Trump and VAT: NAFTA, Trade Barriers, and Retaliatory Tariffs

by Richard T. Ainsworth


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In this report, the author considers the VAT aspects of President Donald Trump's trade policy with a specific focus on the United States' NAFTA partners, Mexico and Canada.

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During the first presidential debate, Donald Trump argued that the VAT operates as a trade barrier to U.S. business interests around the globe. In particular, he pointed to the North American Free Trade Agreement, and he singled out Mexico as a special concern.[1] Trump also identified China as a concern, saying he was troubled both by China's VAT and by the nation's alleged currency manipulation.[2]

A discussion of VAT as a trade barrier to U.S. firms is potentially wide-ranging and cannot be fully accomplished here. To fit in a single article, the scope must be narrowed. The NAFTA agreement between the United States, Mexico, and Canada provides an optimal point of focus.

This report will only consider the VAT aspect of President Trump's trade policy. There appears to be some confusion, at least among the general public, about the operation of the VAT, particularly the so-called "border adjustment mechanism" and how U.S. tariffs might "level the playing field." The confusion needs to be cleared up. Much of the following material informed the first session in the VAT course at NYU's Graduate Tax Program, which was presented on January 19, 2017, a mere 24 hours before the inauguration of our 45th president. We all need to be prepared.

For people interested in the broader issues that underpin Trump's VAT position, Mark Houtzager's VAT Tax Blog frames these matters nicely in a post that connects Trump's proposed tariffs with a proposal for an import tax in a bill sponsored by Rep. Bill Pascrell Jr., D-N.J., titled the Border Tax Equity Act (H.R. 6183), and the "Better Way" tax reform proposal put forth by House Speaker Paul D. Ryan, R-Wis., which includes a similar import tax. As Houtzager illustrates, there is common ground in the three proposals.[3] Houtzager also sums up the basic argument examined in this report:

> 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

[1]Aaron Blake, "The First Trump-Clinton Presidential Debate Transcript, Annotated," *The Washington Post*, Sept. 26, 2016:

> [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 —

(Footnote continued in next column.)

> 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, "First Draft: Donald Trump Says He Favors Big Tariffs on Chinese Exports," *The New York Times*, Jan. 7, 2016:

> 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]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.

> 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.[4] [Emphasis added.]

Trump indicated that as president he would respond to these allegedly ''unfair trade practices'' by imposing retaliatory tariffs on goods and services coming into the United States from any country that imposed an *import VAT* on American businesses exporting goods or services to their country.[5] More than 160 countries have a VAT, and all of them impose an import VAT. Trump is, essentially, promising a global trade war. He vows to set U.S. tariffs at a rate that would force governments and businesses to take notice.

For example, Trump indicated that he would retaliate against Mexico's 16 percent import VAT with a 35 percent tariff,[6] and respond to China's 17 percent import VAT with a 45 percent tariff. These rates 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, he needs the consent of Congress. In other cases, he does not. Trump could conceivably set tariffs this high — or higher.[7]

The argument for imposing U.S. tariffs on imported goods from countries that collect an import VAT on U.S. goods raises three important questions that can be answered using NAFTA as an example. Two of these questions are from the perspective of a U.S. exporter, while the third hypothetical involves a U.S. manufacturer that relocates to a NAFTA country and sells back into the United States. All three questions revolve around the two central aspects of border adjustments — the full VAT refund for exports and the import VAT collected from the importer of record. Trump has concerns with both aspects. The three questions are:

- *On U.S. Exports (normal case)*: In a normal case, does the standard destination-based, credit-invoice VAT create a trade barrier equal to the import VAT?
- *On U.S. Exports (atypical case)*: If it does not create 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 import VAT?
- *On U.S. Imports*: Can an American manufacturing company move its operations to Canada or Mexico and gain an unfair advantage when selling back into the United States VAT-free? Put another way, can a manufacturer unfairly benefit from the VAT refund element of the border adjustment provided to exporters from VAT jurisdictions, as compared to comparable manufacturers producing and selling entirely within the United States?

I. The Normal Case

Typically, a standard destination-based, credit-invoice VAT functions as a withholding mechanism, collecting tax at each stage of a supply chain in proportion to the value added at that stage.[8] 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. Many view these transaction-based consumption taxes (VAT and RST) as equivalent levies.[9]

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[4]Mark Houtzager, ''Trump and a Democrat Want a Retaliatory Tariff Against VAT,'' Value Added Tax Blog (Oct. 3, 2016).

[5]''Import VAT'' refers to the imposition of VAT on goods at the border. It is part of the border adjustment process and collected during the customs clearance process. The rate is always the same rate that would be applied if same goods were being sold by a domestic business to a domestic buyer. The intent is to, within the country, equalize tax treatment for the same goods regardless of origin.

[6]Patrick Gillespie, ''Trump's 35 [Percent] Mexico Tax Would Cost Ford Billions and Hurt Americans,'' CNNMoney (Sept. 15, 2016):

> The Republican nominee reaffirmed his plans to slap a 35 [percent] 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 [percent] tax. And you know what's gonna happen, they're never going to leave,'' Trump told Fox on Thursday morning.

[7]The basic authority for U.S. free trade agreements is the Trade Act of 1974. Section 151 authorizes the president to submit agreements to Congress using Trade Promotion Authority (TPA) procedures. The TPA applies only for a limited period, which has been extended by trade bills in 1988, 2002, and 2015. Each extension included section 125, granting the president ''termination and withdrawal authority.'' Section 125(a) requires that every U.S. trade agreement contain withdrawal authority. Section 125(b) allows the president to revoke earlier presidential actions. Section 125(c) gives the president authority to proclaim higher U.S. tariffs, although there is a limit.

TPA procedures apply to NAFTA. To terminate, the president must give six months' notice per NAFTA article 2205,

(Footnote continued in next column.)

terminate, and then issue a proclamation stating that he has terminated the agreement. Under section 301 (unfair trade practices) of the Trade Act of 1974, at the president's direction, the U.S. trade representative can impose higher tariffs on trading partners. Section 122 of that act allows the president to impose temporary import surcharges up to 15 percent for up to 150 days.

