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TRUMP & VAT: NAFTA, TRADE BARRIERS & RETALIATORY TARIFFS

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During the first presidential debate President-elect Donald J. Trump argued that the value added tax (VAT) operated as a trade barrier to American business everywhere. He particularly pointed to the North American Free Trade Agreement (NAFTA). Mexico was a special concern.[1] China was also a concern, but in this instance Trump was troubled both by China's VAT and by China's alleged currency manipulation.[2]

A discussion of VAT as a trade barrier to US firms is potentially very wide ranging. It cannot be fully taken up here. For our purposes the scope of this discussion needs to be narrowed. The NAFTA alignment of US, Mexico and Canada provides the optimal template.

This paper can only consider the VAT aspect of Trump's trade policy. There appears to be some confusion about the operation of the VAT, particularly the *border adjustment mechanism*, and how US tariffs could "level the playing field." The confusion needs to be cleared up. Not to mention that much of this material will inform the first class in the VAT course at NYU's Graduate Tax Program, which I will teach on January 19, 2016, a mere twenty-four hours before the inauguration of our forty-fifth president. We all need to be prepared.

For people concerned about the broader issues that underpin Trump's VAT position Mark Houtzager's *VAT Tax Blog* frames this issues nicely in a posting that connects (a) Trump's tariffs, with (b) a proposal for a tax on imports in a bill sponsored by Congressman Bill Pascrell, Jr. titled *The Border Tax Equity Act*,[3] and hints at a deeper connections with (c) Congressman Paul Ryan's *A Better Way* tax reform proposal where there is a similar import tax. There is a common fabric here.[4] Houtzager also sums up the area we are concerned with:

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[1] Aaron Blake, *The First Trump-Clinton presidential Debate transcript, annotated*, THE WASHINGTON POST (September 26, 2016) https://www.washingtonpost.com/news/the-fix/wp/2016/09/26/the-first-trump-clinton-presidential-debate-transcript-annotated/

> [Donald Trump] Let me give you the example of Mexico. They have a VAT tax. We're on a different system. When we sell into Mexico, there's a tax. When they sell in—automatic, 16 percent, approximately. When they sell into us, there's no tax. It's a defective agreement. It's been defective for a long time, many years, but the politicians haven't done anything about it.

[2] Maggie Haberman, *Donald Trump Says He Favors Big Tariffs on Chinese Exports*, NYT - FIRST DRAFT (January 7, 2016) *available at*: http://www.nytimes.com/politics/first-draft/2016/01/07/donald-trump-says-he-favors-big-tariffs-on-chinese-exports/

> Donald J. Trump said he would favor a 45 percent tariff on Chinese exports to the United States, proposing the idea during a wide-ranging meeting with members of the editorial board of The New York Times.

[3] Border Tax Equity Act of 2016, H.R.6183, 114th Cong. (2015-2016).

[4] While Trump would impose tariffs, Pascrell would impose an import tax, and Ryan would impose both an import tax and make the corporate income tax border adjustable.

> The idea is that U.S. companies that import goods in VAT countries (i.e., almost every other country in the world) are being charged with import VAT. This *import VAT* is creditable/ recoverable for domestic importers, but not for U.S. importers. Therefore, U.S. companies that import goods elsewhere are significantly worse off than domestic traders. This is protectionism and must be retaliated against.[5]

Trump indicated that as president he would respond to these "unfair trade practices" by imposing retaliatory tariffs on goods and services coming into the US from any country that imposed an *import VAT* on American businesses exporting goods or services to their country.[6] There are more than 160 countries that have a VAT and all of them impose an *import VAT*. Trump is promising a trade war. He promises to set US tariffs at a rate that would force governments and businesses to take notice.

For example, he indicated that he would respond to the 16% Mexican import VAT by retaliating with a 35% tariff,[7] and to the 17% Chinese import VAT with a 45% tariff. These rates would appear to be far more than would be called for to level the playing field. Nevertheless, the President has the authority to set tariffs – in some instances with and in other instances without the consent of Congress. Trump could conceivably set tariffs this high, or higher.[8]

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[5] Mark Houtzager, *Trump and a Democrat want a Retaliatory Tariff against VAT*, VALUE ADDED TAX BLOG (October 3, 2016) available at: http://www.us-vat.com/blog/?p=1258 (emphasis added).
[6] *Import VAT* is the term used for the imposition of VAT on goods at the border. It is part of the border adjustment process, and is collected during the customs clearance process. The rate is always the same rate that would be applied to the same goods if they were being sold by a domestic business to a domestic buyer. The intent is to equalize treatment within the country for the same goods regardless of their origin.
[7] Patrick Gillespie, *Trump's 35% Mexico Tax would Cost Ford Billions and Hurt Americans*, CNNMONEY (September 15, 2016) *available at*: http://money.cnn.com/2016/09/15/news/economy/trump-tariff-ford-mexico/

> The Republican nominee reaffirmed his plans to slap a 35% tax on Ford's cars made in Mexico and sold in the United States.
> "When that [Ford] car comes back across the border into our country that now comes in free, we're gonna charge them a 35% tax. And you know what's gonna happen, they're never going to leave," Trump told Fox on Thursday morning.

[8] The basic legal authority for US free trade agreements is the Trade Act of 1974. §151 of the 1974 Act authorizes the president to submit agreements to Congress under Trade Promotion Authority (TPA) procedures. Extensions of TPA occurred in the Omnibus Trade Act of 1988, Trade promotion Authority Act of 2002, and Bipartisan Congressional Trade Priorities and Accountability Act of 2015. Each extension included §125, which gives the President "termination and withdrawal authority." Under §125(a) every US trade agreement must contain withdrawal authority, §125(b) allows the President to revoke earlier Presidential actions, and §125(c) gives the President the authority to proclaim higher US tariffs (up to a maximum of 50% above the rate in column 2 of the US tariff schedule, or 20% above the rate in effect for that country on January 1, 1975. These provisions apply to NAFTA. The President must (1) give 6 months notice under NAFTA Article 2205, (2) terminate the agreement, and then (3) issue a proclamation stating the same. Under §301 [Unfair Trade Practices] of the Trade Act of 1974 the US Trade Representative (USTR) at the direction of the President has the authority to impose higher tariffs on trading partners. §122 of the Trade Act of 1974 allows the President to impose temporary import surcharges not to exceed 15% that can remain in effect for not more than 150 day. §232(b) of the Trade Expansion Act of 1962 authorizes investigations into imports to see if they pose a hazard to US national security.

