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Promoting American Competitiveness through International Tax Reform: A Discussion of Proposals to Replace the Extraterrestrial Income Exclusion

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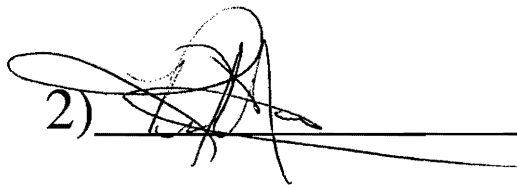
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A Discussion of Proposals to Replace the
Extraterritorial Income Exclusion

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Promoting American Competitiveness through International Tax Reform:

A Discussion of Proposals to Replace the Extraterritorial Income Exclusion

**David Scott Meriwether
University of Tennessee
College Scholars and Honors Senior Thesis
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Promoting American Competitiveness through International Tax Reform: A Discussion of Proposals to Replace the Extraterritorial Income Exclusion

The United States is in a position to make the most radical changes to its international tax structure since legislation enacted in the 1960s. Through a suit brought by the European Union (EU), the World Trade Organization (WTO) ruled a provision of the United States' international tax regime illegal. This specific provision is known as the extraterritorial income exclusion (ETI). To comply with international agreements, the United States must repeal the extraterritorial income exclusion.

In essence, the extraterritorial income exclusion is a tax break for American companies – primarily American manufacturers. It allows U.S. companies to exclude from their corporate income tax a portion of their earnings from U.S. products exported to other countries. In comparison to other nations' tax systems, the United States' worldwide tax system creates an economic discrepancy and hinders U.S. companies. Consequently, the United States has employed a series of export provisions to reduce the negative effect of the U.S. tax system. The extraterritorial income exclusion was the United States' latest attempt to counterbalance the product of its worldwide tax system. However, the European Union challenged ETI as an illegal export subsidy and a WTO dispute body subsequently ruled it illegal.

Many view the WTO ruling as an attack on the sovereignty of the United States and its right to determine its own tax structure. Others view the WTO ruling as another setback to a struggling U.S. manufacturing sector. However, I propose a different perspective on the issue at hand. In my opinion, the United States is being compelled into an unprecedented opportunity to change its tax structure and make American companies

more competitive overseas than under the ETI regime. Currently, American companies suffer from an archaic international tax structure. Because the United States must enact legislation regarding an international tax provision, it has an opportunity to reform an out-dated system and replace it with legislation that will enhance the economy.

Through this thesis, I will present the history of ETI, describe the current situation, discuss the bills in Congress proposed to replace the ETI regime, and give an opinion, taking into consideration the promotion of American competitive interests abroad, as to what steps the United States should take to reform its international tax structure.

THE FUNDAMENTALS OF THE ISSUE: WHY IS THERE AN ECONOMIC DISCREPANCY?

The foundation of the ETI trade dispute lies in international agreements concerning the treatment of direct and indirect taxes. In the 1800's, when governments primarily used excise and property taxes, taxes were logically categorized as direct or indirect. Excise taxes were indirect taxes because they presumably would be passed on to the consumer. Property taxes, on the other hand, were considered direct taxes because they were directly imposed on the owner of the property.¹ Today, taxes continue to be categorized as direct or indirect taxes.

¹ Hufbauer, Gary. "Mutating Tax Incentives: How Will the FSC Drama End?" Tax Notes International. 15 April 2002. p. 177. <http://www.taxanalysts.com>

In 1960, the General Agreement on Tariffs and Trade (GATT), of which the United States was a signatory, was enacted.² GATT agreements permitted indirect taxes to be removed on exports through “border tax adjustments” while direct taxes could not be adjusted. The GATT Working Party agreed that the value-added tax (VAT) was an indirect tax.³ This classification of VAT as an indirect tax is significant because, at this time, the economic discrepancy between the tax systems of the United States and many of its current competitors began. The GATT categorization created the source of the current WTO dispute regarding the extraterritorial income exclusion.

The World Trade Organization was formed in 1995 with the purpose of promoting free trade.⁴ The Subsidies and Countervailing Measures (SCM) Agreement of the WTO charter adopted Article XVI of GATT, which “established that subsidies were prohibited when dependent upon export performance or based upon the use of domestic over imported goods.”⁵ The United States is a member of the WTO and is bound by its charter and the decisions of its dispute bodies. As a result, it must respect the WTO decision concerning the ETI dispute.

The following is a simple explanation of the difference between the U.S. tax system and those of many of its competitors. The United States employs a worldwide tax system that is considered a direct tax on income of U.S. corporations operating within both U.S. borders and foreign districts. Conversely, many nations – including Canada,

² Ibid.

³ Ibid. Hufbauer also notes that “VAT actually is a combination of three direct taxes: a tax on wages, a tax on interest and rent, and a tax on corporate profits.” Furthermore, it should be noted that the United States does not employ a pure worldwide tax system.

⁴ “The WTO in Brief: Part I” http://www.wto.org/english/thewto_e/whatis_e/inbrief_e/inbr01_e.htm

⁵ “Transatlantic Trade Policy Update Sheet.” AmCham Germany. April 2003.

<http://www.amcham.de/fileadmin/templates/main/pdf/Transatlantic-Trade-Policy-Update-April-2003.pdf>

Mexico, and much of Europe⁶ – apply a territorial tax system or a value-added tax. VAT is a consumption tax collected at each stage of the supply chain, but only within the home country. It is not internationally collected by the home country. Notably, of the 30 Organization for Economic Cooperation and Development (OECD) member nations, the United States is the only country that does not employ any variety of a national value-added tax.⁷

The consequence of the distinction between direct and indirect taxes by GATT is that the United States cannot rebate its income tax on exports. However, nations that use VAT can rebate the taxes on their exports.⁸ Border tax adjustments are projected to save European exporters up to \$100 billion a year in tax payments on export sales.⁹ Exporters obviously benefit from a VAT system. In contrast, U.S. exporting companies must pay U.S. income taxes on their earnings from export sales. They also must pay VAT on their sales in countries that have a VAT system.¹⁰ To reduce the effect of the tax differences, the United States instituted the extraterritorial income exclusion.

In further efforts to neutralize the economic discrepancy between its tax system and its competitors, the United States has significantly complicated its tax structure. The United States' international tax structure developed primarily in the 1950's and 1960's. During the post-World War II period, the United States was the world's economic power, and U.S. companies experienced little competition from imports. As a result, Congress

⁶ Hufbauer

⁷ U.S. House Committee on Ways and Means. *Hearings on the WTO's Extraterritorial Income Exclusion*. Testimony of Peter Merrill. "U.S. Tax Policy and International Competitiveness." 107th Cong., 2nd sess., 27 February 2002. Ser. No. 107-67.

⁸ U.S. Office of Public Affairs. Testimony of Kenneth Dam Before the U.S. Senate Committee on Finance Regarding the WTO Decision on the Extraterritorial Income Exclusion Provisions and International Competitiveness. 30 July 2002. PO-3295.

⁹ "Issue Overview: Foreign Sales Corporation/Extraterritorial Income Exclusion." The Tax Foundation. <http://www.taxfoundation.org/internationaltax/overview.html>

¹⁰ Hufbauer.

enacted much of the U.S. international tax regime when American companies had little international competition.¹¹ Subsequent attempts to adapt the tax system caused the system to become very complicated. Because of the increased complexity of the tax laws and the current economic environment, the international tax system has become outdated and needs to be simplified and reformed. Simplification and reform will be discussed in greater detail later in this dissertation.

Clearly, the U.S. tax system impedes U.S. competitiveness. In an economy that is becoming more global and that has increased competition, the U.S. tax system must be reformed. Otherwise, U.S. companies will continue to operate at a disadvantage to foreign companies while foreign companies continue to experience greater growth. As Pamela Olson, former Deputy Assistant Secretary of the Treasury for Tax Policy, stated, “From the vantage point of the increasingly global marketplace in which U.S. companies compete, our tax rules appear outmoded, at best, and punitive of U.S. economic interests, at worst.”¹²

The current ETI dispute is “the biggest trade dispute currently facing the United States,” according to Phillip Galas, Chairman of the International Trade Group at Sandler, Travis & Rosenberg.¹³ The United States will repeal the extraterritorial income exclusion. The questions then arise concerning whether and how to replace it. How will the economic discrepancy be reconciled? Will the United States use this opportunity as a vehicle for reform?

¹¹ Dam.

¹² Hansen, Dave and Daniel Rinke. “Tax Policy Secretary Wary of Direct Repeal of FSC/ETI and Repatriation Bill.” Federal Tax Day. 16 July 2003. CCH Tax Research Network. University of Tennessee Libraries, Knoxville, TN. <http://tax.cchgroup.com/>

¹³ “How Exporters to EU Can Prepare for Possible \$4 Billion in Sanctions.” Managing Exports. June 2003. LexisNexis Academic. LexisNexis Databases. University of Tennessee Libraries, Knoxville, TN. <http://www.lib.utk.edu/databases>

Because taxes are determined by our legislating bodies and have a great effect on the general population, they are inherently political in nature. Consequently, the ETI issue is not simply a matter about tariffs and exports. Rather, it is contentious matter about jobs, taxes, and politics.

THE HISTORY OF UNITED STATES' ATTEMPTS TO RESOLVE THE ECONOMIC DISCREPANCY

The United States has employed three different methods to equalize the basic economic difference between the U.S. tax system and other tax systems. Foreign nations challenged each one of the systems enacted by the United States. In each case, international bodies agreed to the foreign nations' challenges against the United States' system. As a result, the ETI dispute is both a current issue and a lingering international issue that dates back more than 30 years.

The First Attempt

In 1971, the United States established the Domestic International Sales Corporation (DISC), which provided tax benefits to qualifying corporations by granting corporate and shareholder income tax deferral for export income.¹⁴¹⁵ By enacting DISC, the United States granted indirect tax benefits to U.S. exports. In 1976, a dispute panel of the General Agreement on Tariffs and Trade (GATT) declared DISC an illegal subsidy. The challenging nations argued that DISC was an export subsidy because it granted more

¹⁴ U.S. House Committee on Ways and Means. Subcommittee on Select Revenue Measures. *Hearing on the Extraterritorial Income Regime*. Testimony of Michael McIntyre. 10 April 2002.

