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C H A N C E



**THE IMPACT OF  
TRUMP AND BREXIT  
ON GLOBAL TRADE,  
GLOBAL BUSINESSES,  
AND THEIR SUPPLY  
CHAINS**



— **THOUGHT LEADERSHIP**

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## THE IMPACT OF TRUMP AND BREXIT ON GLOBAL TRADE, GLOBAL BUSINESSES, AND THEIR SUPPLY CHAINS

Global trade is undergoing fundamental change. Brexit, President Trump's intention to put "America first" and Asia's focus on trade liberalisation and globalisation will have a dramatic impact on trade for years to come. Here Clifford Chance experts discuss the potential repercussions for businesses and their supply chains.

### Potential outcomes of Brexit

The UK Prime Minister, Theresa May, is anticipating a relatively hard Brexit and has said that the UK will not be a member of the single market or part of the EU Customs Union. The UK will not submit to oversight by the European Court of Justice and we are told that "no deal is better than a bad deal."

Negotiations could result in three, very different outcomes:

- (a) agreements reached at the same time for withdrawal and the future relationship between with the EU and the UK;
- (b) a transitional arrangement with a permanent agreement continuing to be negotiated and coming into force after withdrawal from the EU; or
- (c) no agreement, a very hard Brexit and the UK reverting to WTO rules for its trade with the EU in 2019.