The argument for imposing US tariffs on imported goods coming from countries that collect an import VAT on US goods raises *three questions* that can be adequately handled by looking just at the NAFTA relationship. Two questions consider the issue from the perspective of a US manufacturer exporting to a NAFTA country, the third question hypothetically moves a US manufacturer into a NAFTA country, and considers the impact of VAT refunds on sales that this company will make back into the US. The questions revolve around the two central elements of *border adjustments* – the *full VAT refund* allowed for exports, and the *import VAT* collected from the importer of record. Trump has concerns with both aspects. The three questions are:

(1) *US Exports to NAFTA* - In the normal case, does the standard, destination-based, credit-invoice VAT erect a trade barrier equal to the amount of the *import VAT* ?
(2) *US Exports to NAFTA* - If *not* creating a barrier in the *normal case*, are there other fact patterns where the standard, destination-based, credit-invoice VAT *does* erect a trade barrier equal to the amount of the *import VAT* ?
(3) *US Imports from NAFTA* - Can an American manufacturing company move its operations to Canada or Mexico and gain an unfair advantage when selling their product back into the US VAT-free; that is, can a manufacturer unfairly benefit from the *VAT refund aspect of border adjustment* that is provided to exporters from VAT jurisdictions, as compared to comparable manufacturers producing and selling entirely within the US ?

THE NORMAL CASE

In the normal case, a standard, destination-based, credit-invoice VAT functions as a withholding mechanism, collecting tax at each stage of a supply chain proportional to the value added at that stage.[9] It achieves the same tax result as the normative American retail sales tax (RST), which is imposed only once at the final (retail) stage of a supply chain. It is common to consider these transaction-based consumption taxes (the VAT and the RST) as equivalent levies.[10]

A common fact pattern that can be used for multiple examples is helpful. Assume a 10% RST. Assume further that a manufacturer acquires raw materials for 25 cu, sells

[9] See for example: EU VAT Directive, Article 401.

[10] Joint Committee on Taxation, *Background on Cash-Flow and Consumption-based Approaches to Taxation*, (JCX-14-16), March 18, 2016 at 37-38.

> A broad-based, credit-invoice VAT achieves the same end as a retail sales tax even though it appear to be collecting tax at many stages of production rather than only at the time of final sale to a household. From the perspective of the tax system as a whole [under a VAT], any time a sale is made from one business to another, the inclusion of the sales proceeds into the seller's tax base is offset by a deduction from the purchaser's tax base for the cost of the input. For a business-to-business sale, there is no net tax collected (although there may be payments going between business and the government). It is only at the time a sale is made to a non-business purchaser (i.e., a household) that a net tax is collected, because the inclusion of the sale proceeds is not offset by another business's deduction. That result is identical to what occurs under the retail sales tax: tax is collected only at the time of a final sale to a household. The same argument applies to a broad-based, subtraction-method VAT: net tax is collected only at the time of a final sale to a household.

the product it manufactures for 100 cu to a wholesaler, who marks-up the product by 25 cu and re-sells to a retailer who further re-sells to a final consumer for 190 cu

Figure 1 (below) shows a 19 cu tax collected from the final consumer by the retailer, and remitted to the tax authority. Figure 2 (further below) shows the same 19 cu tax collected in stages along the same supply chain in a 10% VAT. A portion of the tax is collected at each stage. The portion collected is proportional to the value added at each stage, times the rate. The VAT stretches out the timing of the tax collection (but does not change the amount of the tax collected). Portions of the full tax are collected in advance of final consumption. In this sense, tax is being *withheld* from supply chain transactions waiting for the moment of final consumption when the full tax becomes payable. To assure that only an amount proportional to the value added at each stage is collected, the VAT allows each business to deduct from the VAT collected on forward sales (outputs), the amount of VAT paid on purchases (inputs).

The VAT and the RST achieve the same tax result. Consider the following figures. All currency amounts are in neutral currency units (cu).

Figure 1: 10% Retail Sales Tax

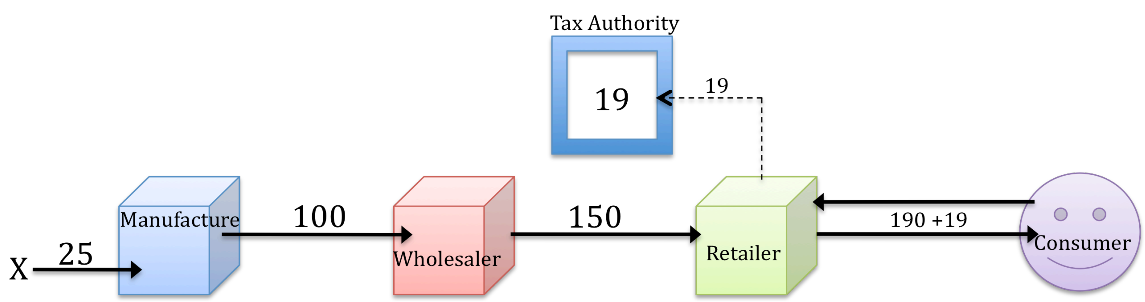
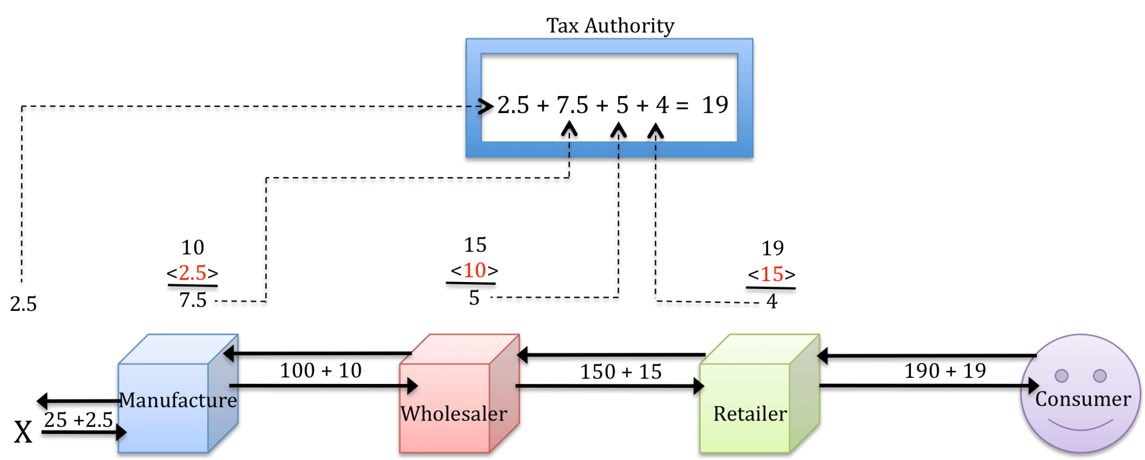


