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Tax Legislation

Karl L. Kellar, George Korenko and Lori Hellkamp look at the practical, legal and policy implications—as well as many unknowns—springing from border adjustments contemplated in the GOP's destination-based cash-flow tax proposal. ''Before the GOP proposal is adopted, far more economic and policy analysis and design are necessary, and much greater attention must be given to details concerning mechanics, implementation and enforcement,'' the authors write.

Border Adjustments in the Destination-Based Cash-Flow Tax: A Bold Proposal With Unanswered Questions

BY KARL L. KELLAR, GEORGE KORENKO AND LORI HELLKAMP

This may be one of those rare times in Washington when there appears to be consensus across party lines (including within the Treasury Department) that the current tax system is broken and reform is desirable. However, this illusion of consensus begins to break down once the different actors start to propose how to reform the rules.

The first salvo, and the subject of this article, was fired in June 2016 when the House Republicans released their blueprint for tax reform: ''A Better Way: Our Vision for a Confident America.'' The House GOP proposal has received renewed attention with the unexpected election of President Donald Trump, as fundamental tax reform now seems a real possibility.

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The opinions expressed in the article are those of the authors and do not necessarily represent the views of Jones Day or Edgeworth Economics.

The GOP proposal promotes a new ''destination-based cash-flow tax'' (the DBCFT), which is intended to move U.S. business taxation toward a simpler, consumption-based model of taxation. This article focuses on selected legal, economic and policy aspects of the most controversial component of the DBCFT, its so-called border adjustments.

Like others who have addressed the DBCFT in general, and border adjustments in particular, we have to make certain assumptions about how the border adjustments would work because the details in the proposal are so scant.

Indeed, the description of the DBCFT occupies less than two pages of the proposal, and only a few sentences describe the border adjustments. We don't yet know, for example, whether or how the new system will apply to the financial sector, digital goods, services, cloud computing or passthroughs; nor do we know the extent to which it will supplant, or supplement, the current income tax system.

Likewise, we don't know what accommodations will be made and what transition rules enacted to facilitate the conversion to such a radically different system, including the need for businesses to switch from income tax accounting to cash-flow accounting—and to protect themselves against the potential (intended and unin-

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tended) adverse effects the proposal could have on business structures put in place in reliance on the existing international tax rules.

Even the high-level description of the DBCFT provided in the proposal raises many questions and issues, both as to the economics—such as the intended and unintended effects it could have on the economy, the financial markets, foreign trade, interest rates and various U.S. business sectors—and to tax policy, including practical enforcement and implementation issues.

Exploring some of these uncertainties and practical issues, from both an economic and a legal perspective, makes one thing clear: Before the GOP proposal is adopted, far more economic and policy analysis and design are necessary, and much greater attention must be given to details concerning mechanics, implementation and enforcement.

The Proposal

The GOP proposal would radically restructure business taxation: It proposes lowering income tax rates on businesses, moving to a (mostly) territorial system by exempting dividends from foreign subsidiaries and repealing much of Subpart F of the U.S. Internal Revenue Code, and introducing the DBCFT, which entails allowing full expensing of most capital investments and denying deductions for net interest expense.

The most complex, and controversial, aspect of the proposal is the DBCFT's ''border adjustments,'' a concept more common in value-added tax (VAT) systems. As used in the GOP proposal, the border adjustments mean that exports of products, services and intangibles would be entirely exempt from U.S. taxation, while goods, services and intangibles imported into the U.S. would remain subject to U.S. income tax. In fact, U.S. importers would be denied any deduction for foreign input costs and thus be taxable on gross revenue—the resulting increased income tax liability being an implicit ''import tax.'' By contrast, not only would U.S. exports be exempt from income tax, U.S. exporters would still be able to deduct their domestic input costs (including labor expenses), thus resulting in tax losses—i.e., negative U.S. tax liability on exports.