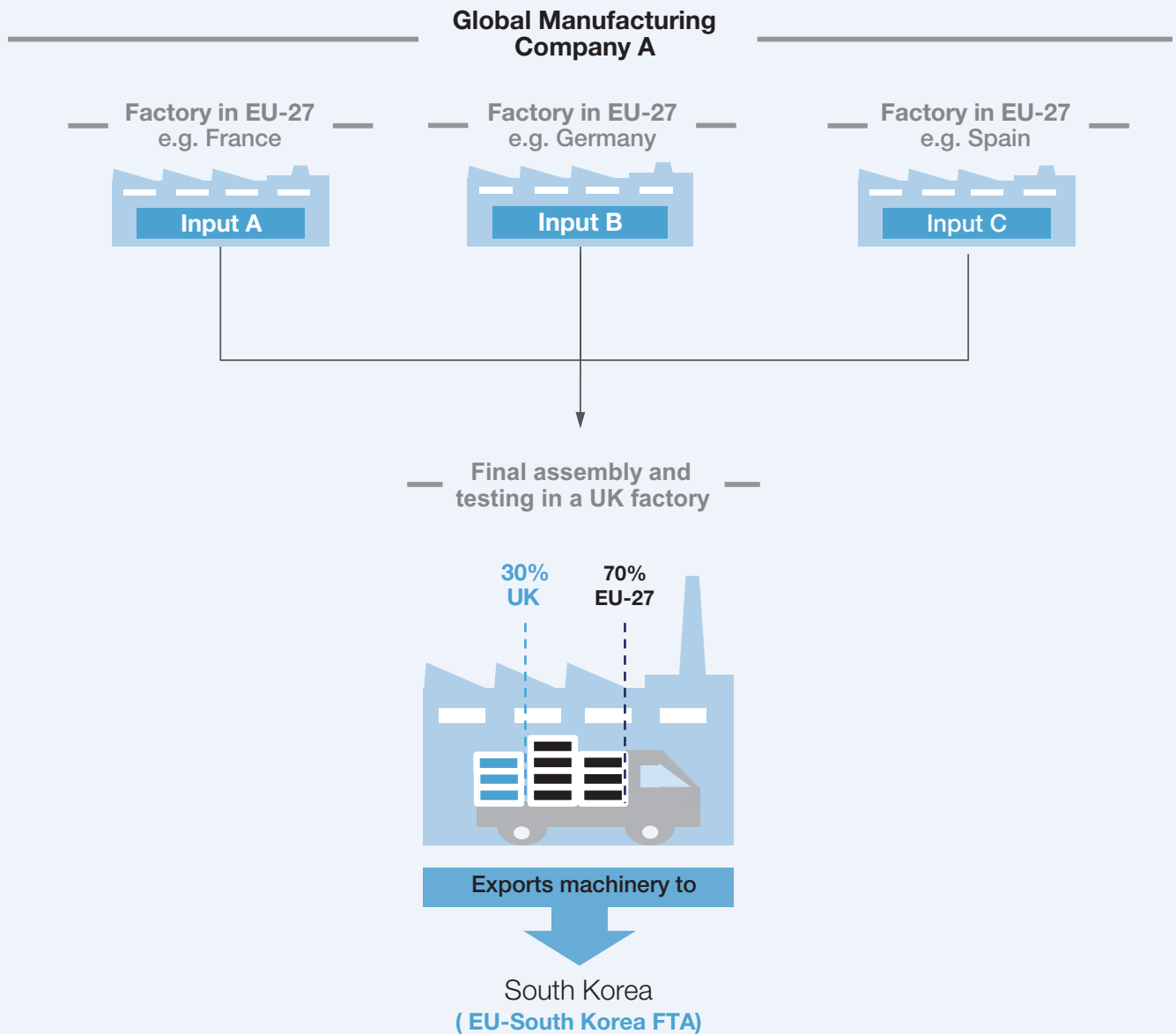
### Impact on supply chains

Multinationals are, of course, aware of the need to analyse their supply chains, and this is the type of consideration they are used to undertaking, as they enter new markets and continually cope with change. However, Mark Poulton, Head of Corporate, London, says: "Untangling existing supply arrangements which have enjoyed a single European market, and the degree of flux affecting trade between Europe and the UK and more globally, is almost unprecedented. This is not business as usual."

Supply chains are extremely interconnected and complex. Goods enter and leave the UK at various stages in their manufacturing process, and components are sourced from the EU and beyond. Jessica Gladstone, who leads our international trade practice and is a former legal adviser at the UK Foreign and Commonwealth Office, says: "The obvious impact when that environment changes is an increase in tariffs and additional non-tariff barriers, including border checks and paperwork." Rules of origin, which are used to determine the country of origin of a product in the context of international trade, will also have a significant impact on businesses. Currently, UK goods are considered to be EU goods. UK manufacturers and suppliers can participate easily in cross-EU supply chains, since goods can move across the EU without tariffs or restrictive customs requirements.

These goods also benefit from preferential rates under existing free trade agreements (FTAs) the EU has agreed with third countries. Without a policy solution, these benefits may well cease to be available even if the UK is able to enter into FTAs with the same third countries on similar terms, because products assembled or manufactured in the UK may not satisfy the relevant rules of origin. Two practical examples are given on the following pages.

## Example one



Pre-Brexit: A global business, 'Company A,' manufactures products in the UK from EU-origin components mainly made in its German, Spanish and French factories and exports them to South Korea, taking advantage of the reduced tariffs in the EU-South Korea FTA.

Post-Brexit: Company A cannot rely on the EU-South Korea FTA, even if its products are mainly made from EU components, because they are being exported from the UK, not from the EU. Even if a UK-South Korea FTA is put in place (and it would take time to do so), if the products are mainly made from EU components then the UK contribution is likely to be too small to take advantage of any UK-South Korea reduced tariffs, and a UK-South Korea FTA would not help in that circumstance.

Potential effect: Without a policy solution, Company A may consider finding alternative UK suppliers so that the products are sufficiently British to take advantage of a UK-South Korea FTA, or Company A may switch assembly from the UK to an EU country instead of the UK.

## Example Two

### Global Manufacturing Company B Factory in EU-27 e.g. Germany



Pre-Brexit: Manufacturing business 'B' ships machinery from Germany to South Korea. The value of the inputs is 20 per cent UK, 50 per cent EU, 30 per cent for the rest of the world. The threshold to take advantage of the EU-South Korea FTA is no more than 45 per cent products from the rest of the world, so the company is currently able to take advantage of those preferential tariffs.

Post-Brexit: Shipping to South Korea post-Brexit is more complicated. 50 per cent of the machinery is made up of non-EU components (20 per cent UK and 30 per cent rest of the world) – which is over the 45 per cent threshold under the EU-South Korea FTA, so reduced tariffs are not available.