Figure 2: 10% Value Added Tax

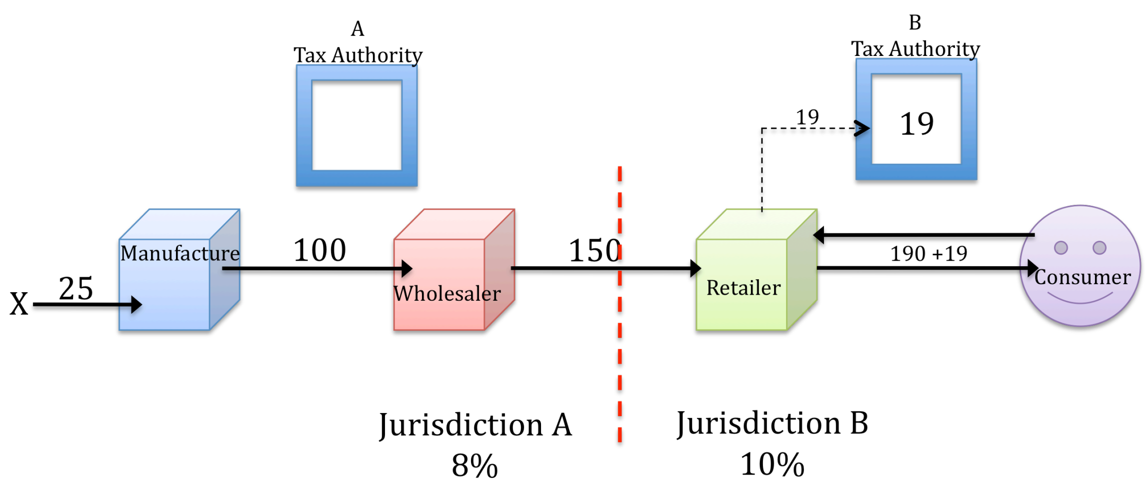


When transaction chains cross borders destination-based consumption taxes have some difficulties. Production is in one jurisdiction, and consumption is in another. But, once again, the RST and the VAT achieve the same tax result, although the VAT (unlike the RST) requires *border adjustments* to do so. This can be demonstrated through the common example.

Suppose in this permutation there are two jurisdictions, A & B, each with a separate tax administration, and each with different applicable tax rates. Assume that the manufacturer and wholesaler are in jurisdiction A where the tax rate is 8%. Assume that the retailer and final consumer are in jurisdiction B where the applicable tax rate is 10%.

Figure 3 applies this permutation to the retail sales tax. No tax is collected in jurisdiction A, and the full tax of 19 cu is collected in Jurisdiction B. There is no need for a border adjustment.

Figure 3: 10% Retail Sales Tax



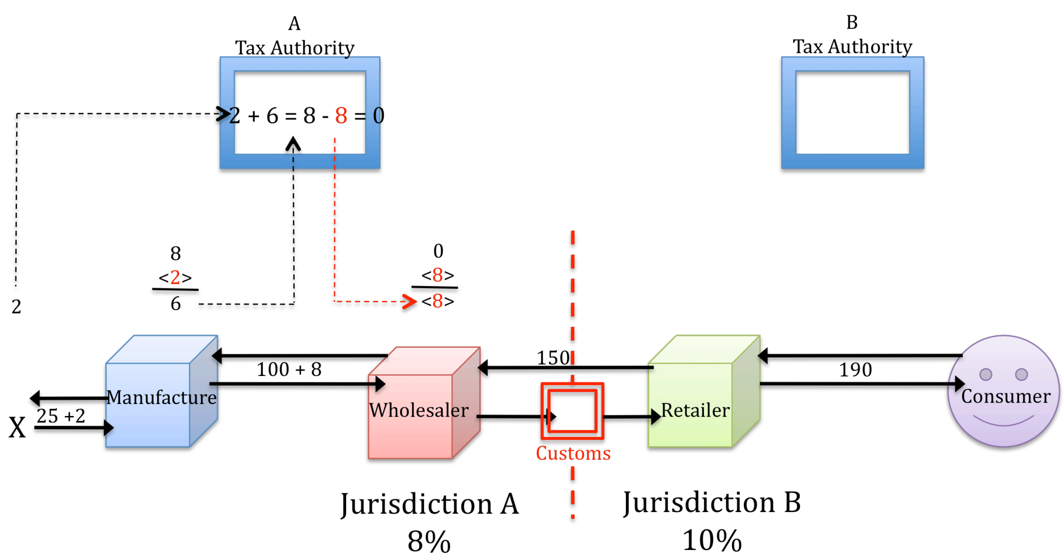
When the same fact pattern is applied to a destination-based VAT the withholding mechanism of the VAT does not function well. There are two immediately apparent problems. First, the "wrong tax administration" will be holding part of the VAT. In our example the VAT collected by the manufacturer and the wholesaler will be sent to Jurisdiction A, but consumption will occur in Jurisdiction B, and this is where the full amount of the tax should be paid. Secondly, the wrong rate is applied for part of the chain. In the early stages of the production chain VAT is collected at 8%, but the full tax, which is due in Jurisdiction B, is assessed at 10%. The withholdings will not be adequate to satisfy the liability at the point of consumption. Even if all the withholdings from Jurisdiction A were to be paid over to Jurisdiction B there would be a shortfall.