A flood of articles and papers discussing various aspects of the GOP proposal, ranging from detailed scholarly analyses to brief summaries, have already been published, and undoubtedly many more can be expected. This is inevitable, given that such a radical change in our business tax system will likely have a profound impact on the U.S. and global economy, global financial markets, international trade and tax policy, not to mention individual U.S. businesses and consumers. Given both its importance and the overload of information and perspectives—of everyone from theoretical academic economists to tax administrators and tax policy experts, practicing lawyers and political actors—it may be helpful to take a step back and consider what we know and don't know about the GOP proposal and its potential impacts. This can point to issues that need more consideration and analysis—in some cases far more—before such a revolutionary system is adopted.

For example, perhaps one of the most obvious, but least discussed (and little understood) set of issues involves behavioral reactions to the DBCFT's implementation. Much of the literature and economic scoring has, to a large extent, assumed static conditions and behavior; but it seems evident that consumers and businesses will react—repositioning themselves and their transactions to exploit, or avoid, the economic (dis)incentives presented by this new tax landscape. We briefly explore these and other issues below.

The Economics

Some supporters of the GOP proposal suggest that its border adjustment mechanism will increase exports and decrease imports, thus providing a boost to domestic businesses and reducing the U.S. balance of trade deficit.

For example, the proposal states that the border adjustments ''will allow U.S. products, services, and intangibles to compete on a more equal footing in both the U.S. market and the global market.'' This argument appears to consider only the direct effects of the tax. That is, it appears to be based on the assumption that, because imports will be taxed, they will become relatively more expensive to U.S. purchasers, who will decrease their purchases. Similarly, since exports won't be taxed, they will become relatively less expensive to foreign purchasers, who will increase their purchases.

Much of the literature and economic scoring has, to a large extent, assumed static conditions and behavior; but it seems evident that consumers and businesses will react.

Other proponents of the DBCFT, however, argue the opposite. Although it may seem counterintuitive to a non-economist, they rely on economic models that show currency exchange rates will automatically adjust—completely offsetting both the benefit to exports and detriment to imports that would otherwise occur—resulting in no net change in the real prices (or quantities) of imports and exports. Thus, the argument goes, the border adjustments will neither distort international trade nor harm U.S. importers. Martin Feldstein makes that case in a Jan. 5 article in The Wall Street Journal, arguing that ''in the end, the prices paid by U.S. consumers would be essentially unchanged.''

Nevertheless, since the U.S. is a net importer, the border adjustments would be expected to increase tax revenues. For example, Feldstein suggests that ''[b]ecause U.S. imports are about 15% of [gross domestic product] and exports only about 12%, the border tax adjustment gains revenue equal to . . . $120 billion a year.''

It isn't clear which of these diametrically opposed viewpoints would bear out in real life, but one thing is clear: They can't both be right.

It is true that, as a matter of economic theory, the border adjustments would trigger an appreciation in the U.S. dollar because a decrease in U.S. demand for imported goods would cause a decrease in demand for foreign currency, resulting in an appreciation in the dollar. This, in turn, would result in imported goods becoming relatively cheaper to U.S. purchasers, offsetting some of

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the decrease in demand for imports. Similarly, as the demand for U.S. exports increases, the demand for U.S. dollars will increase, causing an appreciation in the dollar. This results in U.S. exports becoming relatively more expensive for foreign purchasers, offsetting some of the increase in demand for U.S. exports.

This concept can be illustrated by the following example. Suppose the cost of production of Product A is $90, and Product A sells for $110. If there were no border adjustment, the producers would pay a 20 percent tax on the resulting $20 profit, their tax liability would be $4 and their after-tax profit would be $16. The imposition of the border adjustments means that exporters receive a tax rebate (here shown as a negative tax), while importers pay a 20 percent tax on gross revenue. (For simplicity, this and other examples assume no other operating expenses.) A comparison of the effects of the border adjustments with and without such currency adjustments for U.S. exporters and importers is illustrated in the accompanying table.

As the example shows, assuming a perfect adjustment of exchange rates, there are no real effects on U.S. importers or exporters—after-tax profit is the same in each case.