Potential effect: Company B may reassess the use of UK and rest of the world suppliers and seek to source more or all of its components from within the EU or South Korea.

\*Rest of the world – excluding South Korea

## Potential policy solution

What would a potential policy solution look like? To protect existing supply chains in the EU and UK, there would need to be cumulative rules of origin with the EU in the FTAs post-Brexit. This would allow EU and UK content to continue to count towards the thresholds to achieve the preferential tariff rates under the FTAs. This will require both EU and UK FTAs with third countries to be aligned to allow existing supply chains to continue unchanged.

“There is some precedent for this in other FTAs,” says Gladstone. “The Canada-EU FTA, CETA, has this feature, envisaging the possibility of cumulation of rules of origin with the US for some purposes if both Canada and the EU have FTAs with the US.” Meanwhile, the EU-Singapore FTA envisages cumulation with ASEAN countries with which the EU has a preferential trade deal. “Businesses need to lobby governments now to ensure this issue is top of the priority list for EU-UK negotiations,” she says.

## Non-tariff barriers and their impact on business

Non-tariff barriers take many forms, and impose costs in terms of adhering to regulations, or the costs of delays of complying with additional procedures such as customs controls. They include physical checks at borders, different labelling and health certification standards, extra paperwork and having to apply for limited permits to carry goods through countries. Free Trade Agreements seek to reduce non-tariff barriers by bringing regulations closer together through commitments to cooperate and consult when introducing new standards to try to maintain compatibility.

“The UK is a leader in transport, scientific and technical services, and business services such as law, accounting and architecture. Such service providers will have to look at whether there are requirements, such as registration or special rules on establishment, in the EU’s member states if the UK and EU do not agree a comprehensive deal,” says Phillip Souta, Head of UK Public Policy. For example, non-European lorry drivers need a separate permit to pass through each EU member state. EEA/EFTA states have open access road transport arrangements. This is part of a framework that includes, amongst other things, free movement of people, which the UK has said it will not accept. “The worst case scenario for UK-based logistics businesses is that they would need to negotiate lorry transport quotas with individual EU member states,” says Souta.

Many multinational businesses’ value chains increasingly rely on trade in both goods and services in relation to the financing and marketing of a product (cars, for example) and businesses that export services to the EU and vice versa will need to assess the risks to their current operations and mitigating factors. The best solution will be for the UK and EU to ensure that businesses can continue to operate effectively, but in the event that operations are not covered in any future agreement, the cost of addressing non-tariff barriers will be weighed against relocating service provision elsewhere to benefit from the single market.

## The UK and trading under WTO rules

“If the UK drops ‘over the cliff-edge’ into a WTO scenario, this is a significantly more hostile environment for business than trading under an FTA,” says Gladstone. In this scenario, at the moment of exit, not only will there be no deal with the EU, but there is unlikely to be a deal with third states either – at least at first. This is because many countries will want to see what the UK’s deal is with the EU before committing to trade terms themselves.

“We are talking about the maximum WTO tariffs – and some of these are significant. Selling a lorry, for example, into the EU from the UK would attract a 22 per cent tariff under the WTO. And there is the risk of significant non-tariff barriers applying on each border crossing in and out of the UK in a supply chain,” says Gladstone. The cost of non-tariff barriers can be as great, if not greater, than the tariffs levied. Even if companies are able to comply with the rules of origin, the cost of certification has been estimated at between 4-8 per cent of the value of the good. An extra day in transit can be equivalent to up to a 2 per cent tariff.

Businesses that rely on a small number of markets for the great majority of their output may also be affected. This is not just UK or EU businesses, but businesses from around the world selling into the UK. For example, in Kenya there are concerns about the potential impact of Brexit on the Kenyan flower industry (the UK is a very important market). This is a specialised industry where a significant majority of the produce is assembled in the Netherlands before being exported around the world. The risk of being unable to take advantage of preferential tariffs when selling to the substantial UK flower market, and the potential delays through customs (particularly given the short lifespan of the product) could have severe consequences for the industry unless policy solutions are designed to meet these issues.