[8]*See, e.g.*, art. 401, EU VAT directive (Directive 2006/112/EC).

[9]Joint Committee on Taxation, ''Background on Cash-Flow and Consumption-Based Approaches to Taxation,'' JCX-14-16, at 37-38 (Mar. 18, 2016):

> A broad-based, credit-invoice VAT achieves the same end as a retail sales tax even though it appears to be collecting tax at many stages of production rather than only at the

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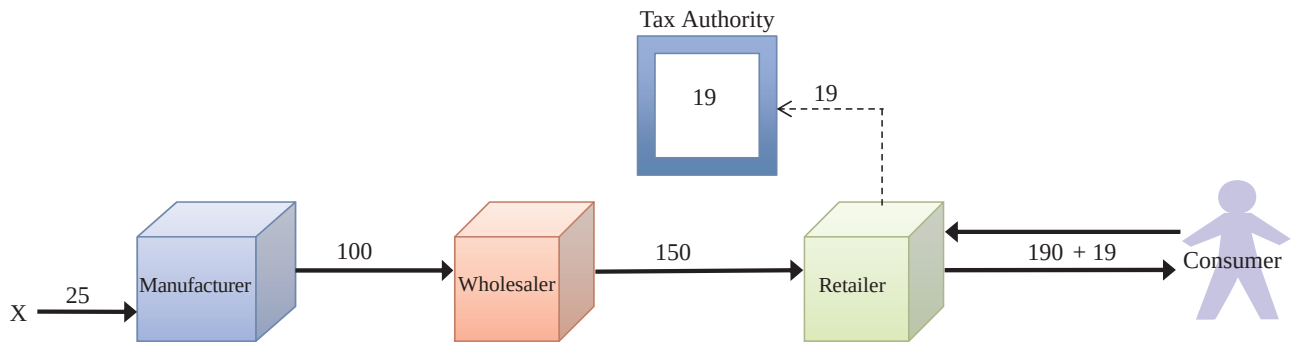
Figure 1. 10 Percent Retail Sales Tax: Common Exchange



A. The Common Example

This article will use a common fact pattern to illustrate various scenarios. Assume a 10 percent RST. Assume further that a manufacturer acquires raw materials for 25 neutral currency units (cu) and sells the manufactured product to a wholesaler for 100 cu. The wholesaler marks up the product by 25 cu and resells it to a retailer that sells to a final consumer for 190 cu.

B. Applying the RST and the VAT

Figure 1 shows the retailer collecting a 19 cu RST from the final consumer and remitting it to the tax authority. Figure 2 shows the same 19 cu tax collected in stages along the same supply chain under a 10 percent VAT. A portion of the tax is collected at each stage. The tax collected is proportional to the value added at each stage. The VAT stretches out the timing of the tax collection, but it 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 until 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 the amount of VAT paid on purchases (inputs) from the VAT collected on sales (outputs).

As illustrated, the VAT and the RST achieve the same tax result.

When transaction chains cross borders (production is in one jurisdiction, consumption in another), destination-based consumption taxes encounter some challenges. But, once again, the RST and the VAT ultimately 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 there are two jurisdictions, A and B, each with a separate tax administration. Assume that the manufacturer and wholesaler are in Jurisdiction A, where the tax rate is 8 percent, while the retailer and final consumer are in Jurisdiction B, where the applicable tax rate is 10 percent.

Figure 3 applies an RST to this scenario. No tax is collected in Jurisdiction A. The full tax of 19 cu is collected in Jurisdiction B. There is no need for a border adjustment.

When a destination-based VAT is applied to the same fact pattern, the withholding mechanism of the VAT does not function properly. 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 is sent to Jurisdiction A, but consumption occurs in Jurisdiction B so that is where the full amount of the tax should be paid. Second, the wrong rate is applied for part of the chain. In the early stages of the production chain, VAT is collected at 8 percent. However, the full tax ultimately due in Jurisdiction B is assessed at 10 percent. The withholdings are not adequate to satisfy the liability at the point of consumption. Even if all the withholdings from Jurisdiction A were paid over to Jurisdiction B, there would be a shortfall. Figure 4 illustrates the cross-border scenario.

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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.