This is sound economic theory, but empirical studies concerning the amount and timing of such exchange rate adjustments are less clear. For example, though it is widely recognized that the trade deficit affects exchange rates, the U.S. experience shows that there can be long and substantial divergence. (See Dennis R. Appleyard and Alfred J. Field Jr., International Economics (Irwin McGraw-Hill: 1998), ch. 24, especially p. 540.)

A 2014 International Monetary Fund study by Atish Ghosh, Mahvash S. Qureshi and Charalambos G. Tsangardes found that a bilateral trade imbalance may persist for two or more years while exchange rates adjust. Other research has concluded that there is little relationship between trade deficits and exchange rate adjustments. (See, for example, ''A Faith-Based Initiative Meets the Evidence: Does a Flexible Exchange Rate Regime Really Facilitate Current Account Adjustment?'' by Menzie Chinn and Shang-Jin Wei in The Review of Economics and Statistics, Vol. 95, No. 1 (2013)).

But even if the currency adjustments precisely offset the tax effects on cross-border transactions, this discussion is incomplete, as it relates to aggregate effects across the entire U.S. economy. It is useful to consider some of the individual factors at work to gain a deeper view of the likely effects in the real world:

- There is no single U.S. dollar exchange rate. Exchange rates are bilateral, and changes in the value of the dollar relative to each currency may vary. For example, the magnitude and speed of adjustment of the dollar relative to each individual foreign currency will depend on, among other things, each country's exchange rate policy. For example, some countries allow their currencies to fluctuate freely in response to market forces, facilitating more rapid adjustment, while some countries peg their currency to other stable currencies, such as the U.S. dollar, which typically slows the adjustment. Regardless, the full adjustment in bilateral exchange rates can be expected to occur over a period of years (see, e.g., Ghosh et al).

- There is a single U.S. dollar exchange rate with each country, and the adjustment that occurs will reflect the average tax effect. However, the effects on a particular U.S. business will depend on the firm's mix of inputs and, particularly, the extent to which those inputs are imports. For example, two firms in a given industry that use different mixes of labor costs (deductible on an ongoing basis as incurred) and capital investment (under the GOP proposal, deductible on a front-loaded basis) will realize different effects. However, both firms will experience the same exchange rate adjustment.

- Firms that have substantial overseas exposure in terms of financial investments may realize a dramatic decrease in the value of those investments. Alan D. Viard of the American Enterprise Institute argues in a 2009 paper that the value of a multinational firm's assets denominated in foreign currencies actually will decrease as the U.S. dollar appreciates in value.

	Exports			**Imports**		
	No Border Adjustment	Border Adjustment Without FX Adjustment	Border Adjustment With FX Adjustment	No Border Adjustment	Border Adjustment Without FX Adjustment	Border Adjustment With FX Adjustment
Sales Price	$110	$110	$88	$110	$110	$110
Input Price	$90	$90	$90	$90	$90	$72
Pre-tax Profit	$20	$20	($2)	$20	$20	$38
Tax @ 20%	$4	($18)	($18)	$4	$22	$22
After-tax Profit	$16	$38	$16	$16	($2)	$16

■ Currency adjustments wouldn't offset tax effects if the product is a commodity traded globally in a single currency. For example, if a product is priced in dollars both in foreign and domestic markets (such as crude oil), an exchange rate adjustment won't offset the effect of the tax.

To illustrate more concretely some of the economic effects of the GOP proposal, consider two examples. The first involves widgets that are produced both domestically and abroad and therefore may be imported to or exported from the U.S., and are priced in the currency of the seller. The second involves crude oil, which is globally priced in dollars.

U.S. purchasers of widgets would have an incentive to use domestically produced (tax-deductible) widgets over imported (non-deductible) widgets. This shift in incentives would lead to an increase in the demand for domestic widgets and an increase in their price, and a decrease in the demand for imported widgets and a decrease in their price. Domestic widget producers will benefit from that price increase, but will they want to sell their widgets domestically and pay taxes on the proceeds? The incentive will be for them to export their widgets and avoid paying a 20 percent tax, unless the U.S. price is sufficiently high. For example, given a 20 percent tax rate and assuming the current price of widgets is $50, the U.S. price at which domestic producers would be indifferent between exporting at $50 or selling into the U.S. would be $62.50 ($50/(1 – 0.2)).