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**— JESSICA GLADSTONE**  
PARTNER, LONDON



**President Trump has said things suggesting that he wants to move away from multilateral trade deals to bilateral free trade agreements.**



**— JANET WHITTAKER**  
PARTNER, WASHINGTON, D.C.

## Trump's trade policy

Despite President Trump's "America First" campaign platform, the precise contours of the administration's trade policies are still unclear. It is still not known who will most strongly influence the direction of the administration's new trade agenda. There are several possible candidates who have a trade-related mandate, including: Peter Navarro, who is the director of the newly formed National Trade Council; Wilbur Ross, the nominee for Commerce Secretary; Robert Lighthizer, the nominee for US Trade Representative; and Gary Cohn, the new director of the National Economic Council. There is widespread speculation about the views of each of these individuals, the direction of policy they intend to take, and how their views will ultimately align with what the President wants to do. As with most areas of policy, the impact that each of these individuals will have on the trade agenda will only be understood over time.

Janet Whittaker, a Partner in our international trade practice in Washington, DC, and former Legal Counsel at the International Centre for Settlement of Investment Disputes, says: "President Trump has said things suggesting that he wants to move away from multilateral trade deals to bilateral free trade agreements, largely on the basis that the US will have better negotiating leverage in a bilateral setting."

To date, President Trump has focused on two trade agreements – the North America Free Trade Agreement (NAFTA) and the Trans-Pacific Partnership (TPP). NAFTA is a two decades-old FTA which has been a major force in liberalising trade across the United States, Canada and Mexico. During his campaign, Trump said NAFTA was "the worst trade deal in the history of this country." Since taking office, he has taken a more measured tone on NAFTA, although he still expresses misgivings about the Mexico-US relationship. In contrast, President Trump took a more aggressive stance in relation to the TPP, withdrawing the agreement shortly after taking office. The TPP is a comprehensive FTA between the US, Canada, Japan and nine other countries.

In line with his preference for bilateral deals, President Trump and the UK Prime Minister, Theresa May, agreed in their first meeting at the White House to set in motion talks about a potential new UK/US free trade agreement. "On the multilateral front it's unclear what will happen with other negotiations that are in the works including the negotiations for the Transatlantic Trade and Investment Partnership (TTIP) – a proposed FTA between the European Union and the United States," says Whittaker. Peter Navarro has reportedly said that talks on TTIP are "dead."

International businesses that operate on a cross-border basis will be most affected by changes in the United States' participation in the various trade agreements. In the NAFTA context, for example, US manufacturers operate under certain domestic content requirements to qualify for NAFTA free trade benefits. If these are altered – through higher NAFTA content requirements as many anticipate – then non-NAFTA businesses supplying to NAFTA countries may find themselves sidelined. "The most important thing for businesses that operate in, or trade with, the United States is to minimise any surprises arising from the new administration's development of its trade policies and to keep close watch for statements on changes in US trade policy so that they can be prepared," says Whittaker.

## Potential changes to the US tax system

During his campaign for the Presidency, as one of the key planks of his economic agenda, Donald Trump cited tax policy as a major drag on US economic growth and promised a comprehensive tax reform and reduction in rates. The US corporate tax system is viewed by the controlling Republican Party as broken: it applies the highest rate in the OECD (35 per cent) to a worldwide tax base (i.e. US corporations are taxed in the US on the profits of their foreign subsidiaries); conversely it is riddled with loopholes that permit multinationals to retain untaxed foreign earnings outside the US. As a result, it is estimated US multinationals have over US\$2 trillion of cash in tax havens.