Figure 2. 10 Percent VAT: Common Exchange

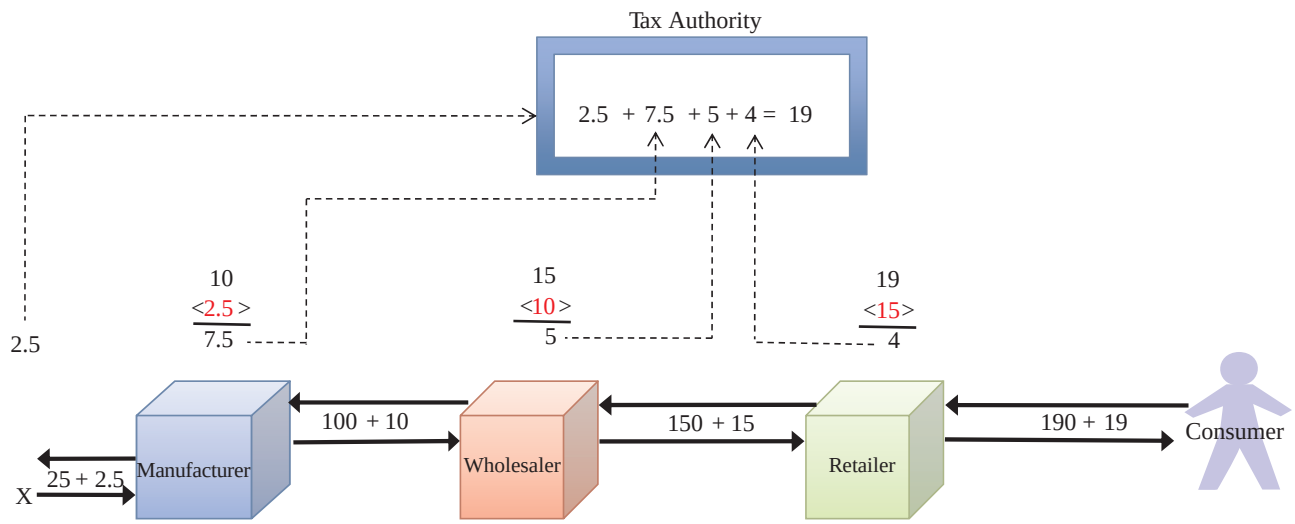
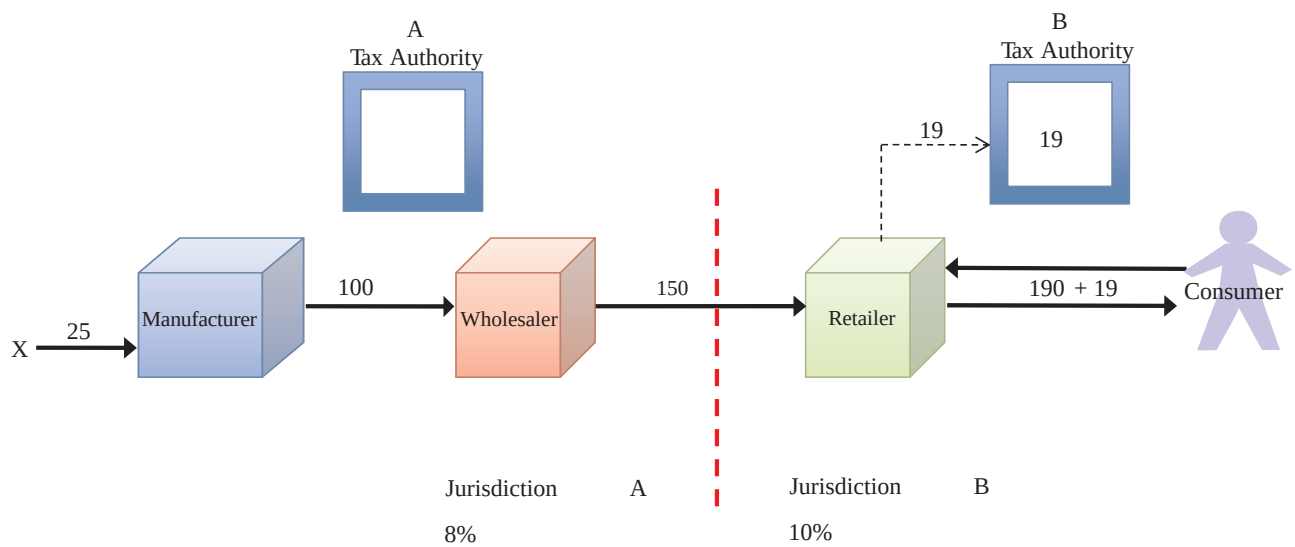


Figure 3. 10 Percent Retail Sales Tax: Cross-Border Application

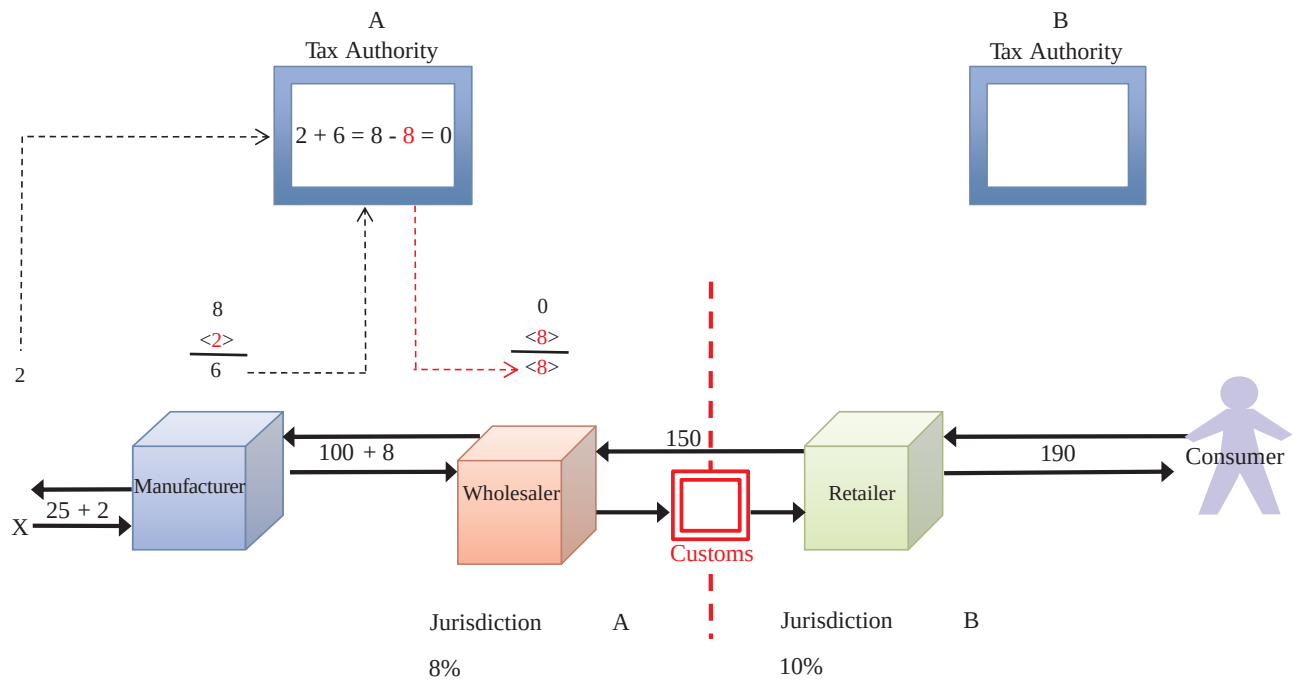


C. The Role of Border Adjustments

Border adjustments solve these problems. The operation of the border adjustment mechanism can be understood in two stages. First, the manufacturer and wholesaler remit VAT (as usual) and submit returns to Jurisdiction A. The 2 cu paid on materials purchased by the manufacturer and 6 cu on net value added by the manufacturer are sent to Jurisdiction A. Then the border adjustment kicks in. Since the wholesaler is exporting (and ensuring that final consumption is entirely outside of Jurisdiction A), the wholesaler is allowed to ''zero-rate'' his export.

