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# MEMORANDUM

**February 10, 2017**

**TO:** Italy America Chamber of Commerce

**FROM:** Frank J. Desiderio

**CC:** Federico Tozzi
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**RE:** Presidential Authority to Implement Tariffs

This memorandum represents a preliminary analysis of potential measures that the Trump Administration might employ to increase duties or taxes on goods imported into the United States. Set forth below are the current authorizations pursuant to which the President may impose increased duties through an executive order, as contrasted with actions requiring an act of Congress. Also set forth below is a summary of the latest proposal to revise the corporate income tax laws to create a so-called "border adjustable" tax system.

## I. AUTHORITY TO IMPOSE ADDITIONAL TARIFFS

Generally, the President cannot increase tariffs via executive action. Article 1, Section 8 of the U.S. Constitution gives Congress the sole authority to impose tariffs and to "regulate Commerce with Foreign Nations." Thus, any attempt to increase tariffs would have to be approved through a new Act of Congress, or it would have to be expressly delegated by Congress to the President through existing statutes.

In addition to complying with U.S. law, increased duties or similar measures must be consistent with the United States' obligations under the World Trade Organization ("WTO") Agreements. Two of the most fundamental WTO obligations are the concepts of "Most Favored Nation" and "Tariff Bindings." Most Favored Nation means that WTO members must treat imports from one member the same as the others. GATT Art. I.[1] In other words, a member cannot place a tariff of 10% on apples from China while only placing a tariff of 5% on apples from Japan. Tariff Bindings refer to the agreement that WTO members cannot impose tariffs that are different than those agreed upon. GATT Art. II. As part of WTO membership, all countries agreed to certain tariff levels on most goods.

[1] Under Article II of the 1994 "Agreement Establishing the World Trade Organization," the contracting parties are obligated to comply with the *General Agreement on Tariffs and Trade 1947* (GATT 1947), 55 U.N.T.S. 194. References in this memo to GATT Art. I and II are from the GATT 1947.

If the U.S. applies a tariff or trade measure that is inconsistent with the WTO Agreement, then the affected countries have the ability to dispute the measure through the WTO dispute settlement mechanism. If the WTO finds against the U.S., the WTO can authorize retaliation against the violating country. Retaliation can include (a) increased tariffs totaling the value of the violation, (b) sanctions on intellectual property and (c) restrictions on services (e.g., preventing U.S. from providing financial services to the country), among other possibilities.

With that background in mind, there are several options President Trump has for increasing tariffs against a specific country. These include:

1. New legislation (act of Congress)
2. Section 301 of the Tariff Act of 1974
3. Section 122 of the Trade Act of 1974
4. Section 232(b) of the Trade Expansion Act
5. Trading with the Enemy Act of 1917
6. International Emergency Economic Powers Act

Each of these are discussed in turn below.

**OPTION 1: New Legislation**

Congress has the authority to impose new tariffs on imported goods. President Trump could work with Congress to enact a law increasing tariffs against goods of a specific country or countries (e.g., a 45% on goods from China). However, while legal under the U.S. Constitution, a a tariff imposed on goods from only selected countries would violate the Most Favored Nation in GATT Art. 1. If Congress imposed an increase in duty rates on products imported from all countries that exceeded the "bound" rates of duty agreed to under the WTO Agreement, the measure would violate GATT Art. II. In either case, the affected countries would likely invoke the WTO dispute settlement mechanism, which would eventually result in retaliatory measures being imposed that would adversely affect U.S. exports.

If, for example, Congress enacted a law imposing a 45% ad valorem duty on goods of Chinese origin, and the WTO Dispute Settlement Body found that the U.S. violated its WTO obligations, then the WTO would authorize China to impose retaliatory tariffs on U.S. exports to China equal to $225 billion ($500 billion [value of 2015 Chinese imports] x 45% [proposed tariff]). As U.S. exports to China are roughly $120 billion a year, the retaliatory duty rate imposed on U.S. origin goods could be nearly 200% ad valorem. China could also prevent U.S. firms from getting patents in China or prevent U.S. banks from providing financial services in China.

**OPTION 2: Section 301 of the Tariff Act of 1974**

Section 301 of the Tariff Act of 1930 (19 U.S.C. §2411 et seq) authorizes the U.S. Trade Representative ("USTR") to investigate foreign government policies or practices that:

a) deny rights of U.S. persons and interests under international agreements; or

b) unreasonable, unjustifiable, or discriminatory foreign government practices that burden or restrict U.S. commerce.