Border adjustments solve these problems. The operation of the border adjustment mechanism can be seen in two stages. First, the manufacturer and wholesaler remit VAT and submit returns to Jurisdiction A. The 2 cu paid on materials purchases by the manufacturer, and 6 cu on net value added by the manufacturer is sent to Jurisdiction A. But after that, the VAT's border adjustment kicks-in. Because the wholesaler is exporting (assuring that there will be no final consumption in Jurisdiction A), the wholesaler is allowed to "zero-rate" his export.

The result is that the wholesaler will file for a full refund of 8 cu – in other words the wholesaler's output VAT is 0, and he is allowed to deduct from this amount his full input VAT of 8 cu, and get back from Jurisdiction A all the VAT he paid. This is a full refund. No VAT remains in Jurisdiction A related to this transaction chain. Or stated from the government's perspective, Jurisdiction A does not withhold VAT for the benefit of Jurisdiction B's tax on final consumption occurring in Jurisdiction B.

For purposes of this example, we assume that the goods are with customs waiting for the "importer of record" to pick them up and pay the *import VAT* (see part 2). Consider figure 4 (part 1) below:

Figure 4 (part 1): 10% VAT with Export



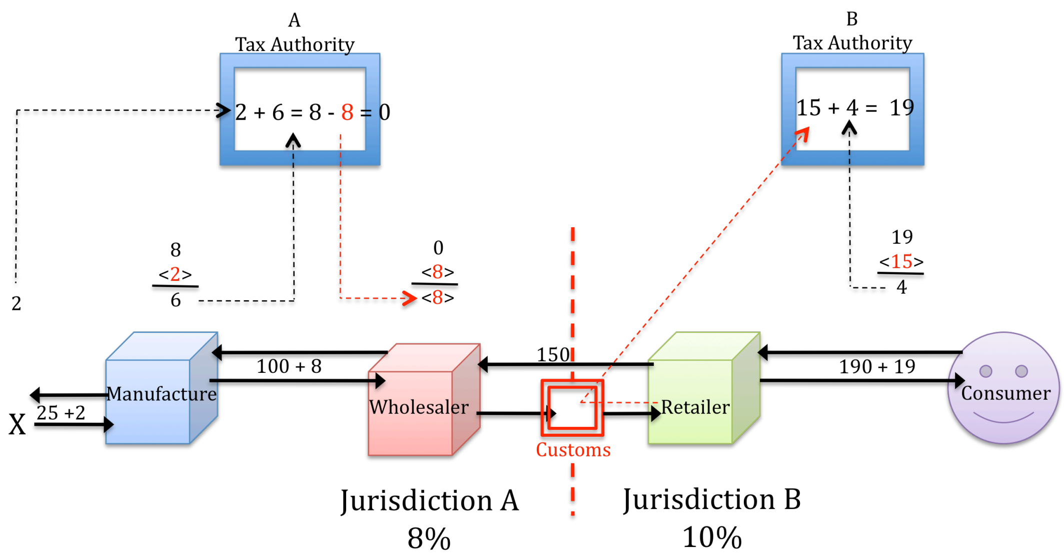
The key to VAT border adjustments is the role played by customs. When goods enter Jurisdiction B they are not burdened with VAT (from Jurisdiction A). VAT must be re-imposed on these goods at the rate of Jurisdiction B, and for the full value of the goods that are entering the country. It is the *importer of record* who secures the goods, and pays the *import VAT* to customs so that the goods may be released into free circulation. The *importer of record* could be any one of a number of people:

- Seller (wholesaler)
- Buyer (retailer)

- Middleman (wholesaler can appoint a middleman, commissionaire, or distributor in-between the wholesaler and retailer, and this middleman would be the *importer of record* and pay the *import VAT*)
- Fiscal representative (if allowed by local law, a fiscal representative can act as the *importer of record* for the wholesaler, pay the *import VAT*, and reclaim the VAT on behalf of the wholesaler).

For purposes of the second part of Figure 4 the assumption is that the retailer (buyer) is the *importer of record*. In this case, the retailer will pay the *import VAT* and will be allowed to deduct it from the output VAT it collects from the final consumer. The retailer is a resident and a registered taxpayer in Jurisdiction B. The transaction is a very normal one.

Figure 4 (part 2): 10% VAT with Border adjustment



The border adjustments work as advertized. All similar goods manufactured in Jurisdiction B are *burdened* to the same degree by the same 10% VAT. All goods manufacturing and processed through the wholesaler in Jurisdiction A are *unburdened* by Jurisdiction A's VAT. No 8% VAT remains on the goods. The playing field is level. VAT is not embedded in the price of the imported goods. No unfair advantage is given to the imported goods from which the 8% VAT of Jurisdiction A has been removed and upon which the same 10% VAT from Jurisdiction B is imposed.

Figure 4 (part 2) shows the same tax result as in Figure 3. 19 cu is collected.

Thus, in the normal case, the standard, destination-based, credit-invoice VAT does not erect a trade barrier equal to the amount of the import VAT. It would not matter if Jurisdiction A imposed a VAT at a different rate from the rate imposed in Jurisdiction

B, or if Jurisdiction A imposed no tax at all on exports. The import VAT only brings imported goods up to the same level of withholding as would be applied on domestically manufactured goods in Jurisdiction B. *Import VAT* levels the playing field. It does not tilt the field in favor of imports or in favor of exports.

