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## Appendix C

# Border Adjustments under the National Retail Sales Tax or Corporate Activity Tax

### Administrative Issues

From an administrative standpoint, it is easy to exempt exports of goods and services from either the NRST or CAT. For the NRST, exemption happens “naturally” because the point of tax collection is a retail sales transaction within US territory. For CAT, exemption requires the exporting firm to claim a deduction for its export revenue, and to back up the deduction with a customs declaration and evidence of payment from the foreign purchaser. However, from an administrative standpoint, tax collection at the border on imports of goods and services presents challenges under both the NRST and CAT.

Under both systems, it would be almost impossible to collect taxes on sales of digital services, such as videos, music, or software, from foreign businesses to domestic consumers. Foreign sellers are not a plausible tax collection point for a US retail sales tax. Moreover, in the absence of a novel tax accord between the United States and the European Union (as well as numerous other countries), foreign business firms would not be liable to pay CAT to the US Treasury on business-to-consumer sales.

Sales of digital services from foreign to domestic businesses would be susceptible to tax under CAT by denying the US firm a deduction for the foreign purchase. Under the NRST, such sales would be taxed when a US firm made a retail sale of a product that included the foreign digital service.

Merchandise imports present different tax collection challenges under the NRST and CAT. Under the NRST, imported merchandise would not

be subject to tax unless the buyer was a household consumer. To collect the tax on consumers—returning tourists, household imports via UPS or FedEx, and direct household purchases of autos and furniture made abroad—customs authorities would need to distinguish between household and business imports. The administrative challenge would be to identify and weed out “dummy” business firms that were fronts for household purchasers to avoid paying the NRST.

Apart from that challenge, it is worth noting that the NRST would tax imports of capital equipment, if at all, only over the period of time that capital services show up in the price of retail goods. In some instances, the services of imported capital would never appear in the price of products subject to the NRST—for example, public services such as roads and hospitals.

## WTO Aspects

Graetz (2002b, paragraph 25) contends that export exemptions are not permitted for the subtraction-method VAT under the WTO Agreement on Subsidies and Countervailing Measures (SCM). The SCM is part of the GATT, and thus applies to trade in goods but not services. Graetz argues that a subtraction-method VAT, as an entity tax, does not qualify as an indirect tax under the SCM. Hence, exemption of exports from a subtraction-method VAT would amount to a prohibited export subsidy. Annex I of the SCM provides an Illustrative List of measures that are and are not considered prohibited export subsidies (SCM, Article 3.1(a)). Item (e) of the Annex lists as a prohibited export subsidy:

(e) 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.

By implication and history, the full or partial remission of indirect taxes is not a prohibited export subsidy, nor indeed any other type of subsidy.<sup>1</sup> In footnote 58 of the SCM, direct and indirect taxes are defined as follows:

For the purpose of the Agreement:

The term “direct taxes” shall mean taxes on wages, profits, interests, rents, royalties and all other forms of income, and taxes on the ownership of real property. . . .

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1. WTO Agreement on Subsidies and Countervailing Measures, footnote 5 to Article 3.1(a) makes this clear: “Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement.”

The term “indirect taxes” shall mean sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges. . . .

This definition makes no distinction between credit-invoice and subtraction-method VAT systems, although both versions were well known by 1994, the year of the Uruguay Round SCM agreement. Furthermore, the footnote enunciates a restrictive definition of direct taxes. A plain reading of the SCM Illustrative List places subtraction-method VAT systems in the indirect tax category, eligible for border adjustment.

Graetz’s core assertion is that, by virtue of the fact that the subtraction-method VAT is administered as an entity tax, it becomes a direct tax rather than an indirect tax. We would be amazed if, in the course of litigation, the WTO Appellate Body could be persuaded by this argument, since it turns on administrative form rather than economic substance. However, if the WTO Appellate Body did conclude that a subtraction-method VAT is a direct tax, the United States, Japan, and other subtraction-method VAT countries should insist that the SCM Code be amended.

A related WTO legal question is whether a border tax can be imposed on imported merchandise in lieu of a subtraction-method VAT. The specific question is whether collecting the in-lieu-of tax on imports at the same rate as the subtraction-method VAT would violate the national treatment requirement of GATT Article III. GATT Article III, paragraph 4 reads:

The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favorable than that accorded like products of national origin in respect to all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use. . . .