19 U.S.C. § 2411 (a) & (b). The USTR is an executive branch agency and it acts at the direction of the President. This statutory authorization may be used to address any unfair trade practice (e.g., market access, intellectual property, etc.). The authorization is very broad and extends to any "unreasonable" practice that "burdens" U.S. commerce. The USTR must first seek consultations with the foreign government whose acts, policies, or practices are the subject of the investigation. If there is no resolution, the USTR is authorized to:

1. Suspend concessions given under trade agreements;
2. Impose duties or other import restrictions (which may constitute a suspension of concessions under one or more trade agreements);
3. Impose fees or restrictions on services;
4. Enter into agreements with the subject country to eliminate the offending practice or to provide compensatory benefits for the United States; and/or
5. Restrict service sector authorizations.

*Id*.

The law does not require WTO authorization to impose tariffs or other measures, and thus the President (through the USTR) can act unilaterally. Historically, it has been the U.S. practice to invoke the WTO dispute settlement procedures and obtain WTO authorization before imposing tariff measures against specific countries. More importantly, the WTO has already ruled that taking any such actions against other WTO member countries without first securing approval under the WTO Understanding on Rules and Procedures Governing the Settlement of Disputes is, itself, a violation of the WTO Agreement. *See United States - Sections 301-310 of the Trade Act of 1974*, WTO Panel Report, WT/DS152/R, adopted January 27, 2000, paras. 7.38-7.39.

**OPTION 3: Section 122 of the Trade Act of 1974**

Section 122 addresses the President's ability to respond to "fundamental international payments problems." It authorizes the President to address "large and serious United States

balance-of-payments" deficits by imposing temporary import surcharges not to exceed 15 percent ad valorem on imported goods; impose temporary import quotas; or both. 19 U.S.C. § 2132. The President can impose a tariff of up to 15 percent or quantitative restrictions, or a combination of the two, for up to 150 days, as a remedy, either on a nondiscriminatory basis or against one or more countries selected because of their large balance of payments surpluses. If President desired to impose the tariff beyond the 150 days, Congressional approval is needed.

**OPTION 4: Section 232(b) of the Trade Expansion Act**

Section 232(b) provides the U.S. Department of Commerce ("Commerce") with authority to investigate imports that threaten "national security." 19 U.S.C. § 1862(b). It states "[u]pon request of the head of any department or agency, upon application of an interested party, or upon his own motion, the Secretary of Commerce . . . shall immediately initiate an appropriate investigation to determine the effects on the national security of imports of the article which is the subject of such request, application, or motion." *Id*. Commerce has 270 days to complete its investigation at which time it must submit a report to the President on its findings and recommendations. There is no limit on the tariffs that can be imposed or the length of time they can be imposed.

The application of this provision turns on the definition of a threat to national security. While the law is silent to its meaning, Commerce's most recent 232 investigation provides guidance. In 2001, Commerce conducted a § 232 investigation on the effects of imports of iron ore and semi-finished steel on the national security of the United States. In that case, Commerce adopted a broad definition of "national security" explaining:

> It is clear that, at a minimum, an assessment of the United States' "national security" requirements must include a military or "national defense" component. This could range from the military defense of the U.S. homeland to, more expansively, the ability to project U.S. military capabilities globally. . . .
>
> In addition to the satisfaction of national defense requirements, the term "national security" can be interpreted more broadly to include the general security and welfare of certain industries, beyond those necessary to satisfy national defense requirements, that are critical to the minimum operations of the economy and government ("critical industries"). [2]

[2] Previous Section 232 investigations have adopted a more limited definition of national security. *See, e.g.*, *U.S. Department of Commerce, The Effects on the National Security of Imports of Crude Oil and Refined Petroleum Products* (1999) (looking only at DOD requirements when assessing national security needs). Moreover, as the Supreme Court has made clear, there are limits to how broadly the term "national security" can be defined. *See Fed. Energy Admin. v. Algonquin*, 426 U.S. 548, 569 (1976) (stating that "national security" must be interpreted more narrowly than "the national interest"). However, the legislative history of Section 232, including the legislative history of predecessor provisions, indicates that some members of

*U.S. Department of Commerce, The Effect of Imports of Iron Ore and Semi-Finished Steel on the National Security*, at 5-6 (October 2001).

The next question that is undefined by statute is, when do imports "threaten" national security? Again, the most recent § 232 investigation is instructive. There, Commerce identified two ways that imports can threaten national security.

