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Border-Adjusted Carbon Tax May Be Administrative Headache

By **Vidya Kauri**

Law360 (December 20, 2018, 6:38 PM EST) -- A proposed tax on imports based on carbon emissions produced overseas during the manufacturing process may be costly and laborious to administer, even though it would help place domestic manufacturers and their foreign competitors on a level playing field.

Bipartisan bills have been introduced in both the U.S. House of Representatives and the Senate, titled the Energy Innovation and Carbon Dividend Act, that would impose a tax on carbon and other greenhouse gas emissions, and redirect the collected revenues to individual households that would inevitably be hit with higher energy costs. The tax starts at $15 for each metric ton of emissions produced in 2019, but rises rapidly by $10 each year, reaching nearly $100 per ton by 2030 — an amount significantly greater than previous carbon tax proposals in Congress.

The proposed legislation also contains a “border fee adjustment,” which means the tax also would be imposed on carbon-intensive imported goods, including iron, steel, aluminum, paper and industrial ceramics. This feature is designed to deter manufacturers from avoiding the carbon tax by moving their plants overseas before selling their products domestically.

However, it may be difficult to track emissions released overseas for every imported product, and there would be significant administrative costs in applying the tax to different industries all over the country and then making monthly payments to eligible households, according to James Chenoweth, an attorney in the tax and energy and infrastructure practice groups at Gibson Dunn & Crutcher LLP.

“Administering this whole thing would be a nightmare,” Chenoweth said. “They’re relying a lot on the administration to come up with rules.”

The bill tries to prepare for the administrative costs by siphoning off 8 percent of carbon tax revenues collected in the first five years, and 2 percent thereafter.

The U.S. Energy Information Administration estimates that gasoline and diesel fuel consumption in the transportation industry, which makes up about 30 percent of total U.S. energy-related carbon dioxide emissions, produced 1.54 billion metric tons of carbon dioxide in 2016. Based on these figures, the tax on these emissions alone would amount to about $23 billion and an administrative budget of roughly $1.8 billion.

David Burton, a tax attorney who heads Mayer Brown LLP's renewable energy group in New York, said that although the administrative cost is small relative to the amount of revenue that would be raised, it would be a material amount compared with the Internal Revenue Service's approximately $11 billion budget.

"The IRS will need to hire additional staff and contract for new IT-type systems in order to implement this," he said.

The border adjustment portion of the bill could also test international trade rules prohibiting the favorable treatment of domestic production over imports. Similar concerns arose last year in the months leading up to the Republicans' revamp of the federal tax code when a controversial proposal for a border-adjusted tax on imports was kicked around.

Although last year's proposal died before its details could be hashed out, the carbon tax proposal may have a better chance of surviving. While the World Trade Organization's rules to prevent discrimination are generally focused on direct taxes such as those levied on corporate income, the carbon tax could be viewed as an indirect tax akin to a sales or use tax incorporated into the price of a product and targeting the domestic consumption of carbon-based products.

"What this border fee adjustment is doing is it's putting that sales tax also on things that are imported into this country, and not just sold or used or produced in this country, and giving them essentially a sales tax credit to the extent that the foreign jurisdiction has already imposed a carbon-motivated sales tax," Chenoweth said.

Kyle Pomerleau, an economist at the conservative-leaning Tax Foundation think tank, said the difference between direct and indirect taxes is an important legal distinction, even though it is consumers who will ultimately bear the burden of such added costs.

"Lawyers at the WTO are going to look at this distinction," Pomerleau said. "They both end up hitting people's income and consumers, but it's just how they get there, and the legal distinction is important."

The proposed legislation attempts to head off any potential challenges before the WTO by applying the border fee adjustment only to products that exceed a given amount of carbon intensity. The fee would also depend on the cost of similar laws, including cap-and-trade systems, in trading partner countries.

A discussion of the Energy Innovation and Carbon Dividend Act must necessarily entail a look at the current political climate to assess its chance of passage. The Trump administration has repeatedly opposed efforts to tackle the fallout from climate change, and the majority of Republicans passed a resolution in July stating that a carbon tax would harm economic growth by raising energy prices and the costs of everyday essential items and utilities.

Still, the carbon tax measure is gaining momentum. The bipartisan House bill has gained two new sponsors — one Democrat and one Republican — since it was first introduced by a group of five lawmakers last month. Sens. Chris Coons, D-Del., and Jeff Flake, R-Ariz., followed suit with a bill that is very similar to the House version.

One reason this particular legislation may be more palatable to some Republicans could be because it relaxes existing environmental regulations in exchange for the carbon tax. It also ultimately lets the market determine the price of carbon.

A press release on the Senate legislation touted Flake as a longtime “champion of market-based climate legislation.”

Depending on the effect that a carbon tax will ultimately have, experts say that more lenient regulations could be a fair trade.

“If we’re going to tax carbon, then we don’t need the hammer of regulation because the market should react accordingly,” said Burton at Mayer Brown, adding that the Senate bill’s provision to allow the Environmental Protection Agency to step in and regulate emissions if the carbon tax proves ineffective could “offend economic purists.”

Edouard Markson, a tax attorney at King & Spalding LLP with a focus on corporate matters and the energy industry, contrasted the carbon tax to an existing federal program that offers tax credits to industries that invest in infrastructure to trap their carbon emissions and prevent them from being released into the atmosphere.

Although the carbon tax is a charge on emissions, it works out to be economically equivalent to the government paying industries to pollute less, Markson said.

“If we have, as a policy matter, Section 45Q, which says we’ll pay you to take the carbon that’s there out, why shouldn’t we have a carbon tax that says we’ll effectively pay you to not put it in in the first place?” Markson said.

Even though a carbon tax may not be realistic until the U.S. has a president and a Congress that do not mind increasing energy costs for the populace, the Energy Innovation and Carbon Dividend Act may be the closest thing to creating incentives for renewable energy in the current political environment.

In addition, the administrative costs and difficulties associated with carrying out the tax may be drawbacks, but they do not have to make it a nonstarter.

“Certainly, we have other very complicated tax laws, and the IRS and Treasury have figured out how to administer those,” Burton said. “So, I would be confident that the IRS and Treasury could appropriately administer this.”

--Editing by Tim Ruel and Robert Rudinger.

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