Therefore, the wholesaler will file for a full refund of 8 cu. In more detail, the wholesaler's output VAT is zero (because he is exporting the goods), but he is still allowed to deduct his full input VAT of 8 cu. Jurisdiction A gives him a full refund, and no VAT remains in Jurisdiction A from this transaction chain. From the governments' perspective, Jurisdiction A does not withhold VAT for the benefit of Jurisdiction B's tax on final consumption occurring in Jurisdiction B.

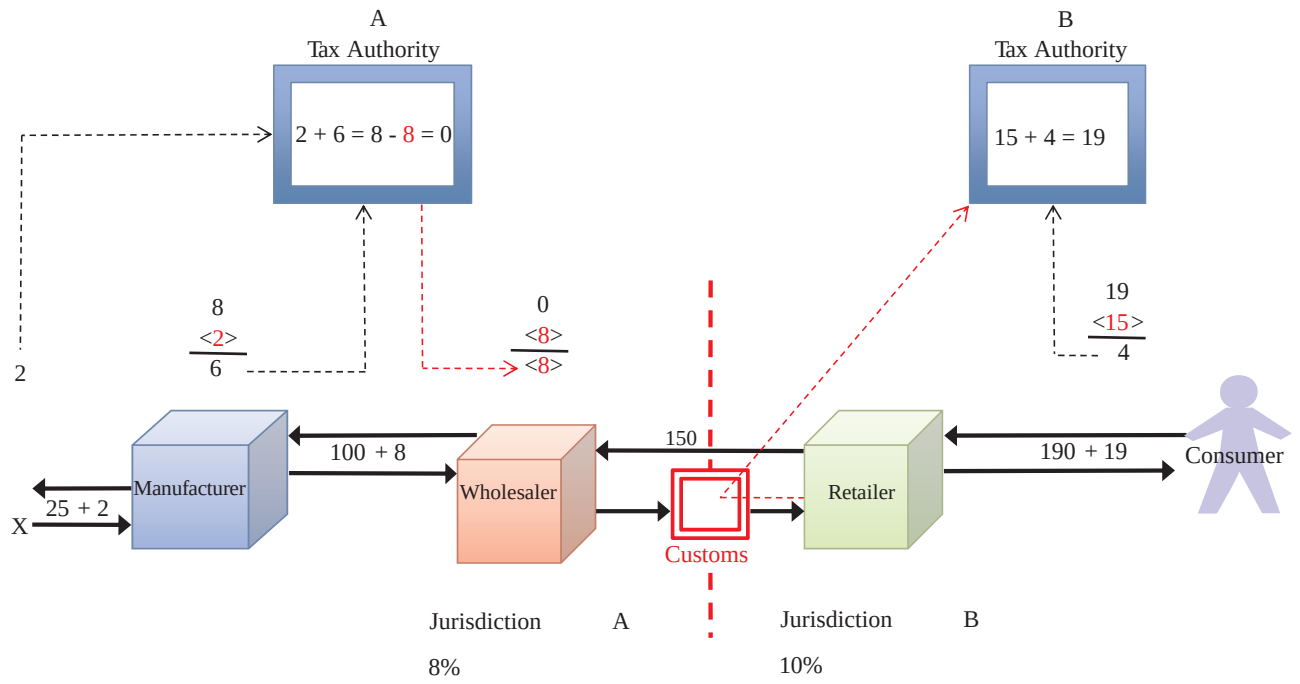
Figure 4. VAT: Cross-Border Application



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 Figure 5).

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 reimposed at the rate applicable in

Figure 5. VAT With Border Adjustment



Jurisdiction B for the full value of the goods entering the country. The importer of record 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 several people:

- seller (wholesaler);
- buyer (retailer);
- middleman (a wholesaler can appoint a middleman, commissionaire, or distributor to operate between the wholesaler and retailer; this middleman is the importer of record and pays the import VAT); or
- fiscal representative (where allowed by local law, a fiscal representative can act as the importer of record on behalf of the wholesaler; the representative pays the import VAT and reclaims the VAT on behalf of the wholesaler).

For purposes of Figure 5, the assumption is that the retailer (buyer) is the importer of record. In this case, the retailer pays the import VAT and later deducts that amount from the output VAT it collects from the final consumer. The retailer is a resident and a registered taxpayer in Jurisdiction B. This transaction is a very typical one.

Here, border adjustments work as advertised. All similar goods manufactured in Jurisdiction B are subject to (or burdened by) the same 10 percent VAT. Similar goods manufactured in Jurisdiction A and processed through customs for sale in Jurisdiction B are unburdened from Jurisdiction A's 8 percent VAT and become subject to Jurisdiction B's 10 percent VAT. VAT is not embedded in the price of the imported goods. There is no unfair advantage.

Figure 5 (a cross-border transaction with VAT) shows the same tax result as in Figure 3 (a cross-border transaction with RST) — 19 cu is collected by Jurisdiction B.

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 does not matter if Jurisdiction A imposes a VAT at a different rate from that imposed in Jurisdiction B or even if Jurisdiction A imposes no tax at all on exports. The import VAT simply applies the same level of withholding to imported goods as is applied to domestically manufactured goods. Ultimately, the retailer in Figure 5 (that is selling imported goods) sells the same goods, charges the same price, and applies the same VAT as the retailer in Figure 2 (that is selling similar, domestically manufactured goods).