¹⁵ Crane, Phil and Charles Rangel. "Building a Level Playing Field for U.S. Exporters." The Tax Foundation. <http://www.taxfoundation.org/frontandcenter-cranerangel.html>

advantageous tax treatment to exports than to equivalent domestic transactions.¹⁶ At this time, the United States entered a counter-challenge to several European tax regimes (France, Belgium, and the Netherlands), and a GATT panel in 1976 ruled against all the contested tax measures.¹⁷ However, the GATT findings were controversial and the challenging signatory countries ignored its rulings for a number of years. The disputes that followed these rulings led to a 1981 GATT Council Decision known as the “1981 Understanding.”¹⁸ Three main agreements comprised the 1981 Understanding:

- 1) “GATT signatories are not required to tax export income that is attributable to economic processes occurring outside their territorial limits;
- 2) “Arm’s length” transfer pricing principles should be observed in transactions between exporting enterprises and related foreign buyers; and
- 3) GATT does not prohibit the adoption of measures to avoid the double taxation of foreign-sourced income.”¹⁹

Foreign nations continued to pressure the United States to remove DISC, as it had already been ruled illegal. The United States claimed that, taking into consideration the 1981 Understanding, it was mirroring the outcome caused by territorial tax systems commonly employed by European countries.²⁰ Eventually, the United States repealed the DISC provisions and enacted the Foreign Sales Corporation (FSC) regime in the Deficit Reduction Act of 1984, Title VIII.²¹

¹⁶ AmCham Germany.

¹⁷ Dam.

¹⁸ Dam.

¹⁹ Ibid.

²⁰ Crane and Rangel.

²¹ Dam.

The Second Attempt

The FSC provisions instituted a partial exemption for export-related income. Lawmakers created this exemption from U.S. tax to provide U.S. exporters with tax treatment that was comparable to the treatment provided to exporters under other tax systems. In addition to providing tax benefits to domestic corporations, the FSC regime provided tax benefits for export-related income earned by corporations that were required to have a foreign presence, or a foreign sales corporation. FSCs were defined as “foreign corporations, organized outside of the fifty United States, and responsible for certain sales-related activities in connection with the sale or lease of goods produced in the United States for export outside the United States.”²² Often, FSCs were controlled foreign subsidiaries of U.S. corporations and were located in offshore jurisdictions – such as Guam, American Samoa, or the U.S. Virgin Islands.²³ The FSC benefits produced a situation in which a portion of the FSC foreign income was exempt from tax to the exporter and the taxable portion was not double-taxed when repatriated to the exporter. Ultimately, transactions that benefited from FSC reduced approximately the taxpayer’s corresponding tax rate by approximately 5.25 percentage points.²⁴

Eleven years after the enactment of the FSC legislation, the United States brought a suit through the WTO against the European Union. On September 27, 1995, the United States announced that, through the WTO, it would challenge the European Union banana import system.²⁵ The United States had brought a suit against the EU regarding the new

²² AmCham Germany

²³ United States. Internal Revenue Service. Publication 953. “Foreign Sales Corporations.” CCH Internet Tax Research Network. University of Tennessee Libraries, Knoxville, TN. <http://tax.cchgroup.com>

²⁴ Crane and Rangel.

²⁵ U.S. Office of the Trade Representative. “United States Will Challenge European Banana Import Regime in the World Trade Organization.” 27 September 1995. <http://www.ustr.gov/releases/1995/09/95-71.html>

quotas the EU had set on banana imports. The EU had given quotas banana imports to regions – including Africa, the Caribbean, and the Pacific – which the United States argued gave these regions a “special quota at the exclusion of other bananas” and discriminated against United States and other nations’ bananas.²⁶ On April 6, 1999, the WTO issued its decision on the Bananas Dispute between the European Union and the United States.²⁷ The WTO found that the EU specifications of 857,700 tons of bananas from the Africa, Caribbean, and Pacific regions represented a tariff quota and violated Article XIII of GATT.²⁸ The United States was in turn permitted to enact \$191 million in sanctions on EU products due to the bananas dispute.²⁹ The WTO agreed that the United States was harmed annually by the EU banana import system more than the \$191 million amount. The nine European products subject to a 100 percent tariff were bath preparations, handbags, wallets and similar articles, felt paper and paperboard, paper or paperboard boxes, lithographs, bed linen, batteries, and coffee makers.³⁰ Afterward, in April 2001, the parties reached a dispute settlement agreement. On July 1, 2001, the United States announced it would lift its sanctions due to EU compliance with the agreement.³¹

Many believe that the bananas dispute and a similar battle between the United States and the EU concerning beef caused the EU to retaliate against the FSC regime. They believe it was an EU attempt to bring a tit-for-tat dispute against the United States.

²⁶ U.S. Mission to the European Union. “USTR Frazier on Bananas and Beef Disputes.” 17 October 2000. <http://www.usue.be/issues/fraz1017.html>

²⁷ Ibid.

²⁸ U.S. Mission to the European Union. “WTO Report on Bananas.” 6 April 1999. <http://www.useu.be/issues/bananrept.html>

²⁹ U.S. Mission to the European Union. “As EU Takes Steps on Bananas, U.S. Lifts Sanctions on EU Products.” 1 July 2001. www.uesu.be/Categories/Bananas/BananasUSSanctionsEUJuly1.html

³⁰ Ibid.

³¹ Ibid.

The European Union did not challenge the FSC regime (enacted in 1984) until after the bananas dispute (begun in 1995). Nevertheless, in December 1997, February 1998, and April 1998, the EU – with support from Canada and Japan³² – complained that FSCs violated both the SCM Agreement and the Agreement on Agriculture Consultations. Accordingly, the EU initiated formal action against the United States and the FSC regime through a WTO dispute settlement body.³³

In October 1999, the WTO panel declared “that the 1981 Understanding had no continuing relevance in the interpretation of current WTO rules” and that “the FSC provisions constituted a prohibited export subsidy under the Subsidies Agreement.”³⁴ Subsidies are not explicitly outlawed by the WTO. However, the panel found that the FSC regime was an illegal subsidy because it was contingent on exports.³⁵ Because of the U.S. worldwide tax system, the WTO panel found that the United States did not collect taxes that were “otherwise due” had the FSC legislation not been enacted.³⁶

The Third Attempt

After entertaining appeals from the United States, the WTO Appellate Body confirmed FSCs were illegal on February 24, 2000. It gave the United States until November 1, 2000 to end the program. On November 15, 2000, President Clinton signed into law the FSC Repeal and Extraterritorial Income Exclusion Act. This Act phased out the FSC benefits and excluded from U.S. taxation certain foreign-source income. Specifically, it excluded a portion of export earnings if the taxpayer can prove 50 percent

³² McIntyre.

³³ AmCham Germany.

³⁴ Dam.

³⁵ AmCham Germany

³⁶ Ibid.

of the value of the transaction was due to U.S. activities.³⁷ According to Senator Max Baucus, Chair of the Senate Finance Committee, “We eliminated the export contingency of the provisions at issue, broadening them to include other categories of foreign source income. Our replacement was designed to avoid double taxation, rather than confer a subsidy.”³⁸ The legislation intended to bring the United States into compliance with WTO rules by addressing the analysis reflected in the WTO decision. It also intended to combat the economic discrepancy among tax systems. However, in reality, the ETI regime simply reworded the FSC legislation.

On November 17, 2000, two days after the United States signed the ETI regime into law, the EU complained to the WTO that ETI represented another illegal export subsidy. The EU requested permission to impose \$4.043 billion in sanctions against the United States. After a process of appeals concerning both the EU challenge against ETI and the sanctions, a WTO dispute settlement panel (DSP) reached a ruling. On August 20, 2001, the DSP ruled that ETI legislation failed to comply with WTO trade obligations. It granted the EU the right to impose sanctions on the United States for past failures to comply with the DSP and Appellate Body recommendations and continuing to violate international trade obligations.

The DSP report contained comprehensive language that had extensive ramifications beyond the ETI dispute. Because of the importance of the issues involved and the troubling implications of the panel's analysis, the United States once again appealed the panel's report. However, on January 14, 2002, the WTO Appellate Body

³⁷ “New Extraterritorial Income Exclusion.” Export Assistance Center. 16 April 2001.
http://www.exportassistance.com/hot_topics41601.html#exclusion

³⁸ U.S. Senate Finance Committee. *Panel I of a Hearing on the Extraterritorial Income Exclusion Act*. 107th Cong., 2nd sess. 30 July 2002.

confirmed the panel's findings. "The Appellate Body report makes four main findings with respect to the ETI provisions:

- 1) The ETI provisions constitute a prohibited export subsidy under the WTO Subsidies Agreement;
- 2) The ETI provisions constitute a prohibited export subsidy under the WTO Agriculture Agreement;
- 3) The limitation on foreign content contained in the ETI provisions violate the national treatment provisions of Article III:4 of GATT; and
- 4) The transition rules contained in the ETI Act violate the WTO's prior recommendation that the FSC subsidy be withdrawn with effect from November 1, 2000."³⁹

The Appellate report upheld most of the rulings, though it did limit the panel's conclusions on some matters. On January 29, 2002, the DSP agreed to the modified Appellate Body report.⁴⁰

After the Appellate Body decision, U.S. Trade Representative Robert Zoellick announced that the United States would respect its WTO obligations and continue to seek cooperation with the EU to resolve the dispute.⁴¹ At this time, the process to repeal and replace ETI began.

³⁹ Dam.

⁴⁰ Ibid.