In other words, the retailer in Figure 4 (part 2) is selling the same goods to consumers, at the same price and is charging the same VAT as the retailer in Figure 2 who is selling competing goods that are manufactured domestically. *Border adjustments* make sure that the playing field is level.

FACT PATTERNS OUTSIDE THE NORM

If the normal fact pattern for the standard, destination-based, credit-invoice VAT *does not* erect a trade barrier equal to the amount of the import VAT, are their other fact patterns (non-standard patterns) where there *would be* a barrier?

The answer is yes. Consider the situation where US exporting firms are *non-resident, and non-registered* in the importing jurisdiction. A barrier arises if the US firm pays the import VAT and is not allowed to recover it. This is a problem in both Mexico and Canada. Canadian rules however, substantially minimize this barrier, allowing corrections; the Mexican rules leave a trap in place for the unwary US firm with no corrective mechanism once the tax is paid and the goods are imported. Chances are, a US firm will be caught only once in this Mexican trap, and will quickly find one of the many "work-arounds" that Mark Houtzager references (below at note 14).

Mexico and Canada are not the only VAT jurisdictions that present this difficulty for non-resident, non-registered US traders. KPMG's *VAT/GST Refund Survey 2014* found that in 29% of the 65 countries it surveyed (Mexico and Canada being among the 29%) non-resident, non-registered businesses who were entitled to claim refunds were generally not allowed to claim them, "… suggest[ing] that a form of discrimination between non-resident and resident businesses is occurring in practice."[11]

KPMG's *VAT/GST Refund Survey 2014* does not go into great detail about the rules in all 65 jurisdictions surveyed. If it did it would have noted that Canada allows the import VAT that has been paid by a non-resident, non-registered party (the US seller) to be "passed through" with the goods to the registered Canadian firm (the buyer). Some paperwork is required, but the problem is solved. The US exporter is not required to subsequently register for Canadian GST. Clearly, the operation of the Canadian statute is much less discriminatory than the Mexican, which in turn is much less discriminatory than other jurisdiction surveyed by KPMG.[12]

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[11] KPMG, VAT/GST Refunds Survey 2014 (June 19, 2014) at 9, *available at*: https://home.kpmg.com/xx/en/home/insights/2015/03/vat-gst-refunds-survey-2014.html (noting that the survey also found that only 34% of the countries surveyed processed VAT/GST refunds efficiently for non-resident, non-registered taxpayers, leaving the rest of the countries, or 37%, spread between these poles.)

[12] It is noteworthy that the KPMG *Survey* indicates that in China not only are *non-resident, non-registered* businesses denied a refund, but so too are *registered*, *non-resident* businesses. *Id*., at 14.

The tension is obvious. The cause is competing international tax rules. US businesses that are exporting into VAT/GST jurisdictions (and otherwise do no business in those jurisdictions) resist VAT/GST registration because they do not want to establish a taxable presence for *income tax purposes*.[13] Canada respects this position much more than Mexico does.

This is not to say that there are not commercial workarounds. They require planning, and cannot be deployed retroactively. The lack of a retroactive remedy makes this a trap for the unwary. Canada provides a way out, even retroactively; Mexico does not.

The commentary in the *Value Added Tax Blog* stresses the abundance of commercial, self-help workarounds and concludes that the trade barrier argument is nonsense. It might be more accurate to acknowledge that there are traps for the unwary. The blog indicates:

> The [tariff by Trump/import tax by Pascrell] proposal is nonsense, because no U.S. trader would substantially import goods in another country if he couldn't get the VAT back. There are multiple alternatives to streamline this type of transaction in the company's supply chain. For example:
>
> (1) The U.S. company can sell to a local customer with the provision that the customer is the importer of record. This is the most common structure. The U.S. company would ideally transfer ownership of the goods to the customer before import, and the customer pays all the import taxes, fees etc. Typically the import VAT is recoverable for the customer.
>
> (2) The U.S. company can appoint a local middleman, commissionaire or a distributor in-between the sales transaction. The middleman would be the importer of record.
>
> (3) In some countries (like in the Netherlands) the U.S. company can even appoint a fiscal representative – a local rep that only reps for the import, and can reclaim the VAT on the U.S. company's behalf.
>
> (4) In the EU and in some other countries, the U.S. company can simply register for VAT. This would make sense if the U.S. company wants to retain control of the goods, for example when the goods are price-sensitive. If the U.S. company registers for VAT, he can potentially reclaim the import VAT.
>
> Anyway, plenty of alternatives are available for a VAT and pain free import.[14]

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[13] There is secondary (non-income tax) set of reasons supporting the American non-registration position. Under the American RST a lack of physical presence in a jurisdiction absolves a seller from an obligation to collect the RST, and some US businesses may be treating the VAT like the RST. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) (standing for the proposition that a lack of physical presence in a state is sufficient grounds to exempt a corporation from having to pay sales and use taxes to a state.)

[14] Mark Houtzager, *Trump and a Democrat want a Retaliatory Tariff against VAT*, VALUE ADDED TAX BLOG (October 3, 2016) available at: http://www.us-vat.com/blog/?p=1258

The common example can be adjusted to reflect the Canadian and Mexican approach to dealing with imports from *non-resident, non-registered* US exporters who become the *importer of record* and pay the *import VAT*. The Mexican example is in Figure 5 (below), and the Canadian solution is in Figure 6 (further below).

Mexico. If the manufacturer and the wholesaler are in the US, there is no withholding in the supply chain up through the export sale to the Mexican retailer. There is no refund; nothing was collected in the USA. The diagram below assumes that the goods are presented to Mexican customs with an invoice value of 150 cu. The VAT is 16%, and the *import VAT* is 24 cu.

Because the wholesaler is neither a Mexican resident, nor a Mexican VAT registered firm the invoice that it issues to the retailer cannot include VAT.[15] Only a Mexican taxpayer" can issue a VAT invoice. In addition, the retailer is not allowed to pay VAT to the wholesaler; that is, if the retailer makes a payment that it "believes to be" VAT, but which is not VAT, then this amount cannot be deducted by the retailer on its VAT return.[16] However, 24 cu in *import VAT* must be paid to Mexican Customs *by the importer of record* to allow the goods across the border. This example assumes that the wholesaler declares to Mexican Customs that it is the importer of record and actually pays the VAT.