Import VAT and the border adjustment mechanism level the playing field. VAT does not tilt the field in favor of imports or in favor of exports.

II. 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 there other (nonstandard) fact patterns in which there *would be* a barrier?

The answer is yes. Consider the situation in which a U.S. exporting firm is nonresident and nonregistered in the importing jurisdiction. A barrier arises if the U.S. firm pays the import VAT but is not allowed to recover it. Canadian rules substantially minimize this barrier, allowing corrections. Mexican rules, however, leave a trap for the unwary U.S. firm, with no corrective mechanism available once the tax is paid and the goods are imported. Chances are a U.S. firm will be caught in this trap only once and will quickly identify one of the many "work-arounds" referenced by Mark Houtzager.[10]

Of course, Mexico and Canada (which has a federal goods and services tax that operates like a VAT) are not the only VAT jurisdictions that present this potential problem for nonresident, nonregistered U.S. traders. KPMG's VAT/GST Refund Survey 2014 found that in 29 percent of the 65 countries surveyed (Mexico and Canada being among the 29 percent), nonresident, nonregistered businesses that were entitled to refunds were generally not allowed to claim them, suggesting "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 examine the rules in all 65 surveyed jurisdictions in great detail. If it did, it would have noted that Canada allows the import VAT that has been paid by a nonresident, nonregistered party (such as a U.S. seller) to be "passed through" with the goods to a registered Canadian firm (the buyer). Some paperwork is required, but the problem can be solved. The U.S. exporter is not required to subsequently register for Canadian GST. Clearly, the operation of the Canadian statute is much less discriminatory than the Mexican version, which in turn is much less discriminatory than some of the other jurisdictions surveyed by KPMG.[12]

The tension is obvious. The cause is competing international tax rules. U.S. businesses that export

[10]*See infra* text accompanying note 13.

[11]KPMG, VAT/GST Refunds Survey 2014 (June 19, 2014) (noting that the survey also found that only 34 percent of the countries surveyed processed VAT/GST refunds efficiently for nonresident, nonregistered taxpayers, leaving the rest of the countries, or 37 percent, spread between these poles).

[12]It is noteworthy that the KPMG survey indicates that in China not only are nonresident, nonregistered businesses denied a refund, but so too are registered, nonresident businesses. *Id*.

into VAT/GST jurisdictions (and otherwise do not conduct 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.

There are commercial workarounds, but 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.

Houtzager's Value Added Tax Blog stresses the abundance of commercial, self-help workarounds, concluding that the trade barrier argument is nonsense. It might be more accurate to acknowledge that there are traps for the unwary, but there are also solutions for those who seek them. The blog indicates:

> The [Trump tariff and Pascrell import tax] proposal[s are] 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]

The common example can be adjusted to illustrate the Mexican and Canadian approaches to dealing with imports from nonresident, nonregistered U.S. exporters who become the importer of record and pay the import VAT (the nonstandard situation without the workaround). The Mexican example is in Figure 6, and the Canadian solution is in Figure 7.

A. Mexico

If the manufacturer and the wholesaler are in the United States, there is no VAT withholding in the supply chain before export. There is no refund because nothing was collected. Figure 6 assumes that the goods are presented to Mexican customs with an invoice value of 150 cu. The VAT is 16 percent; therefore, the import VAT is 24 cu.

The American wholesaler cannot include VAT on the invoice to the Mexican retailer because the wholesaler is neither a Mexican resident, nor a Mexican VAT registered firm.[15] Only a Mexican taxpayer can issue a VAT invoice. When a local retailer (here, the Mexican retailer) purchases goods from a nonresident supplier that does not have a permanent establishment in Mexico (the U.S. wholesaler), the law mandates that the local taxpayer withhold the applicable VAT and submit it to the tax administration.[16] Here, the VAT paid by the U.S. wholesaler at the moment of import can never offset the VAT withheld and paid over by the Mexican purchaser. This means that under Mexican law, there is no way for a nonresident, nonregistered business to get its VAT back.

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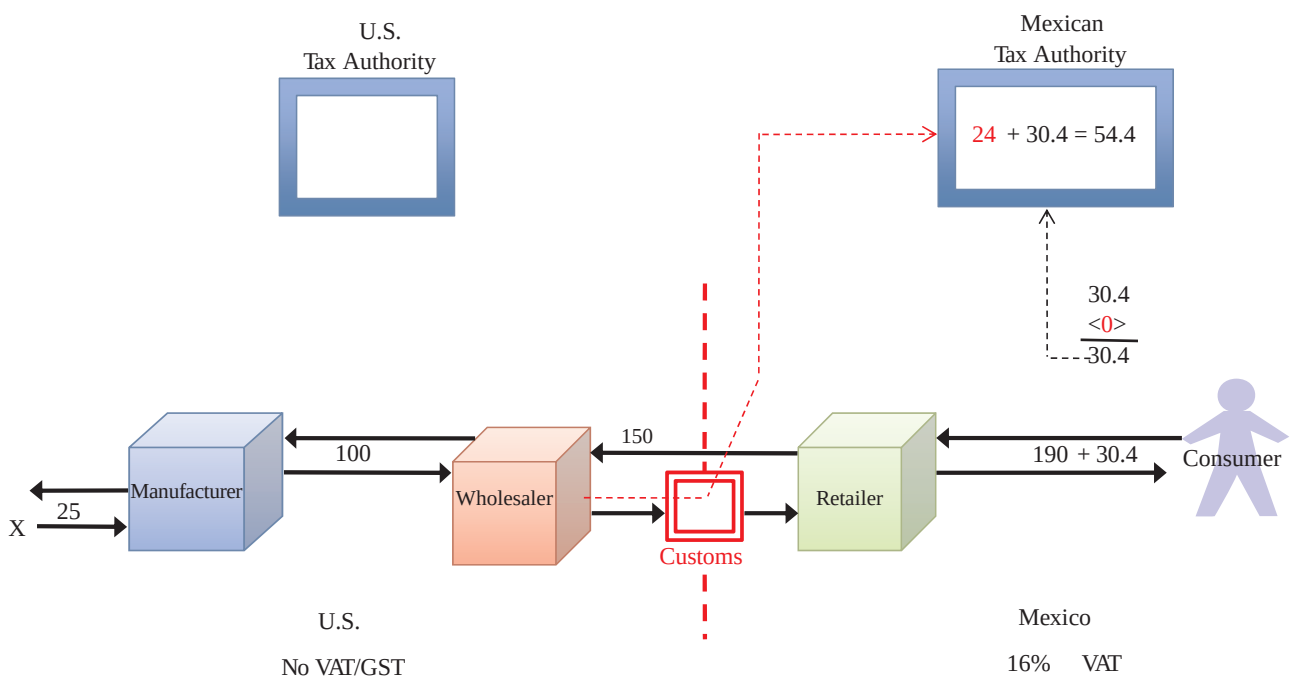
[13]There is second (non-income tax) reason for the desire to avoid registration. Under the American RST, a lack of physical presence in a jurisdiction absolves a seller from an obligation to collect the RST. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) (standing for the proposition that a lack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