⁴¹ Gomez, Berta. "Zoellick Urges Compliance with WTO Ruling on Tax Breaks." The United States Mission to the European Union. 26 February 2003.
<http://www.useu.be/Categories/FSC/Feb2603ZoellickFSC.html>

FURTHER ATTEMPTS TO RESOLVE THE ECONOMIC DISCREPANCY:

An overview of U.S. tax treatment of foreign-earned income

The United States has employed other attempts to equalize the economic discrepancy between its tax system and those of its competitors. The unfortunate result of these efforts is that the United States has severely complicated its international tax regime. The United States treats income earned by U.S. companies in foreign districts differently than if the income had been earned within the United States. A company may subtract from its U.S. tax the amount of tax paid to another country for the income earned within that foreign country. Scott Newlon, Managing Director of Horst Frisch Incorporated, defined several key elements of the U.S. tax system concerning the treatment of foreign earned income. These key elements are discussed in the following sections.

Key Element One: Deferral

The form in which its foreign operation is organized determines when a U.S. company is taxed on its foreign earned income. If the foreign operation is organized as a branch of a U.S. corporation, the income of the branch is taxed as it accrues. In contrast, if the foreign operation is separately incorporated in the foreign country as a controlled foreign corporation (CFC), the income usually is not taxed by the United States until the income is remitted to the U.S. parent, usually in the form of a dividend. Naturally, the CFC has been a preferred choice for multinational companies. This process that postpones the recognition and taxation of a subsidiary's income by a U.S. parent company is referred to as "deferral." Additionally, the process of remitting earnings to

the parent company is known as “repatriation.” To maintain its tax base and not provide incentives to move operations to low-tax jurisdictions, the United States uses a significantly complex system of anti-deferral rules.⁴² The anti-deferral rules were meant to regulate income that was deemed to be acutely mobile. These intricate anti-deferral rules are called “Subpart F,” referencing their location in the U.S. tax code. Subpart F will be discussed further in an upcoming section.

Key Element Two: Foreign Tax Credit

The foreign tax credit was instituted to avoid double taxation of earnings for U.S. companies. The foreign tax credit is a dollar-for-dollar credit against U.S. tax for foreign taxes paid on income earned in foreign districts. The credit exists both for taxes on income repatriated by a controlled subsidiary and for taxes on direct foreign earned income such as royalties and interest. However, due to the numerous forms of income and the vast variance in tax rates around the globe, the U.S. foreign tax credit system is quite complicated.

The U.S. tax code limits the foreign tax credit to the amount of U.S. tax payable on the foreign income. It may not offset tax attributable to domestic income. If the tax paid in the foreign country exceeds what would have been paid, in the United States, a business generates excess credits. The excess credits from the respective year may be carried back two years to refund past tax paid or it can be carried forward five years to offset U.S. tax payable on foreign income in future tax years. However, when computing alternative minimum tax liability, the foreign tax credit is limited to 90 percent of its value. The limitation on the foreign tax credit in general is a debatable issue. The fact that

⁴² U.S. House Committee on Ways and Means. Subcommittee on Select Revenue Measures. *Hearing on the Extraterritorial Income Regime*. Testimony of Scott Newlon. 13 June 2002.

the limitation could create alternative minimum tax liability makes it even more contentious.

The intricacies of implementing the foreign tax credit limitation can result in U.S. companies taxed twice on their foreign earned income, which is exactly the outcome that the foreign tax credit was created to eliminate. In general, most income from foreign sources can be combined and the excess credits created from a jurisdiction with a high tax rate can offset the potential U.S. tax payable on income with a tax rate lower than the U.S.'s tax rate. However, this process of "cross-crediting" is limited. The U.S. tax code has defined nine different "baskets" that consist of assorted forms of foreign source income. Each one of these baskets is subject to its own foreign tax credit limitation. Foreign taxes paid pertaining to income in a specific basket may be claimed as a credit to counterbalance the U.S. tax on income only from that specific basket. The nine different baskets of income result in considerable complexity and expensive bookkeeping requirements.⁴³

Key Element Three: Expense Allocation

Furthermore, the U.S. foreign tax credit system requires that interest expense incurred by a U.S. parent corporation be allocated against both domestic income and foreign-earned income. This process was designed to establish a more accurate value for foreign source income. Often, a U.S. parent company will incur debt and other interest expense and use that capital to fund its overseas operations. However, because the expenses allocated from the U.S. parent are often not deductible in the foreign country, this process understates foreign-earned income and reduces the foreign tax credit. It also can cause income that has been subject to foreign tax at a rate of 35 percent or more to be

⁴³ Ibid.

subject to additional U.S. tax.⁴⁴ This practice is blind to the principle that only domestic expenses that support the earning of foreign-source income should be allocated against foreign-source income. Additionally, allocating interest against foreign source income ignores the fact that a foreign U.S. subsidiary may be completely externally financed on its own.⁴⁵ The functional results are a negation of interest expense within the United States – which increases the cost of investment within the United States – and a reduction in U.S. tax credits for foreign-source income.

Key Element Four: Source Rules

Any tax structure that differentiates between foreign source income and domestic income, as the U.S. tax law does with a foreign tax credit, naturally necessitates source rules to define what income should be considered foreign source. At times it is difficult to determine in what exact location income was earned. In fact, the source rules are somewhat more complicated than simply determining the region in which income is earned. If one closely examines the source rules, one would find that the sales source rule creates an export subsidy comparable to ETI. If a company exports its U.S.-manufactured products, it can consider 50 percent of the income from those products as foreign income. For a company with excess foreign tax credits, this measure in the sales source rule can create an export subsidy with greater benefits than ETI provides.⁴⁶ This provision is notable because it is another measure in the U.S. tax code that could be challenged by other nations as an illegal export subsidy given the WTO's broad ruling in the ETI dispute.

⁴⁴ Merrill.

⁴⁵ Newlon

⁴⁶ Ibid.

SUBPART F

Subpart F refers to the area in the Internal Revenue Code where the anti-deferral rules appear.⁴⁷ Subpart F was enacted in 1962. The impetus for the Subpart F rules is passive, investment-type income earned abroad through a foreign subsidiary, usually a U.S. controlled foreign corporation (CFC). This income is considered highly mobile and easy to shield from taxes. The greatest complaint about Subpart F is its complexity. It is considered quite onerous because the rules create a situation where a U.S. parent company is taxed on certain types of income by its foreign subsidiaries even if that income is not remitted to the parent company during that fiscal year.

Subpart F income is defined, in the case of a controlled foreign corporation, as the sum of insurance income, foreign base company income, the sum of bribes and kickbacks paid by the corporation to government officials, and the sum of income earned by the CFC outside its country of incorporation. Subpart F also relates to several categories of other qualified income including foreign base company shipping income, foreign base company oil related income, foreign base company sales income, foreign base company services income, in the case of a qualified insurance company – insurance income or foreign personal holding company income, or in the case of a qualified financial institution – foreign personal holding company income.⁴⁸ All of such income is taxable to the parent corporation during the fiscal year in which it is earned rather than when this income is repatriated back to the United States.

⁴⁷ U.S. Internal Revenue Code. Chapter 1, Subchapter N, Part III, Subpart F.

⁴⁸ “Subpart F Income Defined.” Sec. 952. CCH Internet Tax Research Network. University of Tennessee Libraries, Knoxville, TN. <http://tax.cchgroup.com/>

Many of the types of income mentioned in the paragraph above refer to foreign-service transactions. The Subpart F rules apply to these transactions as well as foreign sales income. Approximately one-fourth of U.S. multinational parent companies are in the service sector. In comparison, 56 percent of all foreign affiliates are considered to be in the service sector, which includes product support services.⁴⁹ These foreign affiliates are indispensable to maintaining current export volumes.⁵⁰ The consequence of Subpart F taxation of these service affiliates is that U.S. companies are taxed on active operating income that is earned in a specific location for business reasons unrelated to tax considerations.⁵¹ Thus, Subpart F is considered so onerous and unfair by many U.S. multinational companies.

One of the benefits of the FSC system was that it created an exception to the Subpart F foreign base company sales rules.⁵² Under the current system, a CFC of a U.S. multinational is subject to U.S. tax on its current income. However, the CFC must compete with local companies, which are only subject to the local tax. Additionally, a foreign-owned CFC in this same market is often only subject to the local tax rate as well. Often, the result is that the U.S. company is penalized, the cost of selling goods produced in the U.S. is higher, and the U.S. company is less profitable.⁵³

Another concern related to Subpart F is the current U.S. taxation of income earned by CFCs outside of their country of incorporation. When the Subpart F rules were written, most CFCs only operated in the country in which they were incorporated.

⁴⁹ Cited in Merrill. Slaughter, Matthew. "Global Investments, American Returns. Mainstay III: A Report on the Domestic Contributions of American Companies with Global Operations." Emergency Committee for American Trade (1998).

⁵⁰ Merrill.

⁵¹ Dam.

⁵² Merrill.

⁵³ Dam.

According to data published by the Commerce Department in 2000, “less than 11 percent of sales by U.S. controlled foreign corporations were made to U.S. customers.”⁵⁴ Due to globalization and increased trade cooperation, a foreign subsidiary of a U.S. parent can operate on a regional or global scale. Many multinationals seek to create regional hubs and regional centers of operations. However, the CFC’s income from servicing countries outside of its headquarters will still be taxed in the United States during the current year. As a result, a U.S.-based multinational company is penalized for economic efficiency – in this case, by operating on a regional basis.⁵⁵

WHAT EXACTLY IS THE EXTRATERRITORIAL INCOME EXCLUSION?

To have a better understanding of the ETI dispute and actions to resolve it, an explanation of the extraterritorial income exclusion and its beneficiaries is necessary. The extraterritorial income exclusion is a provision in the U.S. tax code enacted into law by the FSC Repeal and Extraterritorial Income Exclusion Act of 2000. It provides a partial exemption from the corporate income tax for income earned from certain foreign sales and leasing transactions. Taxing foreign-earned income at the U.S. corporate tax rate often results in a higher cost to U.S. corporations than if the income was taxed at the local rate. The extraterritorial income exclusion allows U.S. exporters to save up to 30 percent

⁵⁴ Cited in Merrill. U.S. Department of Commerce. “Survey of Current Business.” July 2000. Merrill added “Note that 40 percent of the sales back to the United States were from Canadian subsidiaries.”