When the dust settles, the overall economic effects on U.S. crude oil producers and purchasers are likely to be substantial, with "winners" and "losers" emerging based on the structure of their businesses.

As discussed above, the dollar would appreciate, making U.S. exports relatively more expensive to foreign purchasers. However, the exchange rate adjustment wouldn't be specific to widgets, and only by chance would the adjustment fully offset the changes in the price of domestic and imported widgets. In particular, if exchange rate changes didn't fully offset the effects of the tax, we would observe a net increase in exports of widgets, an increase in the price of domestically produced widgets, and likely higher prices to U.S. consumers when they purchase products that contain widgets.

Next, consider the likely consequences of the border adjustment on crude oil exporters and importers. Generally, the effects of the border adjustment will be similar to those for widgets. For example, as with the example for widgets, exporters will have an incentive to use domestically produced crude oil, as they will receive a tax deduction for the input cost.

However, because crude oil is globally priced in U.S. dollars, changes in the value of the dollar relative to foreign currencies won't lead to a neutral effect on after-tax profits. Rather, exporters of crude oil will experience a windfall because they pay no taxes and don't have to sell their oil at a lower exchange rate-adjusted price. For a hypothetical example, see the "Border Adjustment Without FX Adjustment" column under "Exports" in the accompanying table. In this example, exporters would enjoy greatly increased profits but also have a negative tax liability.

On the other hand, importers of crude oil will be worse off as they will pay the full global price of crude oil in dollars and will also incur the border adjustment. For a hypothetical example, see the "Border Adjustment Without FX Adjustment" column under "Imports" in the table above. In this example, importers would incur a loss on each barrel of imported crude oil.

When the dust settles, the overall economic effects on U.S. crude oil producers and purchasers are likely to be substantial, with "winners" and "losers" emerging based on the structure of their businesses. An extended discussion of the effects of the proposal on crude oil and petroleum products can be found in a Dec. 16, 2016, white paper from the Brattle Group ("Border Adjustment Import Taxation: Impact on the U.S. Crude Oil and Petroleum Product Markets," by Philip K. Verleger Jr., Kevin Neels, Pallavi Seth and Fabricio Nunez).

Selected Legal, Policy And Practical Implications

Leaving aside the very significant (but already much-discussed) issue of whether the DBCFT scheme violates World Trade Organization rules, there are numerous implications that should be considered and issues that will need to be resolved before the border adjustment proposal can be implemented.

Alan J. Auerbach, a University of California-Berkeley economics professor credited as an architect of the GOP proposal, lays out the arguments in favor of border adjustment in two recent white papers: "Destination-Based Cash Flow Taxation," co-written with Michael P. Devereux, Michael Keen, and John Vella, is published by the Oxford University Centre of Business Taxation as Working Paper 17/01 (hereafter, "Auerbach 2017 Working Paper"). "The Role of Border Adjustments in International Taxation," is co-written with economist Douglas Holtz-Eakin of the American Action Forum (November 2016).

University of Michigan law professor Reuven Avi-Yonah and Reed College economics professor Kimberly A. Clausing take the opposing viewpoint in "Problems with Destination-Based Corporate Taxes and the Ryan Blueprint," Law and Economics Research Paper Series (draft, January 2017).

Variations by Industry

As with the currency adjustments discussed above, other legal, tax and practical impacts will vary by industry and business. So, too, will the inevitable reactions by taxpayers. For example, heavily import-reliant industries in which inputs can't be obtained domestically (or can't be obtained in sufficient quantities)—either because doing so would be cost prohibitive or because the U.S. simply doesn't produce the relevant raw materials—will undoubtedly react, rather than be punitively taxed or pin all their hopes on the currency adjustment mechanism discussed above.

Likewise, rather than eliminating transfer pricing, the border adjustments will likely shift its focus, incen-

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tivizing multinationals to minimize the cost of imports by U.S. affiliates (because such costs would no longer be deductible expenses) and maximize U.S. affiliates' revenue from exports (because such income would escape U.S. taxation and possibly even result in tax rebates).