[14]Houtzager, *supra* note 4.

[15]If a nonresident, nonregistered entity sells to a registered Mexican business, it cannot mention VAT on the invoice. Even though the invoice is otherwise valid, the nonresident, nonregistered business is not a Mexican taxpayer. Only taxpayers can receive VAT (that is, include VAT on the invoice as part of the total amount paid, collect the tax, and hold it to remit to the tax authorities). In this case, the law provides that the Mexican taxpayer is the importer of record. Ley del Impuesto al Valor Agregado (Mexican VAT Act) article 1o.-A., D.O. (Dec. 29, 1978).

[16]Ley del Impuesto al Valor Agregado (Mexican VAT Act) article 33, D.O. (Dec. 29, 1978), specifically provides that Mexican individuals and entities that permanently or temporarily acquire or use tangible personal property that is sold or provided by foreign residents that lack a Mexican PE are required to withhold the applicable VAT.

Figure 6. The Mexican VAT Problem



Thus, the example records 24 cu in import VAT paid to Mexican customs by the importer of record allowing the goods across the border. The example assumes that the U.S. 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 nonresident, nonregistered U.S. wholesaler to recover the import VAT paid at the border. This amount effectively becomes a trade barrier for an uninformed U.S. wholesaler. The VAT is being overcollected by the amount of the denied refund of 24 cu. The U.S. manufacturer or wholesaler will be disadvantaged as compared with a similar Mexican manufacturer or wholesaler of the same (or similar) product in the Mexican market. The post-import solutions available to the U.S. manufacturer/wholesaler are to either increase the price or decrease profits in some manner throughout the commercial chain.

The Mexican VAT compels an informed nonresident, nonregistered U.S. wholesaler to adopt one of the many pre-import, self-help workarounds.

B. Canada

The Canadian rules are different. Canada makes a concerted effort to allow a nonresident, nonregistered 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 nonresident, nonregistered party; payment of the import VAT is recorded in that name; and a receipt is issued without requiring the importer of record to register for the Canadian GST (not even after the fact).

Canada, however, allows a "flow-through" of the VAT to the Canadian retailer, which may then take the deduction on its return. The Canada Revenue Agency indicates:

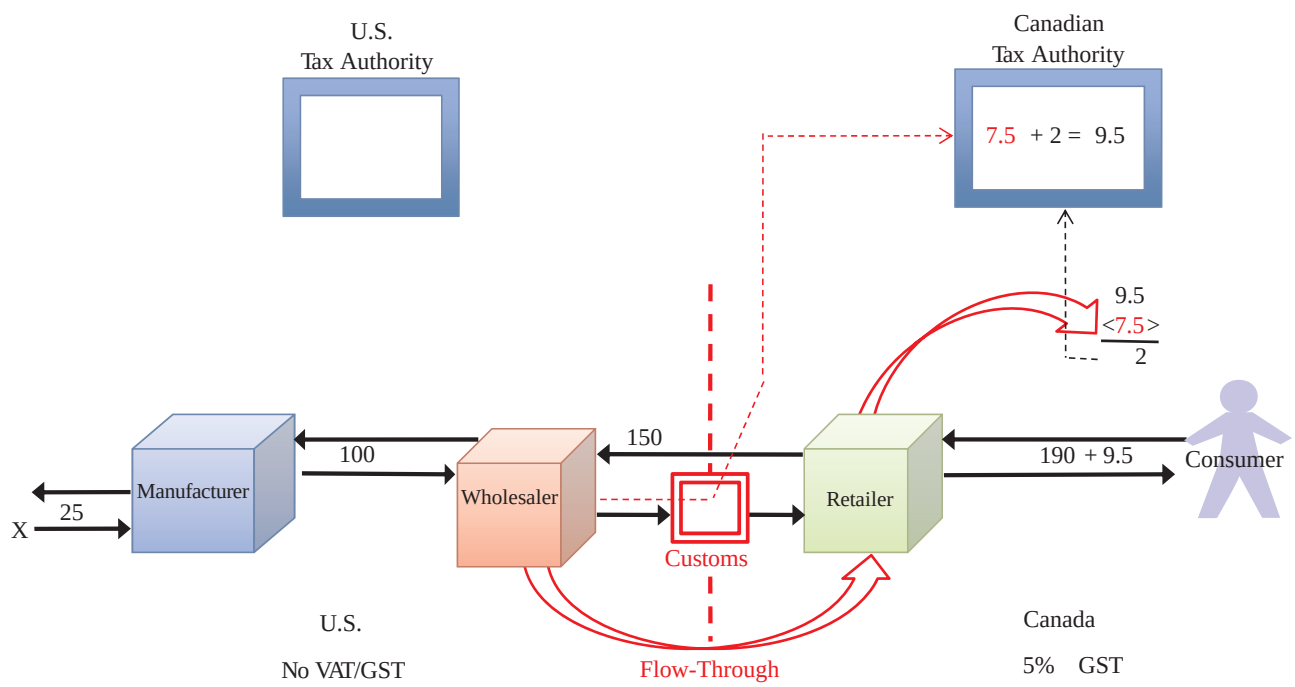
> If you are not a GST/HST registrant, you cannot claim ITCs [Input Tax Credits] for the GST or federal part of the HST [Harmonized Sales Tax] you pay at the time of importation. However, if a customer [of the importer] is a GST/HST registrant, the customer may be able to claim ITCs.[17]

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, not supplies of the seller. Acceptable proof includes:

- a copy of the Canadian Border Services Agency (CBSA) Form B3-3 (called the "Canada Customs Coding Form"), which must be filled out

[17]Canada Border Services Agency, "Doing Business in Canada — GST/HST Information for Non-Residents," RC4027(E) Rev. 10, at 20 (last revised Oct. 27, 2016).