⁵⁵ Ibid.

on their tax payments.⁵⁶ It is vitally important to many of the United States' largest corporations.

As stated earlier, the switch from the FSC regime to the ETI regime enacted little real change. The requirements for foreign trading gross receipts to qualify for the ETI benefits remained largely the same as they had been for FSC. Certain requirements did change, however. Requirements relating to foreign resident directors, foreign management, and meetings outside the United States, for example, were removed.⁵⁷ Furthermore, the ETI benefits expanded the FSC regime. FSC benefits could be claimed only by corporations. The ETI legislation made the exclusion available to all categories of taxpayers – from individuals to C corporations and including foreign taxpayers that chose to be taxed within the United States.⁵⁸

BENEFICIARIES OF THE EXTRATERRITORIAL INCOME EXCLUSION

The extraterritorial income exclusion affects approximately 6,000 U.S. companies that annually save around \$4.4 billion due to this legislation.⁵⁹ A study conducted by PricewaterhouseCoopers for the National Foreign Trade Council found that more than \$310 billion of the nation's \$990 billion of exports of goods and services benefited from

⁵⁶ "EU Commisn Warns US again to Comply with WTO Ruling by Mar. 1" The Main Wire. 30 January 2004. LexisNexis Academic. LexisNexis Databases. University of Tennessee Libraries, Knoxville, TN. <http://www.lib.utk.edu/databases>

⁵⁷ "ETI Provisions: What is Different from FSC?" Quail Street Management Limited. 20 December 2001. <http://www.quailstreet.com/FSC%20vs.%20ETI.htm>

⁵⁸ Ibid.

⁵⁹ "How Exporters"

the FSC tax incentive in 1999.⁶⁰ In 1999, exports that benefited from the FSC regime accounted for 3.4 percent of the Gross Domestic Product.⁶¹ Obviously, these exports are an important sector of the U.S. economy. Because the extraterritorial income exclusion was enacted to aid the profitability of U.S. companies that export goods, it primarily affects multinational corporations and manufacturers. When considering the replacement for ETI and general international tax reform, these two groups must be considered.

Currently, the U.S. manufacturing industry is suffering. Since the beginning of the recession in 2001, 2.8 million manufacturing jobs have disappeared.⁶² President Bush recognized the manufacturing “problem” in a speech on Labor Day 2003.⁶³ Senator Charles Grassley noted that “merely repealing FSC/ETI would raise the tax burden of current beneficiaries by at least \$50 billion over ten years, potentially resulting in further job losses in the already beleaguered U.S. manufacturing sector and effectively transferring jobs to Europe.”⁶⁴ When examining the potential ETI replacements, Congress must be heedful that nearly 90 percent of the present FSC-ETI benefits are used by the manufacturing sector. A \$50 billion tax increase on manufacturing would further harm this sector or the U.S. economy and would not benefit U.S. competitive interests in whole.⁶⁵

⁶⁰ “FSC-Benefited Exports and Jobs in 1999: Estimates for Every Congressional District.” National Foreign Trade Council. Prepared by PricewaterhouseCoopers. 2 July 2002.
http://www.taxfoundation.org/internationaltax/PWC_FSC_Full.pdf

⁶¹ Ibid.

⁶² U.S. House. Senator Pallone. “The Loss of Manufacturing Jobs.” H.R. 2384. 108th Congress, 2nd Session. *Congressional Record*. 27 April 2004. vol. 150, no. 55.

⁶³ Savage, Luiza. “Battle Brewing on Next Tax Cut.” The New York Sun. 16 October 2003. LexisNexis Academic. LexisNexis Databases. University of Tennessee Libraries, Knoxville, TN.
<http://www.lib.utk.edu/databases>

⁶⁴ Crane and Rangel.

⁶⁵ “Daily Tax Update – Treasury Releases 2004 ‘Blue Book.’” Monday Business Briefing. Steptoe & Johnson, United States. 3 February 2004. LexisNexis Academic. LexisNexis Databases. University of Tennessee Libraries, Knoxville, TN. <http://www.lib.utk.edu/databases>

Furthermore, the ETI benefits support valuable jobs for individuals and the U.S. economy. “U.S. workers at plants that export have historically earned substantially more than other domestic workers. Over the 1976-1987 period, export workers’ wages and benefits were 14.5 percent and 32.7 percent higher, respectively, than for other domestic workers.”⁶⁶ These valuable export-related manufacturing jobs should be protected in the search for an ETI replacement.

Another important sector of the U.S. economy consists of multinational companies (MNCs). In regards to manufacturing, U.S. multinationals produce over 50 percent of the gross manufactured product. Furthermore, “approximately one fourth of the output produced by U.S. workers and U.S.-owned companies is produced by U.S. non-bank multinationals, either at home or abroad.”⁶⁷ In 1999, these companies experienced a net trade surplus of \$64 billion.⁶⁸ MNCs account for about two-thirds of overall U.S. merchandise exports. They also account for about 40 percent of all U.S. merchandise imports. Furthermore, MNCs employ over 20 million people in the United States, or about one in every six American workers. In addition, nearly 90 percent of the \$142 billion spent by U.S. non-financial multinationals on research and development in 1999 was performed in the United States.⁶⁹ U.S. multinationals invest in the United States, provide jobs, and continue to support the U.S.’s competitiveness.

It is notable that the software industry, and Microsoft in particular, is highly concerned with the ETI issue due to royalty payment concerns. The airline industry, especially Boeing, is concerned with the treatment of long-term leases and the

⁶⁶ “FSC-Benefited Exports and Jobs.”

⁶⁷ Dam.

⁶⁸ Ibid.

⁶⁹ Ibid.

grandfathering of past leases entered into under good faith under the past FSC and ETI regimes. Caterpillar has been an especially vocal domestic manufacturer as well. The financial service and insurance industries both are carefully watching the development of the ETI issue and the proposed legislation to replace it. Both have been vocal about their desires to repeal Subpart F within ETI reform. The following table, taken from a Tax Notes International study of the top 100 ETI beneficiaries, exhibits the major individual corporate beneficiaries from ETI.⁷⁰

Major FSC-ETI Beneficiaries in 1997-2002

<u>Company</u>	<u>Estimated Tax Benefit (in millions)</u>	<u>Ratio of Tax Benefit to Net Income</u>
Boeing Company	\$1,147	13.2%
General Electric Corp	\$1,023	1.5%
Intel Corporation	\$773	3.5%
Microsoft Corp	\$527	1.3%
Honeywell International Inc	\$525	8.2%
Caterpillar Inc.	\$364	6.9%
Motorola, Inc.	\$351	0.0%
Cisco Systems, Inc.	\$310	3.8%
Du Pont de Nemours	\$296	1.5%
Applied Materials, Inc.	\$266	6.2%
Raytheon Company	\$156	31.0%
Archer Daniels Midland	\$148	6.4%
GM Corp (Hughes Electronics)	\$147	5.4%
Monsanto Company	\$116	0.0%
Dover Corporation	\$83	3.5%
Total, top FSC beneficiaries	\$6,232	0.0%
Other 85 FSC beneficiaries in sample	\$1,970	0.0%
Total	\$8,202	

⁷⁰ Oyola, Jose. "FSC-ETI Beneficiaries: An Updated Profile." Tax Notes International. 6 October 2003. p.101. <http://www.taxanalysts.com>

The ETI regime obviously offers great savings for several of America's largest corporations. Yet, approximately 6,000 companies claim the ETI benefit per year. Each of these companies receives a reduction in its taxes due to ETI. Even a minute amount of tax savings is better than no tax savings at all because these savings can be reinvested in the company or in research and development, both of which help a company grow and stimulate the American economy.

Two other significant groups of ETI-beneficiaries merit mention – the employees and shareholders of these companies. A 1999 PricewaterhouseCoopers report compiled for the National Foreign Trade Council stated: "Over one million U.S. jobs were *directly* attributable to FSC-benefited exports and another 2.5 million jobs were *indirectly* attributable to these exports as a result of intermediate goods and services used in the production and distribution processes. In all, 3.5 million U.S. jobs were attributable to exports that benefited from FSC tax incentives in 1999, an average of 8,000 jobs per Congressional District."⁷¹ By helping American companies save over \$4 billion in taxes per year, ETI helps many businesses maintain employment, benefit its shareholders, and significantly contribute to the U.S. economy.

The obvious concern about removing or replacing ETI is that manufacturers and other companies who previously benefited from the FSC-ETI regime will be tempted to cut U.S. activities and U.S. jobs and move their productions overseas. The General Accounting Office conducted a survey of the top 100 FSC-ETI beneficiaries. In analyzing the results, Jose Oyola, Assistant Director at the General Accounting Office, found that ETI benefits "contributed materially" to a significant portion of surveyed companies. "Thirty-nine companies had FSC-ETI benefits that contributed 5 percent of

⁷¹ "FSC-Benefited Exports and Jobs."

more to higher profits (or smaller losses).” Furthermore, he found that 11 of the top 100 FSC-ETI beneficiaries “showed financial improvements greater than 10 percent due to FSC-ETI benefits.” Finally, if ETI benefits are repealed, the majority of surveyed firms will encounter risks of losing foreign market share. The following table from Tax Notes International displays the results of this study on FSC-ETI benefits.⁷²

FSC-ETI Beneficiaries by Profit or Loss Status

Effect of FSC-ETI Benefits in 1997-2002 on:	Number of Companies	FSC-ETI Benefits (in millions)
Profitable Companies -	90	\$7,512
Profits increased more than 10%	7	\$1,458
Profits increased 5 to 10%	25	\$1,949
Profits increased 5% or less	58	\$4,106
Loss companies -	10	\$690
Losses decreased more than 10%	4	\$233
Losses decreased 5 to 10%	3	\$367
Losses decreased 5% or less	3	\$90
Total	100	\$8,202

Altogether the data demonstrate the importance of ETI to U.S. companies. Furthermore, it evidences the importance of these companies to the U.S. economy. ETI cannot simply be repealed. It must be replaced with legislation that continues to benefit these companies and also reforms international taxation.