Simplicity Assumed, Reality More Complex

To date, most discussions about the possible mechanics of the border adjustments assume a simplified case of a commercial U.S. exporter or importer of a tangible product without a complex supply chain or mixed customer base. One point that isn't always highlighted in these discussions is the reality that an import tax will need to be applied to all U.S. purchasers—not just U.S. businesses that purchase products, components or raw materials abroad and resell them in the U.S. That is, direct sales to U.S. consumers made by a foreign person must also bear tax—otherwise the border adjustment is too easily avoided.

Consider an example to illustrate this point: A U.S. distributor acquires a product from a foreign manufacturer (FM) for $100 and resells it to U.S. customers for $160. (For purposes of this and the next example, we disregard currency adjustments in the figures, as the principle remains the same and, as seen above, perfect and immediate currency adjustments offering universal relief are unlikely.) The U.S. distributor can't deduct the $100 paid to FM, meaning the distributor has taxable income of $160, with tax of $32 (at the proposed 20 percent rate). Without the border adjustment (and assuming the same 20 percent rate), the distributor's tax would be only $12. Inevitably the U.S. distributor will try to push at least some of the economic burden of this additional tax cost onto FM.

If, instead, FM, which otherwise has no nexus with the U.S., sells directly to the U.S. consumer for $160, it bears no U.S. tax. Without the imposition of a stand-alone import tax, FM can increase its profit—and even undercut the retail price relative to what U.S. distributors must now charge, while still making a higher profit. In short order, virtually all sales of foreign goods into the U.S. would be made direct to the end consumer, cutting out the tax-costly U.S. middleman.

Taking this example one step further, a U.S. seller into the domestic market will also have a strong incentive to adopt this same strategy. Assume a U.S. manufacturer sells the same product as in the above example, with a cost of production of $80. It will sell to a U.S. customer at the market price of $160, and would be subject to tax of $16, resulting in an after-tax profit of $64 ($80 – $16). But if it established a foreign distributor (FD) and sold the product to FD for $150, followed by FD's resale to the U.S. customer for $160, the U.S. seller would have $70 of profit, subject to no U.S. tax—plus the $10 of profit residing in FD, also subject to no U.S. tax (assuming FD otherwise has no U.S. taxing nexus; for that matter, FD need not be related—U.S. sellers would probably find little difficulty locating foreign companies willing to earn modest profits for acting as a go-between).

This hypothetical further illustrates why an import tax is required in business-to-consumer (B2C) sales (and previews why adoption of the DBCFT might not mean the end of transfer pricing as some have predicted).

Commissionaire Arrangements

Another potential work-around in the absence of an express import tax would be the use of sales commission arrangements, just as commissionaires are sometimes employed in Europe. Under such an arrangement, the U.S. distributor could presumably avoid any implicit import tax because it is merely facilitating the foreign seller's sale—i.e., providing sales, marketing or logistical support services to the foreign seller—but never actually purchasing an imported good.

Not only would this arrangement enable the parties to escape the implicit import tax, it would potentially result in the U.S. distributor avoiding any U.S. income tax because it would be receiving compensation for services provided in the U.S. for the benefit of a foreign party. Presumably this would be viewed as exporting services. (It isn't actually clear how border adjustments would work for services, because the proposal contains no explanation of how services would be taxed (or not), other than to say the DBCFT would apply.)

Again, without a direct import tax on the foreign-sourced goods, the border adjustment is easily avoided, this time by changing the contractual relationship between the parties.

Why the Mechanics of Collection Are Critical

As seen in the above examples, a functioning DBCFT system can't be achieved by denying deductions alone. As the proposal seems to hint, without explicitly acknowledging, an actual import tax must apply to all sales of foreign goods and inputs into the U.S.—including B2C sales. The proposal seems to leave open the question of whether a new, stand-alone import tax (beyond the additional tax burden borne by commercial importers from the denial of deductions) will be imposed on all purchasers—including U.S. consumers or foreign businesses with no U.S. taxing nexus.

