to sanctions (e.g., the imposition by the complaining Member of higher tariffs on U.S. exports). If the complaining Member found that the BAT was a countervailable subsidy that resulted in or threatened material injury to its domestic industry, the Member could seek withdrawal of the subsidy through the WTO dispute settlement process or impose countervailing duties on U.S. exports.

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Legal Sidebar

Border-Adjusted Taxes and the Rules of the World Trade Organization: The Distinction Between Direct and Indirect Taxes (Part II)

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As discussed in a separate post, the 115th Congress may consider tax reform proposals that provide for adjustment "at the border" of a federal tax imposed on a U.S. business' cash flow. Such proposals may raise questions about the interplay of federal tax policy with the United States' international obligations under the World Trade Organization (WTO) agreements. Determining whether a proposed border-adjusted tax (BAT) is consistent with WTO rules may be complicated by the distinction that some provisions of WTO agreements draw between a direct tax imposed on a person or business entity (e.g., an individual or corporate income tax) and an indirect tax imposed on a transaction involving a product or service (e.g., a value-added tax (VAT), sales tax, or excise tax). Part II of this two-part sidebar explores how WTO agreements on trade in goods distinguish between direct and indirect taxes and discusses the implications that this distinction may have for whether a BAT complies with U.S. WTO obligations.

Provisions in the WTO Agreement on Subsidies and Countervailing Measures (ASCM) demonstrate how the distinction between direct and indirect taxes may have implications for a BAT's consistency with WTO rules. If a WTO panel were to consider whether a border adjustment that exempts export income from taxation was consistent with U.S. WTO obligations, the panel would evaluate the BAT under the ASCM. Notably, the ASCM lists, as an illustrative example of a prohibited export subsidy, the "full or partial exemption, remission, or deferral specifically related to exports, of direct taxes . . . paid or payable by industrial or commercial enterprises." By contrast, the ASCM implies that the "exemption or remission, in respect of the production and distribution of exported products, of indirect taxes" would not constitute a prohibited export subsidy, unless such exemption or remission exceeded the indirect taxes imposed on the production or distribution of similar products sold for domestic consumption. Thus, an initial examination of the ASCM suggests that the ASCM would permit a BAT that exempts or remits an indirect tax, such as a VAT, in connection with the production or distribution of exported products so long as such exemption or remission does not exceed the VAT that the WTO Member levies on products consumed in its domestic market. By contrast, the ASCM would appear to prohibit a BAT that exempts or remits a direct tax, like a corporate income tax, that would otherwise apply to exports regardless of the amount of exemption or remission.

When considering the BAT's application to imports, the WTO's primary goods agreement, the General Agreement on Tariffs and Trade (GATT or GATT 1994), may be relevant. However, the GATT, which was drafted in the mid-20th century, does not clearly state whether a WTO Member may adjust direct tax measures at the border by imposing a charge on imported products that is equivalent to an internal direct tax imposed on domestic businesses. Furthermore, scholars disagree about whether the GATT even regulates direct tax measures beyond prohibiting a WTO Member from conditioning a tax advantage on an enterprise's use of domestic inputs in its production process. The language of the GATT seems more clearly relevant to indirect taxes levied on products. However, it could be argued that a tax levied on a business entity would violate GATT provisions on nondiscrimination if it negatively impacted the competitive opportunities of imported products as compared to similar domestic products.

Although no WTO dispute settlement precedent directly addresses border adjustments under the GATT 1994, a nonbinding 1970 Working Party Report issued under the auspices of the WTO's predecessor agreement, the GATT 1947, recorded a general consensus among GATT parties that the agreement prohibited border adjustment of direct taxes because such taxes were not levied directly on products, but were instead levied on people or businesses. By contrast, the GATT parties generally agreed that indirect taxes levied directly on products were adjustable at the border. However, the reason for this distinction remains unclear.

Therefore, although the distinction between direct and indirect taxes may be relevant to whether a BAT complies with U.S. WTO obligations, it is difficult to evaluate an abstract tax proposal. As an initial matter, it is unclear whether a WTO panel would deem a tax having characteristics of both an income tax and a consumption tax, such as a destination-based cash flow tax, a "direct" or "indirect" tax under WTO rules.

Furthermore, other provisions of the WTO agreements may have implications for whether a tax is adjustable at the border. For example, although ASCM language suggests that border adjustment of an income tax by exempting export income from taxation would constitute a prohibited export subsidy, a BAT would first have to meet the ASCM's definition of "subsidy" in order to be prohibited. One element of this definition is that the government must have foregone "revenue . . . otherwise due." The WTO Appellate Body has held that determining whether a WTO Member has foregone such revenue will often involve a comparison between the revenue raised under the challenged tax measure and a benchmark that reflects the revenue that would have been raised otherwise under the WTO Member's general tax rules. Therefore, a BAT's exemption of a U.S. taxpayer's export income from taxation might not meet the ASCM's definition of a "subsidy" if the exemption is part of a general rule of taxation rather than an exception to a general rule of taxation. In such a circumstance, the federal government arguably would not be foregoing revenue "otherwise due." This simplified example demonstrates that a WTO panel's determination that a tax is a direct tax under WTO rules may not be dispositive as to whether adjustment of that tax at the border would violate WTO agreements.

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