⁷² Oyola.

EUROPEAN UNION SANCTIONS AGAINST THE UNITED STATES

On August 30, 2002, a WTO panel of three judges issued its final ruling in the FSC/ETI dispute.⁷³ This panel gave the EU permission to impose penalty tariffs on U.S. exports to Europe up to \$4 billion per year. These sanctions on the United States are the largest penalty ever authorized by the WTO.⁷⁴ The panel also found that the ETI Act did breach the SCM Agreement and other trading rules.

On April 25, 2003, in Submission WT/DS108/26,⁷⁵ the European Union submitted the products on which they intended to impose the penalty tariffs. On May 7, 2003, the WTO gave its final authorization to impose the penalty tariffs.⁷⁶ EU sanctions were applied at 5% of the total authorized amount on March 1, 2004, and are scheduled to increase 1% per month until March 1, 2005. The duty will have increased to 17% by this time due to the incremental monthly implementations. Sanctions are authorized to increase up to 100% of the value of the U.S. goods. When the U.S. deals with the ETI matter, the EU tariffs will not automatically be lifted. The sanctions will probably remain in place until the WTO reviews and approves the action taken by the United States. Observers estimate that the tariffs will cost U.S. businesses about \$320 million in lower profits if they remain in effect through the end of 2004.⁷⁷

⁷³ Newlon.

⁷⁴ Denny, Charlotte. "\$4bn US Subsidies Incur WTO's wrath." *The Guardian*. 14 January 2002. <http://www.guardian.co.uk/business/story/0%2C3604%2C632208%2C00.html>

⁷⁵ Official title: United States – Tax Treatment of “Foreign Sales Corporations” – Recourse by European Communities to Article 4.10 of SCM Agreement and Article 22.7 of DSU (WT/DS108/26)

⁷⁶ “EU Granted Permission to Apply US\$4 Billion Sanctions against US in Foreign Sales Corporation Case But Delays Application.” *World Trade Organization*. 7 May 2003. http://www.wto.org/english/news_e/news03_e/dsb_7may03_e.htm

⁷⁷ Schneider, Andrew C. “EU Trade Retaliation to Hit Many Sectors.” *Kiplinger Business Forecasts*. Vol. 2004. No. 0130. 28 January 2004. LexisNexis Academic. LexisNexis Databases. University of Tennessee Libraries, Knoxville, TN. <http://www.lib.utk.edu/databases>

Sanctions will take a toll on American products. Very specific products will be affected by the sanctions, and each product is authorized to be subjected to 100 percent tariffs, which would double the price of the U.S. product.⁷⁸ Products targeted for retaliatory tariffs include every geographic region of the United States. The product list includes agricultural products such as cereals produced in the Farm Belt states and citrus fruits in Florida. The Southeast produces large amounts of textiles, which also are listed. High-tech centers including Texas and California will be affected by tariffs on electronics. Industrial regions, especially in the Northeast, will be injured by tariffs added to any export to the EU made with iron, steel, copper, or aluminum.⁷⁹ The EU selected more consumer goods than raw materials to be sanctioned in an effort not to penalize EU industries. The goods selected also are less than 20 percent of U.S. exports to the EU. As a result, EU companies have alternative resources and the impact is greater on U.S. companies rather than on EU companies.⁸⁰

The sanctions created a new dimension to the ETI matter. In 1999, though FSCs were ruled illegal, sanctions were not imposed. The current sanctions establish a need for urgency and could potentially complicate the true international tax reform necessary for U.S. competitiveness. The good news for the United States is that the EU is not imposing the sanctions at their fully authorized level, which would be like a “nuclear bomb” to the

⁷⁸ “How Exporters”

⁷⁹ Schneider.

⁸⁰ “How Exporters”

global trade system, according to U.S. Trade Representative Robert Zoellick.⁸¹ Neither the United States nor the EU can afford to throw up such extensive trade barriers.⁸²

Presently, the EU is tired of waiting for Congress to act. The EU was hesitant to apply the tariffs, continually stating that U.S. compliance was their goal. “We hope that compliance will take place by the first of March,” said Arancha Gonzalez, the EU spokeswoman for trade, before the imposition of the tariffs. “Compliance will mean that we don’t impose sanctions and that we put to bed this very old dispute – it’s in the U.S.’s hands.”⁸³ However, the United States did not comply by March 1, 2004, and the sanctions continue to increase.

The ETI issue is an issue Congress intends to resolve in 2004. However, there is not a true sense of urgency about the matter. If the estimate of \$320 million in lost profits is correct, it would be a minor loss. The main cause of the lack of urgency in resolving the ETI controversy is the weak dollar, which is currently benefiting American exporters. The weak dollar has offset much of the negative impact from the tariffs and has given American exporters a competitive advantage over their European counterparts.⁸⁴ Nevertheless, sanctions will have a negative impact on American products, especially if the applied tariffs continue to increase. If the dollar strengthens against the euro, the sanctions will have an even greater impact within the United States.

⁸¹ Aaron, David. “Heading off a Trade War.” The Washington Post. 7 September 2001. LexisNexis Academic. LexisNexis Databases. University of Tennessee Libraries, Knoxville, TN. <http://www.lib.utk.edu/databases>

⁸² “US’s Grassley Urges EU to Keep Cool on Hill Bid to Repeal FSC.” The Main Wire. Market News International. 2 October 2003. LexisNexis Academic. LexisNexis Databases. University of Tennessee Libraries, Knoxville, TN. <http://www.lib.utk.edu/databases>

⁸³ “EU Commission”

⁸⁴ Schneider.

THE POLITICAL STATE OF AFFAIRS

In a Congressional committee meeting concerning ETI, Senator Max Baucus light-heartedly remarked, “I just have the impression that an objective person watching all this would conclude, number one, that we’ve got to find a solution to the ETI problem. But second, there is none. And third, that it’s a little confusing and it’s unclear as to how quickly one will arrive.”⁸⁵ Senator Baucus humorously summarized the situation the United States now faces. No easy solution exists because many factors play into the controversy beyond simply repealing ETI.

The first factor involved with ETI is the European Union. Unfortunately, the EU challenged the legality of both ETI and FSC. Also, it is the EU that requested permission to levy \$4 billion in economic sanctions against the United States if the United States does not comply with the WTO decision to repeal ETI. Yet, the EU is one of the United States’ major trading partners. U.S. exports to the EU increased from approximately \$100 billion in 1992 to almost \$150 billion in 2002.⁸⁶ Two-way trade is worth about \$770 billion and employs about 4 million people for each party.⁸⁷ Of considerable importance is that over the coming years, the EU will add ten new Eastern and Central European countries – which are populated by 75 million new citizens and potential consumers of American products.⁸⁸ As a result, repealing ETI is a matter of importance on the U.S. international agenda and must be resolved, as our trading partners are closely monitoring progress on the issue. Nevertheless, the war on terror, and especially the war in Iraq, has

⁸⁵ Senate Finance. Panel I.

⁸⁶ “How Exporters.”

⁸⁷ Ibid.

⁸⁸ Ibid.

been a contentious point between the United States and several members of the European Union. The U.S. relationship with the EU is strained, and some fear that the ETI dispute will further divide the two sides. After the failure of the Cancun WTO ministerial, it is especially important that the ETI resolution not produce greater division between the United States and Europe.⁸⁹

The second complicating factor is domestic politics. Two thousand four is an election year. Congress's original goal was to have the ETI replacement legislation enacted in 2003. However, the initial phases of election-year politics delayed action on the issue. Many in Congress believe that "an obligation to U.S. workers and businesses not simply to eliminate the ETI provisions" exists.⁹⁰ However, replacement legislation must be debated, which brings forth the opportunity for superfluous and random amendments with no relation to ETI to be debated in conjunction with the ETI replacement bills. Furthermore, the status of the U.S. economy and its recovery will be a central issue in the election, especially after the early economic struggles during the first years of the Bush administration caused by the September 11 tragedies. President Bush already has enacted tax cuts during his administration and the effectiveness of these cuts will be debated. Repealing and replacing ETI will essentially be another tax cut debate and will create opportunity for Democrats and Republicans to rebuff one another while not focusing on the central issues – repealing ETI and reforming international taxation. Because ETI benefits corporations, Republicans especially will have to educate American citizens that this provision is not merely a tax cut for "Big Business," rather that ETI is necessary for American companies to compete and to keep American jobs.

⁸⁹ "US's Grassley."

⁹⁰ Dam.

OTHER COMPLICATING POLITICAL FACTORS

The Byrd Amendment

The Continued Dumping and Subsidy Offset Act (CDSOA) of 2000, proposed by Senator Robert Byrd, is another complicating international issue affecting the ETI dispute.⁹¹ The act imposes tariffs on imports that have received subsidies from their home governments and imports being sold to the United States at prices lower than in the country where they are produced. The legislation also rewards U.S. companies that sponsor anti-dumping cases.

On June 16, 2003, the WTO Appellate Body previously sustained that CDSOA violated international law by granting disbursements beyond permitted amounts to parties injured by dumping and subsidies.⁹² However, the December 27, 2003 deadline given to Congress to conform the legislation with international agreements passed with no action from Congress. As a result, the EU has asked permission to apply sanctions against the United States. Even more disconcerting is the fact that Brazil, Canada, Chile, India, Japan, Korea, and Mexico, who are all co-complainants in the Byrd Amendment argument, also are requesting permission from the WTO to enforce sanctions against certain U.S. products.⁹³ The Byrd Amendment sanction requests are separate from the

⁹¹ U.S. Congressional Budget Office. "Economic Analysis of The Continued Dumping and Subsidy Offset Act of 2000." 2 March 2004. <http://www.cbo.gov/showdoc.cfm?index=5130&sequence=0>

⁹² Congressional Budget Office. "Economic Analysis"

⁹³ "US Byrd Amendment Dispute: EU requests authorisation to apply sanctions against US." RAPID. 15 January 2004. LexisNexis Academic. LexisNexis Databases. University of Tennessee Libraries, Knoxville, TN. <http://www.lib.utk.edu/databases>

sanctions in the ETI dispute. However, two sanction regimes imposed by the EU – ETI and Byrd sanctions – could seriously affect American competitiveness in the region.