On the one hand, the proposal's general description of the DBCFT states that ''products, services and intangibles that are imported into the United States will be subject to U.S. tax regardless of where they are produced.'' On the other hand, the proposal asserts that it achieves a consumption-based approach ''by providing for border adjustments exempting exports and taxing imports, not through the addition of a new tax but within the context of the transformed business tax system.'' It also states: ''This Blueprint does not include a value-added tax (VAT), a sales tax, or any other tax as an addition to the fundamental reforms of the current income tax system.'' GOP proposal, at 28, 27, 15.

The academics who conceived the DBCFT scheme, however, affirm that a new, stand-alone import tax (including on U.S. consumers) will be required for the DBCFT to work. (See Auerbach 2017 Working Paper.) Commissionaire-type arrangements would also need to be addressed.

Thus, the mechanics for collection will be critical. As it doesn't directly acknowledge the need for an import tax, the proposal can provide no guidance on this question. It appears that there are only two options for whom to impose the tax on—the foreign seller or the U.S. consumer. The former poses practical enforcement issues, especially when a foreign seller otherwise has no nexus with the U.S. The latter looks like a federal sales tax and is presumably politically unpalatable (and also presents collection and enforcement issues). Asking consumers to withhold and pay over a portion of

any outbound payment is probably unrealistic. Credit card processors, banks and/or shipping companies could instead be tasked with the obligation of withholding a portion of every outbound payment—although this can be expected to meet resistance from the financial and delivery services industries.

Assessing the tax at the border like a customs duty or excise tax would seem to be the easiest, most efficient way to collect an import tax. But that approach probably looks too much like a tariff and makes the DBCFT (even more) vulnerable to WTO challenge. It also presents obvious logistical shortcomings when the imports are digital goods, services or any other items not conducive to physical border collection.

A workable mechanism similar to that used in VAT systems could probably be devised, but that too may be politically unpalatable, as it leaves supporters vulnerable to the charge that they are imposing new taxes on American businesses and consumers—and VAT systems also struggle with some of these same issues, including electronic commerce and services. Indeed, imposing a visible, VAT-like tax in the same manner as a conventional VAT would make the close relationship of the DBCFT to a VAT more obvious.

This is the very characterization the GOP proposal sought to avoid by adopting the DBCFT. On page 15 of the proposal: ''This Blueprint does not include a value-added tax (VAT), a sales tax, or any other tax as an addition to the fundamental reforms of the current income tax system.''

Assuming these practical implementation issues can be overcome, the proposal also presents some interesting policy questions, a few of which are considered below.

Fairness

The first is simple tax equity. Consider, for example, two U.S. manufacturers that are identical in every respect except customer mix. Each produces the same product, for the same cost, with the same number of employees and same overhead, and sells the same amount of product for the same price. The only difference is that 90 percent of Manufacturer A's customers are located abroad, and only 10 percent are domestic. Manufacturer B is the opposite, with 90 percent of its customers located in the U.S. Manufacturer A will pay tax on only 10 percent of its income, while Manufacturer B will pay tax on 90 percent of its sales revenue—nine times as much.

One could argue that this result is fine as it will encourage more exports, but one must also consider the two-fold counterargument: Is it fair to treat similarly situated taxpayers so differently, and are exports so beneficial that their promotion justifies such disparate treatment?

Again, although currency adjustments are expected to mitigate the disparity, as discussed above, such relief is likely to be neither perfect nor uniformly enjoyed by all industries and taxpayers. Some importers potentially disadvantaged by the border adjustment scheme seem unwilling to put their faith in the exchange rate adjustment theory. Fortune magazine reported Feb. 1 that Wal-Mart Stores Inc., Target Corp. and Best Buy Co. are among more than 100 major retailers battling the border adjustment tax proposal through a coalition backed by the National Retail Federation and the Consumer Electronics Association.

Tax Rebates and NOLs

In order for the DBCFT to function most effectively, its implicit export subsidy (border adjustment) must produce an actual tax benefit to the U.S. exporter. This means, ideally, that any negative tax liability should be refunded to U.S. exporters. For obvious political reasons, though, Congress may be reluctant to adopt a scheme requiring Treasury to write large checks to multinational exporters.