When the retailer sells on to the final consumer for 190 cu, VAT will be collected. The amount at this stage will be 30.4 cu.

Under Mexican law there is no way for a non-resident, non-registered US wholesaler to recover the *import VAT* paid at the border, and this amount effectively becomes a trade barrier for an uninformed US wholesaler. The VAT is being over-collected by the amount of the denied refund of 24 cu. The US manufacturer/wholesaler will be disadvantaged as compared with a similar Mexican manufacturer/ wholesaler of the same (or similar) product in the Mexican market. The *post-import* solutions are to either increase the price, or decrease profits in some manner throughout the commercial chain.

The Mexican VAT compels the non-resident, non-registered US wholesaler to adopt one of the many *pre-import* self-help workarounds.

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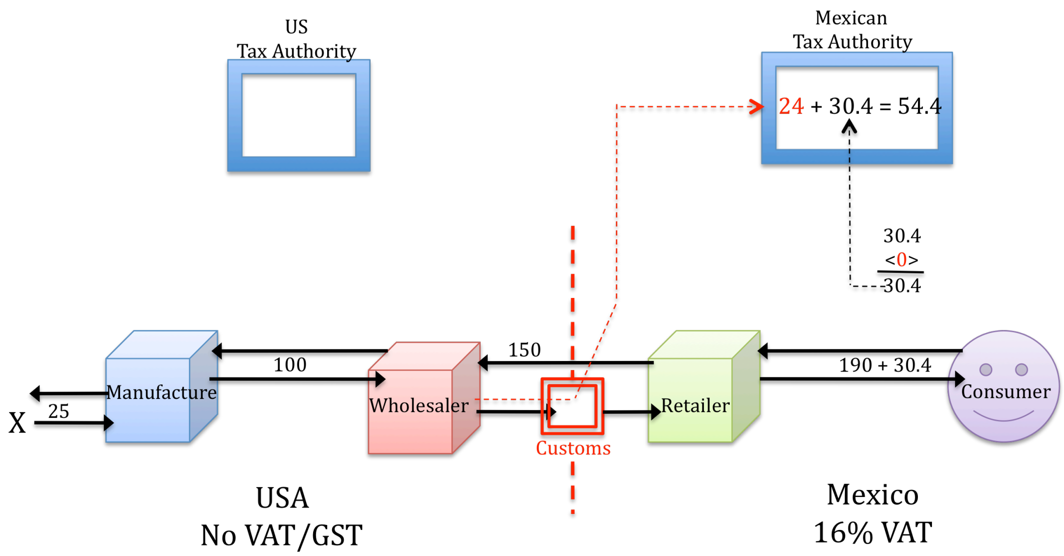
[15] If a non-resident, non-registered (i.e., American) seller enters into an agreement to supply a registered Mexican business, he cannot mention VAT on the invoice. Even though the invoice is otherwise valid, a non-resident, non-registered business is not a taxpayer. Only taxpayers can receive VAT (that is, mention it on the invoice as part of the amount required to be paid for the goods transferred, and then collect VAT.) MEXICAN VAT ACT article 5 ????

[16] A Mexican registered taxpayer cannot deduct an amount that it honestly believes is VAT, even though it pays the amount to a seller who has fraudulently represented himself as a taxpayer. MEXICAN VAT ACT article 4, 5 or 6 ????

Figure 5: Mexican "trap for the unwary"



Canada. The Canadian rules are different. Canada makes a concerted effort to allow a non-resident, non-registered party to secure the equivalent of a refund on *import VAT* that it paid as the *importer of record*. Customs documents are not changed. The importer of record remains the non-resident, non-registered party, payment of the import VAT is recorded in that name, and a receipt issued without ever requiring the importer of record to register for the Canadian GST (not even after the fact).

Instead, Canada allows a "flow through" of the VAT to the Canadian retailer who may then take the deduction on its return. The Canadian Revenue Authority indicates:

> If you are not a GST/HST registrant, you cannot claim ITCs [Input Tax Credits] for the GST or federal part of the HST [Harmonized Sales Tax] you pay at the time of importation. However, if a customer [of the importer] is a GST/HST registrant, the customer may be able to claim ITCs.[17]

For the customer to be able to claim the ITCs the CRA simply requires proof that *import GST* was paid on the specific goods in question, and they were truly imports for the buyer, and not supplies of the seller. Proof includes:

(1) A copy of the Canadian Border Services Agency (CBSA) Firm B3-3, *Canada Customs Coding Form*, which must be filled out to show that the GST or federal part of the HST was paid at the time of import, and

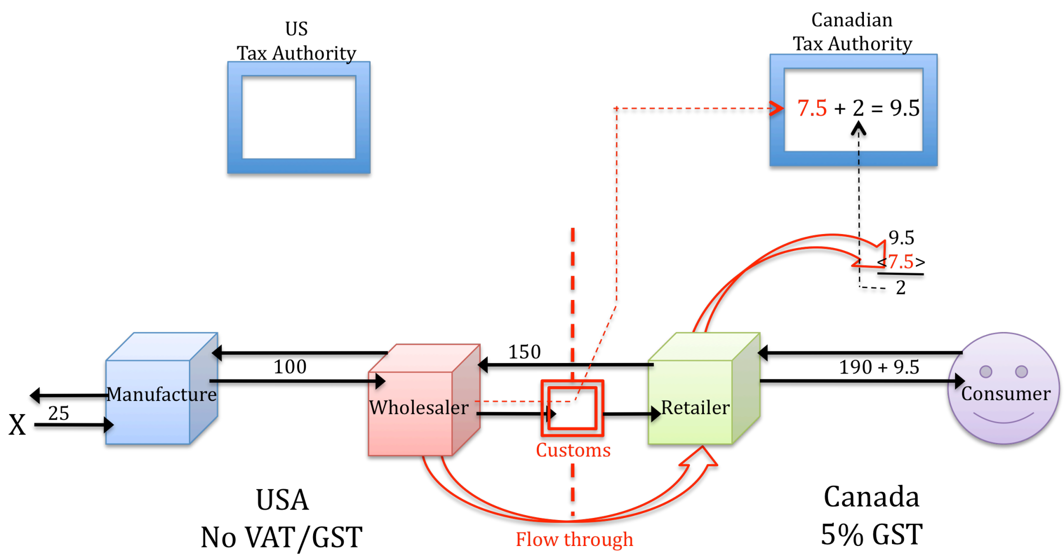
[17] Canadian Revenue Authority, *Doing Business in Canada – GST/HST Information for Non-Residents* (RC4027(E) Rev. 10) at 20, *available at*: http://www.cra-arc.gc.ca/E/pub/gp/rc4027/rc4027-16e.pdf