The War on Terror

An obvious concern when examining America's foreign or fiscal policies is the current war on terror. With expensive military campaigns simultaneously occurring in both Afghanistan and Iraq, can the United States afford a tax break? The issues with the war on terror, especially in Iraq, will cause political divisions in an election year. There are concerns that election-year politics could preclude the cooperation necessary from both Republicans and Democrats to reform international tax laws.

"Revenue Neutral" – Preserving Tax Income

The Treasury Department prefers that any bill replacing ETI would be revenue neutral.⁹⁴ Likewise, a Senate bill concerning the issue also must be virtually revenue neutral as the Senate budget is more financially hamstrung this year than the House budget. Therefore, any bill to be passed must not be of great cost to the Treasury. This constraint concerns many international tax reformers because much tax reform involves the elimination of some foreign-source income taxes that hurt American competitiveness. The hope is that eliminating these tax rules will increase American productivity and offset the tax cuts.

⁹⁴ Wells, Rob. "Bush Proposes Options on Replacing Export Tax Break." Dow Jones Newswires. 3 February 2004. LexisNexis Academic. LexisNexis Databases. University of Tennessee Libraries, Knoxville, TN. <http://www.lib.utk.edu/databases>

FOUR RESPONSES TO THE WTO'S RULING

The United States can respond in four ways to the WTO's ruling. It can 1) do nothing, 2) repeal the ETI with no replacement, 3) repeal and replace ETI, or 4) repeal ETI and reform the international tax laws. The following examines these four options.

Option 1: Do Nothing

The United States could keep ETI and ignore the WTO ruling and increasing European Union sanctions. However, this option is not realistic given the political climate of the dispute. The United States already has stated its commitment to repealing ETI, and members of Congress have introduced legislation for its repeal. This option will not be further discussed.

Option 2: Repeal ETI

The easiest route for the United States would be to repeal the Extraterritorial Income Exclusion Act. However, Congress has continually stated it does not intend to merely repeal ETI. Yet, in the face of increasing sanctions, simply repealing ETI may be the easiest way for Congress to resolve the trade dispute.

Although the prevailing sentiment in Washington is that merely repealing ETI is unacceptable, one could argue against the existence of ETI. Is ETI really necessary? "FSC has become just a special-interest tax break for some of America's largest corporations," charged Dan Griswold, associate director of the Center for Trade Policy Studies at the Cato Institute, a Washington, D.C. think tank. He contends that the export subsidies of the FSC/ETI are "economically unnecessary," based on a 2000 Congressional Research Services study regarding 1996 data which demonstrated that

FSC boosted exports by less than half a percent.⁹⁵ Furthermore, the dollar has been weak against the euro and American products have benefited from the exchange in the European market. Some feel that the trade benefits caused by a weaker dollar would offset the repeal of the ETI provisions. Due to the currency exchange, U.S. exports have benefited in the external market. U.S. businesses likely could weather the repeal of ETI in the short-run.

In contrast, testifying before Congress about the importance of ETI, Lynn McPheeters, CFO of Caterpillar, stated, “The loss of ETI without a suitable replacement could undermine the ability of U.S. exporters to compete in a global trade environment.” McPheeters continued to state that repealing ETI would increase taxes on exporters by more than \$5 billion and would “increase the competitive disadvantage U.S. companies face internationally.”⁹⁶

The arguments lead to the conclusion that merely repealing ETI is not the best route for the United States. It eliminates an import tax reduction for exporters who play a vital role in the U.S. economy. U.S. businesses are lobbying against simply repealing ETI in Congress, which would assuredly leave U.S. companies in low-tax jurisdictions at a disadvantage.⁹⁷ Moreover, it eliminates the opportunity for true reform of the international tax code, which is the best potential benefit ETI repeal could offer to U.S. companies.

⁹⁵ Nyberg, Alix “A Taxing Dispute.” *CFO Magazine*. 18 August 2003. LexisNexis Academic. LexisNexis Databases. University of Tennessee Libraries, Knoxville, TN. <http://www.lib.utk.edu/databases>

⁹⁶ U.S. Senate Committee on Finance. *Hearing on the Role of the Extraterritorial Income Exclusion Act in the International Competitiveness of U.S. Companies*. Testimony of Lynn McPheeters. 107th Cong., 2nd sess., 30 July 2002.

⁹⁷ Luscombe, Mark. “What to Do About International Taxation?” *The Tax Magazine*. Tax Trends. March 2002. LexisNexis Academic. LexisNexis Databases. University of Tennessee Libraries, Knoxville, TN. <http://www.lib.utk.edu/databases>

Option 3: Repeal and Replace ETI

The third reaction the United States could undertake in response to the WTO ruling is to repeal the ETI Act and replace ETI with a very similar export tax break. As a result, the United States would not have to change much of its current tax system and could still offer a tax break to U.S. businesses. This is the approach the U.S. took when responding to the illegality of Foreign Sales Corporations. However, this approach would certainly not be an acceptable option in the eyes of the European Union and the WTO. Deputy Secretary Dam gave his opinion on trying to replace ETI with similar legislation, “We've tried to, in ETI, as a country, replicate FSC under slightly changed language and so forth. That won't work. The possibility of that passing muster with the WTO are nil, and certainly the European Union would challenge any such legislation immediately.”⁹⁸

Simply altering the FSC/ETI provisions will not be consistent with the WTO ruling, nor will it serve U.S. competitive interests. The European Union would not remove its sanctions and the United States would not have improved the current state of affairs.

Option 4: Repeal ETI and Reform the International Tax Code

The United States' final option is to repeal ETI and, instead of replacing the ETI provisions with similar provisions, reform its international tax laws. Making changes to the tax code to promote the international competitiveness of U.S. companies would best serve U.S. interests. Reforming the international tax laws will require significant time and work, but it is the best response to the WTO ruling against ETI.

If the United States is to maintain its current worldwide system of taxation, reforms to the current system must be made. In his testimony to Congress, Scott Newlon

⁹⁸ Senate Finance. Panel I.

described several principles that lawmakers must consider when reforming our international tax provisions: competitiveness, economic efficiency, preservation of the tax base, and simplicity.⁹⁹ Newlon singled out one of his four principles that could easily be changed and have a great impact on U.S. interests – simplifying the international tax laws. Simplicity must be one of the guiding principles in promoting international tax reform.

The proposals to replace ETI and neutralize the economic discrepancy caused by the U.S. direct tax system will now be discussed.

THE NEXT STEP –WHAT HAS CONGRESS PROPOSED TO RESOLVE THE ECONOMIC DISCREPANCY

To be into compliance with the WTO ruling and to end the sanctions against the U.S. products, Congress must pass legislation to repeal ETI. Furthermore, it is apparent that reforming the international tax laws are paramount to U.S. economic competitiveness abroad.

The objective is to enact the correct tax policies that avoid making the creation of capital and jobs more attractive in foreign countries than in the United States. The United States enacted ETI to level the playing field with competitors. Keeping American jobs and promoting American competitiveness are the key principles that should guide the international tax reform debates.

Considering these factors, Congress has passed two bills to replace the FSC Repeal and Extraterritorial Income Exclusion Act. The American Jobs Creation Act of

⁹⁹ Newlon.

2003, sponsored by House Ways and Means Chairman Bill Thomas, passed the House on June 17, 2004. In the Senate, the Jumpstart Our Business Strength (JOBS) Act, written by Charles Grassley, passed on May 17, 2004. Philip Crane and Charles Rangel sponsored the Job Protection Act of 2003, which was another bill considered in the House. Due to its considerable support, it will be presented in this discussion though the passage of the American Jobs Creation Act essentially negates its further consideration by the House. A fourth bill proposed by Orrin Hatch was filed in the Senate only for debate and to highlight measures that Hatch believed Congress should take to reform international taxation. It will not be discussed. This paper will now discuss the three bills proposed to replace ETI giving consideration to the international tax reform obviously necessary to promote American competitive interests abroad.

JOB PROTECTION BILL OF 2003

Overview:

The Job Protection Bill of 2003 is a functional bill that repeals ETI and benefits manufacturers. According to the bill synopsis, it is “a bill to amend the Internal Revenue Code of 1986 to comply with the World Trade Organization rulings on the FSC/ETI benefit in a manner that preserves jobs and production activities in the United States.”¹⁰⁰

Other co-sponsors of the bill, other than primary sponsors Philip Crane (R-IL) and Charles Rangel (D-NY), include Michael Collins (R-GA), Ray Lahood (R-IL), Sander Levin (D-MI), Donald Manzullo (R-IL), Robert Matsui (D-CA), James McDermott (D-WA), Richard Neal (D-MA), and John Shimkus (R-IL). The five states that received the

¹⁰⁰ U.S. House. Job Protection Bill of 2003. 108th Cong., H.R. 1769.

largest FSC benefits in 1999 were California, Texas, Michigan, New York, and Washington. The top five exporting states were California, Florida, New York, Texas, and Illinois.¹⁰¹ Not surprisingly, the bill's sponsors represent all of these states, save Texas and Florida.

Proposals:

The authors of the Job Protection Bill of 2003 stated that the bill accomplishes three things. First, it immediately repeals FSC/ETI. Second, it provides transition relief through a phase-out period for companies that have benefited from ETI. Third, it institutes a permanent tax benefit for the U.S. manufacturing sector.¹⁰² The bill is basically revenue neutral, as it is projected to cost the government "only \$126 million over 10 years."¹⁰³ For deficit hawks, this is one of the bills strongest qualities. Because the 2004 U.S. budget is strained due to the war in Iraq, the Treasury has made it clear that it prefers a revenue neutral bill. This bill fits that specifications.