The ''next best'' approach and the one offered by the proposal, is to allow U.S. exporters to carry forward their net operating losses (NOLs) indefinitely. If a net export business remains in a perpetual tax loss situation and can't utilize its NOLs, however, the functioning of the system (and currency adjustment) is impaired.

Accordingly, another wrinkle in need of resolution—assuming tax refunds aren't on the table—is how to provide relief to these businesses. Expect new and creative markets for unusable NOLs to spring up—whether or not blessed by the government. For example, U.S. Internal Revenue Code Section 382 and other loss limitation rules would come under pressure as profitable companies try to combine with loss companies in market-distorting merger and acquisition deals.

Or perhaps NOLs could be used to offset employment and state and local taxes, or otherwise monetized. An historical example of such monetization is provided by the ''safe harbor leasing'' provisions found in the Economic Recovery Tax Act of 1981.

Behavioral Responses

In addition to incentivizing transfer pricing manipulation to increase income from exports and decrease the cost of imports, multinationals would also be incentivized in many cases to move intellectual property to the U.S. (assuming no U.S. tax on the receipt of royalties from foreign affiliates). This may be a selling point for U.S. lawmakers, but it introduces an interesting twist to the Organization for Economic Cooperation and Development's base erosion and profit shifting project: The U.S. could become ground zero for the facilitation of base-eroding profit shifting—at least from other members' perspectives.

Expect other countries to react as multinationals transfer assets and income out of foreign jurisdictions and into the U.S. Possible concerns include an increase in foreign-initiated transfer pricing audits/disputes, the imposition of retaliatory tariffs or import taxes (or increased VAT charges) on imports from the U.S., the denial of deductions for royalties or other payments made to the U.S. and the denial of treaty benefits. (Such potential responses would appear to be generally consistent with U.S. tax treaty policy, which in recent years has focused on countering base erosion and profit shifting. See, e.g., ''Treasury Releases Select Draft Provisions for Next U.S. Model Income Tax Treaty,'' Treasury news release (May 20, 2015).)

Adverse Reliance

Multinational taxpayers, particularly those headquartered in the U.S., have structured their global business operations in reliance on the existing U.S. international tax system. While some structures are undoubtedly tax-motivated, there are also many valid non-tax business reasons for adopting a global business structure. Moreover, even a business without a tax-motivated structure would be negligent not to factor tax effects into its op-

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erations and structures. It is obvious that adoption of the GOP proposal would profoundly change the taxation of such structures.

For example, consider a U.S. company ''USCo'' that has a large customer base in Asia, and because labor, construction and regulatory costs are substantially lower in Asian Country A, USCo forms an Asian subsidiary ''ACo.'' ACo builds a manufacturing facility and produces the product for the global market, selling to unrelated distributors. USCo imports the product for resale in the U.S. market. Absent the border adjustments of the GOP proposal, USCo would have U.S.-source income from its sales in the U.S. (See I.R.C. Section 861(a). We disregard potential Subpart F complications for purposes of this basic example.) USCo would deduct the amount paid to ACo for the product as the cost of goods sold.

Assuming USCo paid ACo $100 and sold the product for $150, it would have taxable income of $50. But with the border adjustment, USCo would pay tax on $150. Even factoring in the reduction of the corporate tax rate from 35 percent to 20 percent, USCo's tax bill of $17.50 under the old system (35 percent x $50) would increase to $30 (20 percent x $150). As discussed above, currency adjustments would ameliorate this effect, but it isn't clear they would completely offset the adverse impact. And as seen, if USCo and ACo had contracted to conduct their intercompany sales in dollars, there may be no alleviation of the adverse impact without revising the contract.

The GOP proposal provides no indication as to whether or how this harsh result would be softened. Congress could take the position that taxpayers who structured their transactions in a tax beneficial way are out of luck; they previously got the benefit and now must suffer the detriment of their tax planning. But fundamental issues of fairness arise: Why should a taxpayer who relied on, and fully complied with, prior law be penalized under the new system?