Figure 7. The Canadian 'Flow-Through' Solution



to show that the GST or federal part of the HST was paid at the time of import; and

- sales invoice (or at least a written agreement between the buyer and the seller) showing either:
  - actual delivery of the goods; or
  - that the goods were made available to the registered Canadian buyer and that the goods were not "used" by the seller in Canada.

These flow-through rules apply even to the import 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]

The flow-through solution helps both the U.S. seller and the Canadian buyer. The seller can pay the GST promptly at the border to facilitate the expeditious delivery of the goods and reflect this amount in the selling price without establishing a taxable presence in Canada for income tax or nexus for provincial sales tax purposes. The Canadian buyer will know that the upward price adjustment it sees on the invoice can be immediately reclaimed when it files its next GST return. There is no prohibition to buyer and seller arranging this transaction in advance, and the efficient use of this provision by Canadian buyers can be used to assure American sellers that there is no GST-based trade barrier at the border.

C. Analysis

Thus, on a general level, import VAT is not a trade barrier. Import VAT is imposed by all VAT jurisdictions on all imports. All it does, in the normal case as illustrated in figures 4 and 5, is restore the withholdings on value added that were removed when the goods were exported.

It is only in a much smaller subset of import transactions that an import VAT creates a trade barrier. Only when a nonresident, nonregistered business declares itself to be the importer of record and then pays the import VAT is there a potential barrier. Even then, the barrier doesn't appear in all cases.

[18]The interplay of taxable services and imported goods related to that service has long been a problem under the 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* at 81, 86, and n. 38 (Mar./Apr. 2002).

KPMG's study suggests that the potential trade barrier arises in less than 29 percent of all countries that impose a VAT. Within this group there are also countries like Canada where the barrier has been substantially (if not entirely) eliminated for parties that do the administrative paperwork to trigger the ''flow-through'' VAT deduction.

There is no available quantification on the number of countries or the amount of commerce affected by this type of barrier, but the numbers appear to be very small. Litigation appears to be nonexistent.

III. The Trade Barrier Inverted

Trump's two most senior economic policy advisers, Peter Navarro and Wilbur 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 tax and trade statements that Trump made 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 Trump's basic 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 U.S. corporations overseas. They suggest that this dynamic is obvious to the careful observer. Corporate flight is, they posit, the logical outcome of two basic facts:

> 1. The VAT is an ''implicit export subsidy'' (benefiting foreign manufacturers exporting from VAT jurisdictions to the United States); and
>
> 2. The VAT is an ''implicit tariff'' (harming U.S. manufacturers that 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). The power of the inversion derives both from parallel construction, the flawed premise (implicit subsidy/implicit tariff) and the fact that both of these require the reader/listener to ferret out the truth in what is probably very unfamiliar tax territory — the VAT. The foundational arguments are both wrong, but it takes some effort to get there.

It is clear that there is no subsidy in any credit-invoice destination VAT, but somehow making the asserted subsidy ''implicit'' rather that explicit or statutory makes it seem more probable. Similarly, whatever ''tariff-like'' attributes a VAT like that in Mexico may have can always be corrected with self-help measures, if not through the more elegant Canadian pass-through solution. The tariff is hardly implicit. With very few exceptions, it is really nonexistent.

Navarro and Ross use these erroneous premises to draw an inverted conclusion, one that does not speak to the functioning of the VAT, but one that quite directly argues that the intended design of the VAT is to take American jobs. The norm in this kind of economic/tax policy argument would be to offer some measures or some quantification of what was asserted. Perhaps we are supposed to accept that the ''implicit'' effects of a VAT are not subject to normal metrics. Nevertheless, Navarro and Ross flip this argument to job losses and manufacturing migration, and Trump was all too anxious to point here, even though the argument of his advisers did not get him there.

Navarro and Ross argue that what follows from (1) and (2) is that:

> 3. VATs draw U.S. corporations overseas, directly causing the loss of American manufacturing jobs.

In other words, manufacturers flee the United States seeking the benefits of foreign VAT subsidies and the free pass that comes from the absence of any U.S. import VAT on the goods they sell back into the United States. Navarro and Ross state:

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

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 U.S. declines to impose a VAT itself, U.S. corporations are pulled overseas. Rather than driving home Trump's VAT argument with a clarifying insight, the inversion undoes it — although this is only apparent to the attentive reader who goes back and gives thought to the true operation of the VAT.

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[19]Peter Navarro and Wilbur Ross, ''Scoring the Trump Economic Plan: Trade, Regulatory & Energy Policy Impacts,'' at 13 (Sept. 26, 2016).

What the inversion argument does is makes it clear that, assuming American corporations are indeed moving overseas to secure a tax advantage by selling back into the United States, this is not actually a VAT problem; it is an American retail sales tax problem. Under current law, only businesses with a physical presence in a state where a taxable sale has been made are required to collect RST.[20] This national tax rule, which essentially creates a loophole in the RST system, disadvantages local sellers over nonlocal sellers. States find it exceptionally difficult to collect taxes due from consumers (the use tax). Foreign sellers into the U.S. market sell ''tax free.'' Local sellers never sell ''tax free.'' There is considerable inconsistency in Trump's tax policy arguments here. Allowing ''tax-free'' competitors into local markets puts local merchants into financial difficulty, and this directly affects U.S. jobs. This is a consumption tax problem that could easily be remedied with federal action under the interstate commerce clause, but Trump never mentions this aspect of consumption taxation. He never mentions it even though this is a tax rule that the federal government has complete control over.