The Crane-Rangel bill eliminates the ETI benefit as of the date of the enactment of the Act. It continues ETI for certain binding contracts with an unrelated entity in effect on April 11, 2003. This ensures that companies with legal pre-existing contracts entered into in good faith are not penalized. These binding contracts include purchase options, renewal options, and replacement options included in the contracts. Furthermore, the bill allows a foreign corporation that had chosen to be treated as a domestic corporation for tax purposes to transfer its assets to a foreign corporation without being required to recognize a gain on the transfer of the assets.

¹⁰¹ U.S. Census Bureau. Economics and Statistics Administration. "*Highlights from A Profile of U.S. Exporting Companies, 2000-2001.*" United States Department of Commerce News. 20 February 2003.

¹⁰² Crane and Rangel.

¹⁰³ Ibid.

The Crane-Rangel bill phases out the ETI benefits for companies determined as a current FSC/ETI beneficiary. A current ETI beneficiary is defined as “any corporation which entered into one or more transactions during its taxable year beginning in calendar year 2001 with respect to which FSC/ETI benefits were allowable.”¹⁰⁴ The following table displays the phase-out of ETI benefits.

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009 and beyond</u>
Phase-out of Allowable Percentage	100%	100%	75%	75%	50%	0%

The base ETI amounts will be indexed for inflation. It should be noted that the United States allowed the EU a five-year transition period in the Bananas Case.¹⁰⁵

The most promising provision of the Job Protection Bill of 2003 is the permanent tax cut created for domestic production activities, primarily for a struggling manufacturing sector. U.S. production activities are defined as “any sale, exchange, or other disposition of, or any lease, rental, or license of qualifying production property which was manufactured, produced, grown, or extracted in whole or in significant part by the taxpayer within the United States.” This is the same property that is currently eligible for the ETI benefit.¹⁰⁶ The tax deduction applies regardless if the property is to be exported. The Crane-Rangel bill will phase in a deduction for certain income attributable to domestic production activities. The tax rate for this income will ultimately be lowered 3.5 percentage points, from 35 percent to 31.5 percent. The phase-in will adhere to the following schedule.

¹⁰⁴ H.R. 1769. Sec. 2(e)(2).

¹⁰⁵ Crane and Rangel.

¹⁰⁶ Ibid.

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010 and beyond</u>
Manufacturing Deduction Percentage	1%	2%	4%	9%	10%
Manufacturing Tax Rate Reduction	0.35%	0.70%	1.40%	3.15%	3.50%
Resulting Tax Rate ¹⁰⁷	34.65%	34.30%	33.60%	31.85%	31.50%

These percentages will be reduced by a ratio of domestic to foreign production. Domestic production will be the numerator and worldwide production will be the denominator in this limiting fraction.

Discussion of the Bill's Effectiveness:

The Crane-Rangel bill is a functional, effective bill. It repeals ETI and gives a tax break to manufacturers who received the majority of the ETI benefits. According to Rangel, “the general transition relief in HR 1769 is not tainted in any way because it is not a continuation of the FSC/ETI program. Manufacturers are not required to export anything to receive the benefit, and as the WTO Subsidies Agreement states: ‘The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.’”¹⁰⁸ As a result, the Crane-Rangel bill rectifies the primary flaw of the FSC/ETI regime – the export contingency of its benefits. The Job Protection Act of 2003 has the support of domestic manufacturers who benefited from the ETI regime, primarily Caterpillar, Boeing, and Microsoft. The bill’s supporters believe it “rewards big manufacturing corporations the right way – it rewards them for investing in U.S. production. If a corporation makes 100% of its goods in the United States, it gets 100% of the bill’s tax benefit – 50%

¹⁰⁷ Assumes a 35% maximum corporate tax rate.

¹⁰⁸ Crane and Rangel.

production means 50% of the tax cut, and so on.”¹⁰⁹ The bill also benefits many small businesses as it does not discriminate as to the goods or organization of the producer that will receive the bill’s assistance. As a result, sole proprietorships, partnerships, and S-corporations are eligible for its benefits. The Crane-Rangel bill would certainly buoy a struggling manufacturing sector.

However, the Crane-Rangel bill misses the mark. Although it repeals ETI, the bill provides no international tax reform. It contains no Subpart F reform, no restructuring of the foreign credit system and foreign-source income baskets, no elimination of the double taxation of corporate income, no reorganization of expense allocation, no simplification of the U.S. tax code, and no penalty for corporate inversions. Other than a rate cut, the bill includes no measures to resolve the economic discrepancy caused by the U.S. tax system. The Crane-Rangel bill should be only a stopgap measure to repeal ETI. It does little to promote the international competitiveness of American companies.

Also, the Crane-Rangel bill is sector specific. It only benefits the manufacturing sector and not the broad range of American companies. “We like the Crane-Rangel-Manzullo approach,” says Kimberly Pinter, director of corporate finance and tax for the National Association of Manufacturers, “but we don’t think it should be a choice between manufacturing benefits and international tax reform. We would like to see something that addresses both.”¹¹⁰

Furthermore, the Crane-Rangel might still violate the WTO’s ruling. The phase-out period lasts until 2009, and the European Union has warned that this transition period

¹⁰⁹ Ibid.

¹¹⁰ Nyberg.

is too long and unacceptable.¹¹¹ Moreover, the bill that passed the Senate is much more complex than the Crane-Rangel bill. Reconciling the two bills in committee would be difficult and maybe impossible. The Crane-Rangel bill is not the best choice for the House of Representatives to pass to repeal ETL.

In conclusion, nothing is explicitly wrong with the Crane-Rangel bill. However, it has many inherent faults as it is simply too narrow to provide any long-range reform or benefits to the U.S. economy, to resolve the economic discrepancy, or to promote American competitiveness.

AMERICAN JOBS CREATION ACT OF 2003

Overview:

The American Jobs Creation Act was the other option in the House of Representatives to repeal the extraterritorial income exclusion. The House approved it on June 17, 2004. The American Jobs Creation Act is commonly referred to as the “Thomas bill” after its sponsor, William Thomas (R-CA). Representative Thomas is the Chair of the House Ways and Means Committee.

The bill’s stated objects is “to amend the Internal Revenue Code of 1986 to remove impediments in such Code and make our manufacturing, service, and high-technology businesses and workers more competitive and productive both at home and abroad.”¹¹² In general, the Thomas bill is much broader than the Crane-Rangel bill and has more sweeping international tax reforms.

¹¹¹ “Foreign Tax Fight.” The Wall Street Journal. 17 September 2003.

¹¹² U.S. House. American Jobs Creation Act of 2003. 108th Cong., 2nd sess., H.R. 2896.

Proposals:

The American Jobs Creation Act of 2003 includes many international tax reforms and domestic benefits. The bill's greatest stumbling block has been its cost. It was initially reported to cost \$128 billion. That figure was lowered to \$60 billion¹¹³ and has since been claimed to be "virtually revenue-neutral" and to only cost \$4 billion over ten years.¹¹⁴ This \$4 billion figure is likely understated, however. The bill's decreasing cost is due to several rewrites, amendments, and revenue raisers added to aid its passage in the House. Many considered the bill too weak on domestic manufacturing and were wary that it too heavily favored international companies. While the bill still benefits multinationals, Thomas has added several features to the bill to aid domestic companies.

Due to the bill's many proposed reforms, it is considerably more complex than the Crane-Rangel bill. Not all aspects of this bill will be included in this discussion. The bill's proposals related to the ETI dispute will be discussed in a topical manner.

ETI Repeal

It should be mentioned first and foremost that the American Jobs Creation Act of 2003 repeals the extraterritorial income exclusion for transactions after December 31, 2003 and grants two years of transition relief. These provisions can be found in Title IV of the bill.¹¹⁵ Additionally, it retains the FSC grandfather rules.¹¹⁶ The following table

¹¹³ Hearn, Josephine. "Thomas Sets FSC Markup Date at Last: Chairman says he has gained support needed to pass proposed provision." The Hill. 21 October 2003. LexisNexis Academic. LexisNexis Databases. University of Tennessee Libraries, Knoxville, TN. <http://www.lib.utk.edu/databases>

¹¹⁴ "Daily Tax Update: Senate Gears Up For FSC/ETI Repeal Bill Debate Next Week – House To Deliberate Budget Resolution." Steptoe & Johnson. 2 April 2004. LexisNexis Academic. LexisNexis Databases. University of Tennessee Libraries, Knoxville, TN. <http://www.lib.utk.edu/databases>

¹¹⁵ H.R. 2896.

¹¹⁶ Bernstein, Rachelle, Harrison Cohen, Tom Fuller, and Diane Renfroe. "Analysis of U.S. International Tax Reform Proposals." Tax Notes International. 4 August 2003: p. 463. <http://www.taxanalysts.com>

presents the percentage of ETI-base benefits allowed to be deducted in the coming years.¹¹⁷

	<u>2004</u>	<u>2005</u>	<u>2006 and beyond</u>
Phase-out of Allowable Percentage	65%	35%	0%

All other provisions in the bill are designed to spur the economy and counteract the economic discrepancy between the U.S. tax system and those of its competitors.

Subpart F Reforms

The Subpart F reforms can be found in Title I, Subtitle J of the Thomas bill. The bill greatly simplifies this onerous section of the tax code. Highlights of the bill's reforms are as follows:

- The bill repeals foreign base company sales and services income rules because these types of income should be classified as active income rather than passive. Income from sales of products made and sold for use or consumption in the United States remains subject to current tax.¹¹⁸
- The bill extends active financing income exception for one year through the end of 2008. This provision extends current exemptions for insurance income and income derived from banking, financing, and similar business active income.¹¹⁹
- The bill includes a provision for “look-through” treatment of payments between related CFCs under foreign personal holding company income rules as long as this income was not considered Subpart F income to the related CFC.¹²⁰ “This provision creates a new, broad exception from subpart F income for dividends,

¹¹⁷ Ibid.

¹¹⁸ H.R. 2896, sec. 1101.

¹¹⁹ Ibid., sec. 1102.