**Clifford Chance view:**  
Why the border adjustment tax can be a tariff, but VAT can't

	VAT	BAT/DBCFT
DOMESTIC	<p><b>VAT – domestic sale of goods</b></p> <p>Sells goods for 50 plus 10 of VAT → Sells goods for 100 plus 20 of VAT → Overall VAT: 20</p> <p>Pays VAT of 10      Pays VAT of 10 (20 output -10 input)</p>	<p><b>DBCFT – domestic sale of goods</b></p> <p>Labour cost 10 → Sells goods for 50 → Labour cost 40 → Sells goods for 100 → Overall DBCFT: 10</p> <p>Pays DBCFT of 8 (20% of 50-10)      Pays DBCFT of 2 (20% of 100-50-40)</p>
	<p><b>VAT – imported goods sold domestically</b></p> <p>Sells goods for 50 10 VAT @ customs → Sells goods for 100 plus 20 of VAT → Overall VAT: 20</p> <p>Pays VAT of 10 (20 output -10 input)</p>	<p><b>DBCFT – imported goods sold domestically</b></p> <p>Labour cost 10 → Sells goods for 50 10 import DBCFT → Labour cost 40 → Sells goods for 100 → Overall DBCFT: 22</p> <p>Pays DBCFT of 12 (20% of 100-40)</p>
	<p><b>VAT – direct import of goods to consumer</b></p> <p>Sells goods for 50 → 20 VAT @ customs → Sells goods for 100 → Overall VAT: 20</p>	<p><b>DBCFT – direct import of goods to consumer</b></p> <p>Labour cost 10 → Sells goods for 50 20 import DBCFT → Sells goods for 100 → Overall DBCFT: 20</p>
EXPORT	<p><b>VAT – exporting goods with domestic supply chain</b></p> <p>Sells goods for 50 plus 10 of VAT → Sells goods for 100 No VAT → Overall VAT: zero</p> <p>Pays VAT of 10      VAT refund of 10 (zero output -10 input)</p>	<p><b>DBCFT – exporting goods with domestic supply chain</b></p> <p>Labour cost 10 → Sells goods for 50 → Labour cost 40 → Sells goods for 100 → Overall DBCFT: credit of 10</p> <p>Pays DBCFT of 8 (20% of 50-10)      DBCFT credit of 18 (20% of zero-50-40)</p>
	<p><b>VAT – exporting goods with foreign supply chain</b></p> <p>Sells goods for 50 10 VAT @ customs → Sells goods for 100 No VAT → Overall VAT: zero</p> <p>VAT refund of 10 (zero output -10 input)</p>	<p><b>DBCFT – exporting goods with foreign supply chain</b></p> <p>Labour cost 10 → Sells goods for 50 10 import DBCFT → Labour cost 40 → Sells goods for 100 → Overall DBCFT: 2</p> <p>DBCFT credit of 8 (20% of zero-40)</p>
		<p><b>Examples assume no exchange rate adjustment.</b> Other assumptions: rate 20%, prices/labour costs remain static, all payments in same period, all transactions fully taxable</p> <p>© Clifford Chance 2017</p>



**For China the US withdrawal from TPP presents a strategic advantage.**



— **ROMESH WEERAMANTRY**  
FOREIGN LEGAL CONSULTANT,  
HONG KONG

The House Republicans have published a tax Blueprint with a radical proposed fix: the destination-based cash flow tax (DBCFT) or border adjusted tax (BAT) to replace US Federal corporate income tax. Dan Neidle, an international tax Partner, explains: “The basic idea is as follows. The DBCFT taxes cash flow, rather than profits. It is “border adjusted”: imports are taxed but exports are exempt from tax. Exchange rates may move dramatically to compensate, with some envisaging the US dollar appreciating by up to 25 per cent. To the extent it does not, the DBCFT will behave like a tariff.”

Neidle adds: “It seems an incredibly ambitious tax. A formidable lobbying campaign has started up against it and President Trump himself hasn’t made up his mind whether to support it. But this proposal has significant backing in the House. I’d bet against it happening – but you can’t dismiss the chances of this, or something like this, becoming law.”

The bottom line is this: if the dollar fully appreciates, DBCFT will behave like a VAT, not like a tariff or export subsidy. To the extent it does not, it would behave in part like a VAT and in part like a tariff and export subsidy. And, of course, any dollar appreciation would have effects much wider than just trade.

“There is a serious question as to whether the tariff and subsidy like effects of the DBCFT breaks WTO rules,” says Neidle. There’s a real possibility of a WTO challenge – and the European Commission is already making noises to that effect. There have been WTO challenges on tax measures before, but the border-adjustment feature is fundamental to the DBCFT – hence the amounts at stake would be many hundreds of billions of dollars. A WTO challenge takes years; in the meantime, we could see countries imposing retaliatory measures such as tariffs of their own.