(2) Sales invoice (or at least a written agreement between the buyer and the seller) showing:
  (a) Actual delivery of the goods, or that
  (b) The goods were made available to the registered Canadian buyer, and that
  (c) The goods were not "used" by the seller in Canada.

These "flow through" rules will even apply to the importation of goods that will be used in the provision of taxable (commercial) services including:

- Manufacturing;
- Testing;
- Processing, which includes marginal manufacturing such as packaging, repackaging, finishing, and cutting to size;
- Evaluation;
- Inspecting; and
- Repair or maintenance.[18]

Figure 6: Canadian "flow-through" solution



Thus, it is not the *import VAT* (generally) that is a trade barrier. *Import VAT* is imposed by all VAT jurisdictions on all imports, and all it does in the normal case is

[18] The interplay of taxable services and imported goods related to that service has long been a problem with Swiss VAT, notably in the context of installations. The Swiss VAT, like the Mexican VAT, has a trap for the unwary and would benefit from a flow through rule like that in the Canadian system. *See*: Reginald A. Derks, *Swiss VAT and Cross-Border Supplies of Goods*, INTERNATIONAL VAT MONITOR (March/April 2002) 81, 86 and n. 38.

restore the withholdings on value added that were removed when the goods were exported. See Figures 4 (part 1) and (part 2) above.

The trade barrier erected by the *import VAT* appears in a much smaller subset of all import transactions. It is only when a *non-resident, non-registered* business declares itself to be the *importer of record*, and then pays the *import VAT* that we have a potential barrier. Even then, it is not a barrier in all cases.

KPMG's study suggest that problematical jurisdictions are less than 29% of all countries imposing a VAT, and within this group there are countries like Canada where the barrier has been substantially (if not entirely) eliminated for parties that do the administrative paperwork to "flow through" the VAT deduction.

There is no available quantification on the size of this group, or the amount of commerce involved, but the numbers appear to be very small. Litigation appears to be non-existent.

THE TRADE BARRIER INVERTED

Trump's two most senior economic policy advisors, Peter Navarro and Wilber Ross, drafted the campaign's economic policy document, *Scoring the Trump Economic Plan: Trade, Regulatory, & Energy Policy Impacts.* Trump's VAT positions are set out under the heading "Ending the Unequal Value-Added Tax Treatment Under WTO Rules." The president-elect's tax and trade statements in the first presidential debate are carefully set out in the policy document.

But the policy document does something more. Near the middle of the VAT section Navarro and Ross offer an extraordinary inversion of the basic Trump argument. Essentially by turning Trump's VAT analysis upside down they observe that the VAT is not so much a barrier as it is an economic force *pulling* US corporations overseas. They suggest that this dynamic is obvious to the careful observer. Corporate flight is the logical outcome of two basic facts.

1. VAT is an "implicit export subsidy" (benefiting foreign manufacturers exporting to the US) and
2. VAT is an "implicit tariff" (harming US manufacturers who export into VAT jurisdictions).

The fact that neither of these "basic facts" is accurate does not diminish the power of the inversion (although it does disguise the genesis of the argument for those unwilling to burrow into the VAT and how it works). Navarro and Ross argue that what follows from (1) and (2) is that:

3. VATs draw US corporations overseas and thereby directly cause American job losses in manufacturing.

In other words, manufacturers flee the US because they seek the benefits of foreign VAT subsidies and the free-pass that comes from the absence of any US *import VAT* on the goods they sell back into the US. Navarro and Ross state:

> It is thus not surprising that US corporations want to move their factories offshore and then export their products back to the US and to the rest of the world. An American subsidiary located overseas gets the VAT benefits on its exports *back* to the US. Of course, such exports to America from the offshore production facility add to the US trade deficit. Such offshoring of capital investment also subtracts from GDP growth.[19]

It simply does not make good sense to argue that when VAT jurisdictions return funds that have been withheld (in anticipation of domestic consumption that never occurs), or when the US determines *not* to impose a federal VAT, that US corporations are pulled overseas. Rather than driving home Trump's VAT argument with a clarifying insight, the inversion undoes it. But this is only apparent to the thoughtful reader who goes back and thinks about the nature of the VAT.

What the inversion does bring into focus (if American corporations are indeed moving overseas to secure a tax advantage by selling back into the US) is not a VAT problem; it is an American retail sales tax problem. Only businesses with a physical presence in a state where a taxable sale has been made are required to collect the RST. *Quill v. North Dakota.*[20] This national tax rule disadvantages local sellers over non-local sellers. States find it exceptionally difficult to collect taxes due from consumers (the use tax).

If Trump's analysis of consumption tax inspired manufacturing flight is correct, then the "tax advantage" of going to Canada and selling back into the US would fall twice as heavily on the RST loophole than on any alleged GST "subsidy." The Canadian GST is 5%, and the vast majority of US RSTs are 70% to 100% higher. If there is a compelling argument here, it is domestic, not foreign.[21] Strong support for the *Marketplace Fairness Act*[22] would make much more sense than an assault on foreign VAT systems.