> (1) imports can threaten to impair U.S. national security if the United States is excessively dependent on imports from unreliable or unsafe sources, and thereby is vulnerable to a supply disruption.
>
> (2) imports can threaten to impair U.S. national security if they fundamentally threaten the viability of U.S. industries and resources needed to produce domestically goods and services necessary to ensure U.S. national security.

*Id*. at 6-7. Ultimately, in this case, Commerce found that imports did not threaten national security because "[t]here is neither evidence showing that the United States is dependent on imports of iron ore or semi-finished steel, nor evidence showing that such imports fundamentally threaten the ability of domestic producers to satisfy national security requirements." *Id*. at 1.

Based on the history of § 232 investigations, the changing definitions of "national security" in those investigations, and the general nature of Commerce as an "executive agency" whose views can be strongly influenced by the President, the future use of a § 232 investigation by the Trump Administration is a very real possibility. However, using these investigations to achieve higher tariffs on a particular product would likely result in both U.S. court challenges[3] and WTO challenges. If challenged at the WTO, the United States could claim the little used GATT Article XXI Security Exceptions, which permit a member country to depart from WTO obligations in "time[s] of war or other emergency in international relations." Employing this provision in this manner would be unprecedented and could trigger retaliatory actions by affected countries.

**<u>OPTION 5: Trading with the Enemy Act of 1917 (TWEA)</u>**

TWEA, enacted when the U.S. was entering World War I, permits the President to regulate all forms of international trade, travel, investment, and finance during war time. It has been extended to cover national emergencies as well. As an example, the current U.S. embargo on trade with Cuba relies upon TWEA for its authorization. While the act does not specifically identify the

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Congress intended that "national security" should encompass certain domestic economic concerns, in addition to national defense concerns. See e.g. S. Rep. No. 85-1838, at 12 (1958).

[3] There would a strong case against an even broader definition of national security based on past Commerce decisions. However, the courts typically give the executive much deference in matters of national security.

imposition of increased duties, at least one federal appeals court has held that TWEA delegates to the President, for use during war or during national emergency only, the power to impose duties on imports. *United States v. Yoshida International, Inc*., 526 F.2d 560, 573 (C.C.P.A. 1975). In that case, President Nixon had imposed a 10 percent surcharge on zippers from Japan. The "national emergency" in that case was the Korean War, which ended in 1953, but for which a state of national emergency was still in place. Ultimately, the court concluded that:

> Congress, in enacting § 5(b) of the TWEA, authorized the President, during an emergency, to exercise the delegated substantive power, i.e., to "regulate importation," by imposing an import duty surcharge or by other means appropriately and reasonably related, as discussed below, to the particular nature of the emergency declared

*Id*. at 576-77.

TWEA has not been used since 1971 to increase import duties but it remains possible for this statue to be used to increase tariffs against a specific country.

**OPTION 6: International Emergency Economic Powers Act (IEEPA)**

IEEPA was passed in 1976 as a companion to the TWEA. It authorizes the President to address unusual and extraordinary threats to national security, foreign policy, or the economy of the United States:

> **§ 1701. Unusual and extraordinary threat; declaration of national emergency; exercise of Presidential authorities**
>
> (a) may be exercised to deal with any **unusual and extraordinary** threat, which has its source in whole or substantial part outside the United States, to the national security, foreign policy, or **economy of the United States**, if the President declares a **national emergency** with respect to such threat.
>
> (b) The authorities granted to the President by section 203 [50 USCS § 1702] may only be exercised to deal with an unusual and extraordinary threat with respect to which a national emergency has been declared for purposes of this title [50 USCS §§ 1701 et seq.] and **may not be exercised for any other purpose.**

50 U.S.C. **§** 1701 (emphasis added). IEEPA permits the President to, among other things, " investigate, regulate, or prohibit . . .the importing or exporting with respect to any property, subject to the jurisdiction of the United States." Id. IEEPA requires the President to consult with Congress, providing reports and updates, but does not require Congressional approval. IEEPA is currently the statutory authorization for sanctions against Iran, Syria, Russia and other countries and entities.

The contextual purpose of IEEPA was to give the president tools to inflict economic sanctions on America's enemies and adversaries. However, while the unilateral increase in tariffs against countries such as China is not necessarily what IEEPA was enacted to address, the past, broad interpretation of an "unusual or extraordinary threat" suggests that the President could interpret IEEPA in such a manner.

As with the other statues addressed, the use of IEEPA in this manner would likely trigger WTO challenges.