The threshold question is whether a subtraction-method VAT may properly be considered a tax on products—again highlighting the administrative differences between a credit-invoice VAT and a subtraction-method VAT. Some commentators (such as Graetz 2002b) might argue that because the credit-invoice VAT is applied transaction by transaction, it is a tax on individual products; meanwhile, since the subtraction-method VAT is a tax on the whole entity, it cannot be attributed to individual products. This argument again elevates form over substance. Each subtraction-method VAT payer is perfectly capable, just as credit-invoice VAT payers are, of producing an invoice showing purchasers how much tax was collected through the whole chain of production, simply by multiplying the tax-inclusive rate by the tax-inclusive price. The only difference is that for a subtraction-method VAT firm, there is no trail of invoices going back to the farm or mine. We feel confident that the Appellate Body would not cite this difference to rule that the subtraction-method VAT is not a product tax.

As mentioned earlier, we propose that US firms that are not CAT-registered be required to pay a tax on merchandise imports in lieu of CAT (our preferred version of a subtraction-method VAT). A national treatment problem might arise if the importing US firm is a pass-through entity. This firm might claim that it is not subject to CAT, directly or indirectly, when it buys the equivalent good from a domestic pass-through entity. Therefore, it should not have to pay the in-lieu-of tax on imports. This argument would have merit in those rare instances where the alternative domestic supplier was indeed a pass-through entity, and where that supplier also purchased all its inputs from pass-through entities. Provided the eligibility test for taxation as a pass-through entity is sufficiently narrow, only a small amount of intermediate inputs made in the United States would be sold by these entities. In most cases, the alternative domestic supplier would directly or indirectly pay CAT. Hence, there is no real difference in the great majority of transactions: imports would pay the in-lieu-of tax; domestic suppliers would pay CAT.

If the WTO Appellate Body nevertheless ruled that imports by pass-through entities should be exempt from the in-lieu-of tax, a gaping revenue hole would be created. Such a ruling would lead nearly all importers selling consumer goods to conduct their purchases from foreign suppliers by using pass-through entities. We are very doubtful that the WTO Appellate Body would open this loophole. If it did, the United States would have to sharply narrow the CAT exemption for pass-through entities.

A special question arises for household imports under CAT. In a few cases, households might argue that the alternative domestic supplier was a pass-through entity, such as a small jewelry or leather goods firm. However, it is worth noting that US imports of “low-value” shipments (under \$1,250 each, predominantly purchases by returning tourists) were only \$14 billion in 2003. If the WTO rules against the United States on this point, the revenue loss from exempting low-value imports by returning tourists would not be great.

The hypothetical argument for exemption from the in-lieu-of tax is stronger when it comes to legal, accounting, and consulting services provided by foreign firms. Article XVII of the General Agreement on Trade in Services (GATS) requires national treatment with respect to imported services that are scheduled by a WTO member. Within the United States, these services are often supplied by pass-through entities, notably partnerships and limited-liability corporations. As we have envisaged CAT, it would not attempt to tax imports of such services per se, but only when purchased by a US firm subject to CAT. Hence, under our plan, there would be no conflict with the GATS national treatment standard for business-to-business sales of such services. Imported business services, like domestic business services supplied by a pass-through entity, would not qualify as a deduction from the CAT base. However, when foreign firms supplied these services directly to domestic households,

those purchases would escape the CAT net (the same as purchases from domestic service firms).

## Summary

While potential loopholes exist, both the NRST and CAT are broadly adjustable at the border, in contrast to the corporate income tax. Both regimes would fully exempt exports, and both would assess business tax on nearly all imports of goods and business services. Under both regimes, some imports would escape taxation, but this quantity appears to be small. As with any tax system, loopholes would be enlarged over time. Periodic reviews and amendments would thus be required. Moreover, in the context of broader trade negotiations on a bilateral or regional basis, such as the North American Free Trade Agreement (NAFTA), the United States and its partners might agree, on a reciprocal basis, to eliminate their border adjustments on imports from one another. This is an intriguing possibility, but a topic beyond the scope of the present monograph.