To be sure, some taxpayers may be able to restructure their transactions. Ironically, the most abusive paper transactions may prove the easiest to restructure, while real transactions with more economic substance will be more difficult to correct. It is easy to transfer intellectual property or the residence of a holding company with no activities, but totally impractical to relocate a billion-dollar manufacturing plant.

Query what kind of transitional or other relief might be extended to relieve taxpayers stuck with international structures that are no longer economically viable—particularly ones with substantial imports into the U.S. Congress could, for example, adopt a substantial transformation rule, similar to that found in the Subpart F context (Treasury Regulations Section 1.954-3(a)(4)(ii)), thus erasing the taint of imports if a U.S. taxpayer substantially transforms the imported inputs to produce a new product. (That approach wouldn't help USCo because it is only a reseller, not a manufacturer.)

Another possibility would be to allow related parties to adjust their transfer pricing to take the tax effects from the border adjustment into account, at least for some transition period. In the example above, if USCo purchased product for $87.50 instead of $100, it would still pay $30 U.S. tax, but would have $32.50 of after-tax income—the same as it did under the prior system. The problem with this is that it wouldn't be an arm's-length price, and ACo's taxing authority wouldn't be happy about its corresponding reduction in income.

Both of these approaches also suffer from the obvious shortcoming that they would reduce the revenue the GOP proposal is expected to generate. A satisfactory solution to such issues will need to be found.

U.S. Tax Treaties

If its label as an income (rather than indirect) tax is respected, the DBCFT may cause issues with U.S. income tax treaties. For example, imposing an income (import) tax on foreign residents' sales into the U.S. regardless of U.S. nexus would likely be viewed as a legislative override of the permanent establishment concept.

Interestingly, adopting the DBCFT may also result in the denial of treaty benefits to U.S. taxpayers under our own model treaty, as the DBCFT may be a ''special tax regime'' and trigger the ''subsequent changes in law'' provision. (See 2016 U.S. Model Income Tax Convention, Preamble and Articles 3(1), 28.) A new model may need to be developed and all affected U.S. treaties renegotiated—a task that could take years.

The Alternative: A VAT?

According to Auerbach and Devereux, the authors credited with designing the DBCFT tax scheme, it is the economic equivalent of introducing a VAT and reducing taxes on payrolls. If Congress were willing to modify the DBCFT along the lines of a more traditional VAT and offer payroll tax relief, most of the issues and implementation complexity fall away. (This may be the reason no other country has a DBCFT but most have VATs.)

A more traditional VAT would also be expected to withstand a WTO challenge, be compatible with the U.S.'s existing network of income tax treaties, and enjoy the benefit of other countries' experiences, which could provide guidance for a VAT's adoption and implementation.

This conclusion may seem obvious, but only if one ignores political realities—there is no appetite in Congress for enacting a ''new tax,'' particularly one that would ultimately fall on American consumers.

Where Do We Go From Here?

The foregoing discussion raises numerous questions and potential issues. For some, there are no definitive answers. For example, we simply don't know the actual impact that border adjustments would have on the global economy, and impacts on separate sectors and actors in the economy can at best be only roughly modeled, and are controversial. Likewise, we don't know the extent to which exchange rate adjustments will ameliorate any such effects. Economists acknowledge there is no perfect model—no empirical data yet exists for the impact of a tax that, to date, hasn't been implemented anywhere else in the world.

In other cases, however, the technical issues such as means of implementation and enforcement can be resolved. But, given the far-ranging impact the DBCFT is likely to have, any such solutions should be the product of careful analysis and consideration through proper administrative and legislative institutions. The Tax Reform Act of 1986 (TRA) offers a successful model of how our tax system could be substantially transformed.

It was a truly bipartisan effort in which the disparate interests of various stakeholders were filtered through the political process, but it took more than four years and many legislative drafts, amendments and hearings to finally enact TRA in 1986.

The DBCFT concept shows real promise and could fundamentally transform our tax system to be fairer, more efficient and neutral, and less burdensome. But that will happen only if the process is done right. A tax system devised without sufficient deliberation and input from stakeholders might fail to meet these goals.

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