**Conclusion**

These six options are the potential avenues that we see for the President to increase tariffs on imports from a specific country. Of all the options, the most likely would be Section 301 of Trade Act of 1974, as this procedure puts the action in the hands of the USTR, who acts at the direction of the President. The other options are less likely but still possible.

Since most unilateral action would almost certainly violate the WTO, an important predictor of whether these statutes will be used is how the new administration views the WTO. If the administration expresses a lack in confidence in the efficacy of the WTO regime, it is more likely that we will see one of these unilateral actions put in place.

While the President and his trade team determines whether unilateral action is needed, it is likely that we will see an increase in the use of other trade remedy and enforcement mechanisms, including (1) possible self-initiation of new antidumping/countervailing (AD/CVD) duty cases, (2) anti-circumvention proceedings, and possible (3) safeguards (duties or quotas). All of these measures are imposed only after an investigation by the Department of Commerce and/or International Trade Commission, in which interested parties can participate. Because these trade remedies can only be imposed if specific statutory standards are met, and the agencies' final decisions are subject to judicial review, these trade measures are not easily influenced by the President.

## II. BORDER ADJUSTABLE TAX PROPOSAL

Various members of Congress have raised the prospect of substantially revising U.S. income tax laws. One of the most significant aspects of the leading proposal published by the House Ways and Means Committee—the "Border Adjustment Tax"—dramatically affects importers and retailers in the United States.

**Background**

Currently, corporations are taxed in the US on their profits, which are roughly defined as revenue minus costs, at a marginal rate of 35%. The proposed Border Adjustment Tax ("BAT") changes the corporate income tax in five ways:

1. The tax rate would be lowered to 20%.
2. Businesses would no longer need to depreciate capital investments. Instead they will be able to write off, or expense them, in the way in which they purchased them.
3. Businesses would no longer need to pay tax to the IRS on profits they earn overseas.
4. Businesses would no longer be able to deduct interest as a business expense.
5. The corporate tax would be "border adjusted".

**How Does the "Border Adjustment" Work?**

Under the plan, the revenue from sales to nonresidents would not be taxable. The cost of goods purchased from non-residents would not be deductible. The following example, which has been used to illustrate how the BAT works, suggests that US taxes on an imported sweater could go from $1.75 to $17.00.

**Example 1**

A US distributor buys a sweater from its overseas supplier for $80. The US distributor has an additional $15 in other expenses associated with that sweater. The US distributor sells the sweater at retail for $100.

Currently, tax is calculated on $100 in revenue, less the $80 cost of the good, less the $15 other costs. This leaves $5 in profit (100 – 80 = 20 and 20 – 15 = 5). If the US distributor pays a typical 35% tax rate on the $5 profit, it is taxed $1.75 in the US (5 x 35% = 1.75).

If the proposed plan is adopted, the tax is still calculated on $100 revenue, but only the $15 of "other expenses" is deductible. That leaves taxable revenue of $85 (the $80 cost it paid for that sweater from the overseas supplier plus the profit of $5). The 20% tax rate is applied to $85, and thus the tax goes from $1.75 to $17 (more than three times the profit in this example).

Another example is designed to illustrate how the proposal would impact exporters and importers differently.

**Example 2**

An Export Company and Import Company each earn $1,000 a year in revenue from selling their products. Export Company spends $800 a year buying parts for its products, earning a $200 profit. Import Company spends $800 a year buying imported products from abroad, also earning a $200 profit. Currently, those profits would (all else being equal) be treated the same. Both companies would be subject to a 35% tax rate, and both would pay $70 a year in taxes.

However, under the BAT, Export Company makes all of its revenue from exporting its products. That revenue would be exempt, and therefore its taxable revenue would be $0.

Under the BAT, Export Company would pay no taxes and even potentially receive a rebate under certain variations of the plan.

In contrast, all of Import Company's revenue would still be taxed and Import Company would not be allowed to deduct the $800 it spends on imported goods. Import Company's taxable profit would increase to $1,000. Even at the lower tax rate (20%), Import Company is taxed $200.

Essentially, the proposed corporate tax would disregard revenues and costs associated with cross-border transactions. The tax would be solely focused on taxing business transactions from sales of goods in the United States.

Businesses that source products from overseas for sale in the United States will be severely disadvantaged under this type of border adjustable tax plan, and would presumably need to increase selling prices in order to have sufficient revenue to cover the tax obligation.

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If you would like more information on any of the potential trade measures outlined above, such as publication requirements and time frames within which the President can implement particular measures, you may contact Frank J. Desiderio, Esq., Tariff and Trade Advisor to the Italy America Chamber of Commerce at 212-973-7740.