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[19] Peter Navarro & Wilber Ross, *Scoring the Trump Economic Plan: Trade, Regulatory, & Energy Policy Impacts* (September 26, 2016) at 12, *available at*: https://assets.donaldjtrump.com/Trump_Economic_Plan.pdf

[20] 504 US 298 (1992)

[21] The top two cities for sales taxes in the US are both in Alabama (Birmingham and Montgomery) where a 4% state sales tax is combined with a 3.5 to 4% city sales tax, and a 2 to 2.5% county tax for a combined 10% rate. The next four "highest sales tax" locations are in California: Long Beach, Los Angeles, Oakland and Fremont where a 7.5% state tax combines with city and county taxes in various permutations to reach a combined 9.75% rate.

[22] The *Marketplace Fairness Act* is proposed legislation that would enable state governments to collect sales taxes and use taxes from remote retailers with no physical presence in their state. Identical versions were introduced into both the US House and US Senate during the 113th US Congress. The current bill (the *Marketplace Fairness Act of 2013*) was introduced on February 14, 2013 in the House as H.R. 684 and in the Senate as S. 336. It was introduced a second time in the Senate as S. 743 on April 16, 2013, and was passed there on May 6, 2013.

State revenue losses from RST avoidance due to the *Quill* loophole are estimated to exceed $10 billion per year, with a substantial portion of these losses attributable to foreign businesses.[23] Some states participate in an exchange of information agreement with US Customs and Border Protection, where they, "… receive quarterly extracts of certain goods shipped into the state from international locations."[24] However, US customs is nowhere near as efficient in securing sub-national taxes as is the Canadian Border Services Agency (CBSA) where Provincial taxes are *actually collected* for the Provinces (not just part of an information exchange).[25]

The Trump position on retaliatory tariffs and trade barriers does not seem to have changed much since the election. Trump was on Fox News, Sunday, December 11, 2016. The *Wall Street Journal* reported his appearance as follows:

> How Mr. Trump chooses to go about disciplining companies is being debated by trade experts and watched closely by multinational companies concerned that the president-elect will fulfill repeated threats to impose tariffs of up to 35% on goods coming into the US from American companies who decide to move production out of the country.
>
> Mr. Trump reiterated those warnings at the weekend.
>
> "There's a 35% tax, but there's no tax if you don't move," Mr. Trump said on Fox News Sunday, referring to hypothetical relocation plans by a US company. "If you move your plant or factory and you want to sell back into our country, you fire all your people, there are going to be consequences for that."[26]

Trump's hypothetical company that moves all production, eliminates all employees, but continues to sell back into the American market is a classic picture of a business that could not be compelled to collect the RST under the *Quill* doctrine. Support for the *Marketplace Fairness Act of 2013* should be expected, but has not appeared yet.

CONCLUSION

There seems to have been some misunderstanding within the Trump presidential campaign about the operation of the standard destination, credit-invoice VATs that are in common use globally, and which can account for 30% or more of many country's revenue. This misunderstanding has merged with the president-elect's dislike of NAFTA so that the operation of the VAT, notably the two elements of the border adjustment mechanism, has been construed as a trade barrier. Both (a) the *import VAT* element, which is collected by customs on all taxable imports, and (b) the *zero-rate,* which is

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[23] Richard T. Ainsworth & Boryana Madzharova, *The International Implications of the U.S. Marketplace Fairness Act for E-Commerce,* 71 TAX NOTES INTERNATIONAL 49 (October 7, 2013).
[24] Harley Duncan, *Administrative Mechanisms to Aid in the Coordination of State and Local Retail Sales Taxes with a Federal Value Added Tax* [paper for the American Tax Policy Institute].
[25] "[T]he Provincial Sales Tax is collected by the CBSA on taxable goods imported by, or released to, residents who are defined as individuals who reside in, or carry on businesses in these provinces." http://www.cbsa-asfc.gc.ca/publications/dm-md/d2/d2-3-6-eng.html.
[26] William Mauldin & John D. McKinnon, *Trump's Punitive Powers in Trade Appear Hedged,* WSJ (December 13, 2016) at A-6.

applied to all exports thereby generating a full VAT refund, are seen as offensive tax provisions that need to be corrected (long-term) in a re-negotiation of NAFTA. Trump's proposed short-term response is a sizeable retaliatory tariff (or import tax).

While there could be a sliver of truth in the president-elect's asserted VAT-based trade barrier, it concerns only US exporters who are *non-resident, and non-registered* in the importing jurisdiction and who assume the position of the *importer of record* for the imported goods. This structure is a problem in approximately 29% of all VAT jurisdictions globally. There are a large number of self-help remedies that an informed American exporter can take which completely eliminate this problem. There is no study assessing the number of US firms, or the volume of US exports that fall victim to this problem.

This paper has considered the Canadian and Mexican VATs in this context. It has shown where the Mexican VAT does not correct for the *non-resident, non-registered* importer flaw, but how the Canadian GST provides a fully corrective "flow through" procedure. A Canadian business purchasing goods from a *non-resident, non-registered* importer can quite easily cure the statutory fault that remains in the Mexican VAT, and the cure can be applied retroactively. The Canadian remedy should be offered by Mexico in any re-negotiation of NAFTA.

It is somewhat more troubling when the unusual VAT positions of the incoming Trump administration are used to support the argument that job losses in the American manufacturing sector are caused by the VAT. Essentially, this proposition is that the basic operation of the VAT inexorably *pulls* US firms overseas. As difficult as it is to understand this argument, riding on an inversion of the earlier VAT position of the Trump team, this seems to be the position of both Mr. Trump and the person who will be nominated as the US Secretary of Commerce, Wilber L. Ross, Jr. Mr. Ross co-authored the Trump campaign's primary economic policy document, *Scoring the Trump Economic Plan: Trade, Regulatory, & Energy Policy Impacts,* and most likely fully supports the inverted view of Trump's VAT position, and will fight for tariffs to bring back jobs from the countries that have VATs.

It seems unlikely that players involved in these positions will be backing down from these difficult to justify trade postures. It is disappointing that all of this has been placed at the foot of the VAT.