It is occasionally suggested that VAT acts as a tariff – and President Trump has

himself asserted that this is the case. However, VAT in the EU (for example) applies equally to all supplies of goods or services made to an EU person, regardless of the location of the supplier, and regardless of the details of the supplier’s own supply chain. The DBCFT, on the other hand, can potentially act like a tariff, because (unlike VAT) it permits a deduction for labour costs – but this deduction is only available to domestic suppliers and not to foreign suppliers. This key distinction between the DBCFT and VAT is illustrated on the previous page showing that if we hold prices, labour costs and FX static then DBCFT does behave like a tariff; but VAT does not.

If the DBCFT is introduced, there are a number of things businesses should be thinking about.

First, US multinationals may be able to repatriate all their offshore cash without a US tax charge – or with a small transitional tax – up to US\$2 trillion. “The question is: what will they do with it? The theory is they will drive M&A activity in the US,” says Neidle.

Second, US parties, and people contracting with US parties, may want to make sure their contracts do not make them bear their counterparty’s DBCFT risk. “In Europe we’re very used to standard contractual documentation passing on VAT cost. Those same clauses could have a very unpredictable effect if DBCFT is imposed. Businesses may want to start reviewing contracts now,” he says.

Finally, businesses should take the prospect of a 25 per cent appreciation in the dollar seriously. Businesses outside the US may be less sanguine about taking on dollar liabilities, or seek to hedge existing liabilities. The good news is that DBCFT developments will be very visible to business. “The consequences for global trade and the global economy are so immense that the tax is likely to dominate the front pages if and when it gets closer to becoming reality,” Neidle says.



## The Trans-Pacific Partnership

Many in Asia viewed the TPP as a vital means by which the US would have maintained its influence in Asia. The US withdrawal is a turning point in international trade for the region, at a time when China is ramping up its presence on the world stage and espousing free trade.

Foreign Legal Consultant Romesh Weeramantry, an expert in international trade and investment law based in Hong Kong, says: “For China the US withdrawal presents a strategic advantage. Two of the jewels in its trade crown stand to gain significantly: the One Belt, One Road Initiative, and a multilateral trade pact called the Regional Comprehensive Economic Partnership or RCEP.” Under the One Belt, One Road Initiative, China plans to spend over a trillion dollars on developing roads, railways and ports, primarily in Central Asia, southeast Asia, the Middle East and Africa, to promote trade into and out of China. If completed successfully, the potential gain for China is vast, both economically and politically.

And with the TPP currently off the table, China can now forge ahead with RCEP, a trade deal comprising 16 countries including China, India, Japan and South Korea. It accounts for almost half of the world’s population, almost 30 per cent of global GDP and over a quarter of world exports. “We will be hearing a lot more about RCEP in the future,” says Weeramantry.

He adds that the effort that has been put into negotiating the TPP has not gone to waste. “RCEP is still under negotiation and there will not be a fully agreed text for

at least the next two years. Some nations see value in salvaging and implementing what has already been agreed in the TPP, even in a reconfigured form.” There are calls for a “TPP minus one” (minus the US), and there will be an important meeting in Chile in March at which eight remaining countries in the TPP will meet; this may set the direction for the future of the TPP.

Despite Brexit and the US withdrawal from the TPP, Asia is looking outward and is progressing steadily in its negotiation of trade and investment treaties. A number of trade deals have been signed and are in force between ASEAN, (a regional bloc that includes Indonesia, Thailand, Vietnam, Singapore and Malaysia), and other states including South Korea, China, Australia and New Zealand.

In Asia, trade and investment liberalisation will continue energetically in spite of the US withdrawal from the TPP, and businesses should seek out the right investment structures into the region to take advantage of this.

## Conclusion

While global trade policies are in a state of flux, there are practical steps that businesses should take. In the context of Brexit and developments in the US and Asia, businesses should engage with governments to make their voice heard on specific areas where agreement is needed to support their business models. “We expect Governments around the globe will be lobbied increasingly by businesses to support their interests, and so it is important to present unified voices, through trade bodies where appropriate, and deliver granular proposals, where possible in a ready-to-use format, in order to maximise impact,” says Poulton.



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