If Trump's belief in consumption-tax-inspired manufacturing flight is accurate, then the supposed ''tax advantage'' of fleeing to Canada and selling back into the United States would come more from the RST loophole than any alleged GST/VAT subsidy. While the Canadian GST is 5 percent, the majority of U.S. RSTs are 70 to 100 percent higher. Thus, businesses would benefit more — potentially doubly — from avoiding the U.S. RST (and being able to charge customers more or offering an attractive total price that is lower than those local businesses that collect RST) by not having a local presence in *any* state than they would benefit from any purported VAT-related tax advantage. 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.

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 U.S. Customs and Border Protection, receiving ''quarterly extracts of certain goods shipped into the state from international locations.''[24] However, U.S. customs is nowhere near as efficient at securing subnational taxes as the CBSA where provincial taxes are *actually collected* for the provinces (versus simply being 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 appeared on Fox News on December 11, 2016. *The Wall Street Journal* reported on 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 [percent] on goods coming into the US from American companies who decide to move production out of the country.
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> Mr. Trump reiterated those warnings at the weekend. ''There's a 35 [percent] tax, but there is 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 and eliminates all employees but continues to sell back into the American market is a

[20]*Quill*, *supra* note 13.

[21]The two cities with the highest sales taxes in the United States are both in Alabama. In Birmingham and Montgomery, state, city, and county taxes combine to create a 10 percent rate. The next four ''highest sales tax'' locations are in California. In Long Beach, Los Angeles, Oakland, and Fremont, state, city, and county taxes combine in various permutations to hit a 9.75 percent rate.

[22]The Marketplace Fairness Act is proposed legislation that would enable state governments to collect sales and use taxes from remote retailers with no physical presence in their state. Identical versions were introduced into both the House and Senate during the 113th U.S. Congress. The current bill (the Marketplace Fairness Act of 2013) was introduced on February

(Footnote continued in next column.)

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.

[23]Ainsworth and Boryana Madzharova, ''The International Implications of the U.S. Marketplace Fairness Act for E-Commerce,'' *Tax Notes Int'l*, Oct. 7, 2013, p. 49.

[24]Harley Duncan, ''Administrative Mechanisms to Aid in the Coordination of State and Local Retail Sales Taxes With a Federal Value Added Tax'' (2010) (paper for the American Tax Policy Institute).

[25]The Provincial Sales Tax is collected by the CBSA ''on taxable goods imported by, or released to, residents who are defined as individuals who reside, ordinarily reside, or carry on businesses in these provinces.'' CBSA, ''Non-Commercial Provincial Tax Collection Programs,'' Memorandum D2-3-6 (June 8, 2016).

[26]William Mauldin and John D. McKinnon, ''Trump's Punitive Powers in Trade Appear Hedged,'' *The Wall Street Journal*, Dec. 13, 2016, at A-6.

classic picture of a business that could not be compelled to collect and remit the RST under the *Quill* doctrine. Support for the Marketplace Fairness Act of 2013 would make sense and should follow from the Trump team's reasoning, but has not appeared yet.

IV. Conclusion

There seems to have been some misunderstanding within the Trump presidential campaign about the operation of the standard destination-based, credit-invoice VATs that are in common use globally and account for 30 percent or more of many countries' revenue. This misunderstanding has merged with the president's dislike of NAFTA so that the operation of the VAT, particularly the border adjustment mechanism, has been construed as a trade barrier. Both (a) the import VAT, which is collected by customs on all taxable imports, and (b) the zero rate, applied to all exports to generate a full VAT refund, are seen as offensive tax provisions that need to be corrected long-term via a renegotiation of NAFTA. In the short term, Trump proposes a sizable retaliatory tariff (or import tax).

While there may be a sliver of truth in Trump's assertions regarding a VAT-based trade barrier, it is *only* a sliver. The barrier only affects U.S. exporters that are nonresident and nonregistered in the importing jurisdiction and act as the importer of record for the imported goods. This problem arises in approximately 29 percent of all VAT jurisdictions globally and there are many self-help remedies that an informed American exporter can take to completely eliminate the problem. There is no study assessing the number of U.S. firms, or the volume of U.S. exports, that fall victim to this trap.

This article has examined the Canadian and Mexican VATs in this context. As demonstrated above, while the Mexican VAT does not correct for the nonresident, nonregistered importer flaw, the Canadian GST provides a fully corrective procedure. A Canadian business purchasing goods from a nonresident, nonregistered U.S. importer can easily cure the statutory flaw that remains a problem in Mexico; the cure can even be applied retroactively. Any renegotiation of NAFTA should include a provision applying the Canadian remedy to sales from the United States into Mexico.

It is somewhat more troubling when the unusual VAT positions of the incoming Trump administration are used to support the argument that the VAT is responsible for job losses in the American manufacturing sector. Essentially, this proposition suggests that the basic operation of the VAT inexorably *pulls* U.S. firms overseas. As difficult as it is to understand this position, which rests on an inversion of the Trump team's broader (flawed) VAT argument, it seems to be the position of both Trump and his nominee for secretary of commerce, Wilbur Ross. Ross coauthored the Trump campaign's primary economic policy document, "Scoring the Trump Economic Plan: Trade, Regulatory & Energy Policy Impacts."[27] He most likely fully supports Trump's inverted trade barrier position and will probably fight for tariffs to bring back jobs from the countries that have VATs.

It seems unlikely that the players involved in these positions will back down from these difficult-to-justify trade postures. It is disappointing that so much blame has been placed at the foot of the VAT. ■

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[27]*Supra* note 19.