¹²⁰ Ibid., sec. 1103.

interest, rents, and royalties received by a CFC from a related CFC, regardless of whether the payer is organized in the same jurisdiction as the recipient.”¹²¹

- The bill bestows “look-through” treatment for sales of partnership interest by a CFC in which the CFC has a minimum 25 percent ownership.¹²²
- The bill repeals foreign investment company and foreign personal holding company rules and creates a new category of Subpart F income for income earned for personal service contracts.¹²³
- The bill creates an expanded exception for commodity hedging transactions,¹²⁴ which would apply to all CFCs.¹²⁵
- The bill repeals foreign base company shipping income rules and creates a “safe harbor for certain leasing activities,”¹²⁶ which permits an exception from foreign personal holding company income for rents or leases of aircraft or other vessels for use in foreign commerce.¹²⁷

¹²¹ Bernstein, Cohen, Fuller, Renfroe.

¹²² H.R. 2896, sec. 1104.

¹²³ Bernstein, Cohen, Fuller, Renfroe.

¹²⁴ H.R. 2896, sec. 1107.

¹²⁵ Bernstein, Cohen, Fuller, Renfroe.

¹²⁶ H.R. 2896, sec. 1108.

¹²⁷ Bernstein, Cohen, Fuller, Renfroe.

Reduction of Double Taxation of Corporate Earnings – Foreign Tax Credit Reforms

The Thomas bill reforms many of the international tax provisions that cause double taxation of corporate earnings. This section will describe the proposals that specifically affect the foreign tax credit.

- The bill changes interest expense allocation rules to an asset basis so that interest expense is more accurately allocated to foreign and domestic divisions. Taxpayers may choose to maintain the current system of interest expensing if it is more favorable. However, this election is a permanent choice.¹²⁸
- The bill creates similar treatment for domestic and foreign losses. This treatment permits taxpayers to recharacterize portions of “overall domestic loss” as foreign-income and still keep foreign tax credits when domestic loss occurs.¹²⁹
- The bill reduces the number of foreign tax credit baskets from nine to two: passive income and general (or active) income.¹³⁰ This provision greatly simplifies record-keeping burdens and complexity.
- The bill extends the foreign tax credit carryforward period from five to ten years.¹³¹
- The bill proposes to eliminate a separate income basket for noncontrolled section 902 corporation, often referred to as 10/50 companies.¹³² The bill would result in the application of look-through rules to all earnings of such companies.¹³³

¹²⁸ H.R. 2896, sec. 1111.

¹²⁹ Ibid., sec. 1112.

¹³⁰ Ibid., sec. 1113.

¹³¹ Ibid., sec. 1114.

¹³² Bernstein, Cohen, Fuller, Renfroe.

¹³³ H.R. 2896, sec. 1115.

- The bill redefines how indirect foreign tax credits can be apportioned in partnerships. It treats stock owned directly or indirectly by a partnership in a foreign entity as proportionately owned by its partners.¹³⁴ As a result, there is a flow-through of foreign taxes paid to the individuals who can then claim foreign tax credits.¹³⁵

Reduction of Double Taxation of Corporate Earnings - International Tax Simplifications

The Thomas bill further simplifies international tax provisions beyond the foreign tax credit modifications. These further simplifications are as follows:

- The bill changes how the uniform capitalization of inventory (UNICAP) rules apply to foreign persons.¹³⁶ If the foreign person capitalizes inventory costs for financial reporting purposes, the bill permits these persons to be exempt from the UNICAP rules.¹³⁷ A foreign person is subject to UNICAP rules only for income associated with operations within the United States.¹³⁸
- The bill allows taxpayers to elect to report foreign taxes paid in a foreign currency at a spot currency exchange rate rather than the average exchange rate for the entire year.¹³⁹ This provision simplifies the foreign tax reporting process for businesses with few foreign tax payments in foreign currencies. It could potentially improve tax reporting accuracy.¹⁴⁰

¹³⁴ Ibid., sec. 1116.

¹³⁵ Bernstein, Cohen, Fuller, Renfroe.

¹³⁶ H.R. 2896, sec. 1118.

¹³⁷ Bernstein, Cohen, Fuller, Renfroe.

¹³⁸ "Congress Begins Work on ETI Replacement Legislation." PricewaterhouseCoopers. Washington National Tax Service. 1 August 2003. http://www.fei.org/download/eti_summary_8_11_03.pdf

¹³⁹ H.R. 2896, sec. 1121.

¹⁴⁰ Bernstein, Cohen, Fuller, Renfroe.

- The bill repeals the secondary withholding tax on dividends paid by foreign corporations¹⁴¹ and exempts the tax on select elements of dividends from a U.S. mutual fund received by nonresident aliens and foreign corporations.¹⁴²

Foreign Repatriation

The Thomas bill creates a six month period during which a U.S. company can deduct 80 percent of dividends-received in excess of base period distributions from CFCs.¹⁴³ This provision is a one-time offer to entice companies into repatriating income back to the United States that otherwise would never be repatriated.

Depreciation Reform

The Thomas bill changes several aspects of depreciation to aid certain industries. The following table shows the changes of depreciable lives.

Depreciable Lives of Property Used in the United States

Manufacturing Property

<u>Was</u>	<u>Is Now</u>
10 years	7 years
7 years	5 years
5 years	3 years ¹⁴⁴

Leasehold Property and Restaurant Property

<u>Was</u>	<u>Is Now</u>
30 years	20 years ¹⁴⁵

Furthermore, the leasehold property and restaurant property are made eligible for 50 percent bonus depreciation, and the Thomas bill extends the 50 percent bonus depreciation provision through the end of 2005.¹⁴⁶

¹⁴¹ H.R. 2896, sec. 1122.

¹⁴² Ibid., sec. 1120.

¹⁴³ Ibid., sec. 1021.

¹⁴⁴ Ibid., sec. 1043.

¹⁴⁵ Ibid., sec. 1041.

¹⁴⁶ Ibid., sec. 1041.

Research Tax Credit

The Thomas bill extends the research tax credit for 3.5 years, from June 30, 2004 to December 31, 2007. It also offers an “alternative simplified credit.” This credit equals 12 percent of the amount greater than 60 percent of average qualified research expenses (QRE) for three out of the last five years – excluding the two years in which the QRE is the largest and the smallest.¹⁴⁷

Relief for Small Businesses

The most notable reform for small businesses in the Thomas bill is the reduction of the top corporate tax rate on companies with less than \$10 million in taxable income to 32 percent. This reform will begin in 2005 and be phased in over eight years.¹⁴⁸ The bill includes S corporation reforms including treating up to three generations of the same family, including spouses, as one shareholder¹⁴⁹ and increasing the shareholder maximum from 75 to 100.¹⁵⁰ Moreover, the bill extends Section 179 expensing for two additional years through the end of 2007.¹⁵¹ Previous tax cuts increased Section 179 expensing to a \$100,000 expensing limit restricted by phase-out threshold of \$400,000. Additionally, the Thomas bill expands the five year corporate net operating losses carryback extension to losses incurred during 2003, as well as 2002 and 2001.¹⁵²

¹⁴⁷ Ibid., sec. 1011.

¹⁴⁸ Ibid., sec. 1001.

¹⁴⁹ Ibid., sec. 1071.

¹⁵⁰ Ibid., sec. 1072.

¹⁵¹ Ibid., sec. 1031.

¹⁵² Ibid., sec. 1051.

Alternative Minimum Tax Reform

The Thomas bill significantly reforms the alternative minimum tax (AMT) requirements. Notably, the bill increases the base amount to be exempt from AMT consideration from \$7.5 million to \$15 million.¹⁵³ This measure will relieve most small businesses from AMT and it also reduces the penalty for bigger businesses. This measure alone has been estimated to give \$17 billion in relief to the U.S. business community.¹⁵⁴ Furthermore, the bill repeals the limitation that only 90 percent of net operating losses and foreign tax credits could be applied against AMT.¹⁵⁵ The bill also reduces the depreciation adjustment by 50 percent points, from 150 percent to 175 percent, for property placed in service after December 31, 2005.¹⁵⁶

Other Provisions

Several last-minute amendments were added to the Thomas bill to secure the votes necessary for its passage in the House. Specific items, including bows, arrows, tackle boxes and sonar fish-finders, were identified for tax cuts.¹⁵⁷ However, despite these extraneous additions, two late amendments are significant. A group of House Republicans indicated their support of the bill was dependent on a provision that permits citizens of states without state income taxes to deduct state sales taxes from their federal income tax returns.¹⁵⁸ This deduction was included in the bill and will affect taxpayers in

¹⁵³ Ibid., sec. 1062.

¹⁵⁴ "Foreign Tax Fight."

¹⁵⁵ H.R. 2896, sec. 1061.

¹⁵⁶ Ibid., sec. 1063.

¹⁵⁷ Sullivan, Bartholomew. "Bill Offers Tax Relief, Trade Corrective – Legislation Is a Mix of Ideas." The Commercial Appeal (Memphis, TN). 17 June 2004. LexisNexis Academic. LexisNexis Databases. University of Tennessee Libraries, Knoxville, TN. <http://www.lib.utk.edu/databases>

¹⁵⁸ Bourge, Christian. "Analysis: Tax Bill Waiting for Final Blow?" United Press International. 22 March 2004. LexisNexis Academic. LexisNexis Databases. University of Tennessee Libraries, Knoxville, TN. <http://www.lib.utk.edu/databases>

Texas, Florida, Nevada, South Dakota, Tennessee, Washington and Wyoming.¹⁵⁹ In addition, a tobacco buyout was included in the Thomas bill. The tobacco buyout grants almost \$10 billion in federal payments over the subsequent five years for farmers who discontinue price-supported quotas.

Tax Avoidance Penalties

The Thomas bill includes many other tax reforms. For example, it eliminates many tax shelters and imposes strict penalties on those that still try to avoid specific tax provisions. Title III of the bill is entirely related to tax shelter removal and penalties. The bill also contains several measures related to expatriated entities and corporations. Title II of the bill is devoted to tax avoidance through earnings stripping and expatriation.

Of note are the new rules against corporate inversions, which have been highlighted in recent political debates. In a corporate inversion, a parent company is acquired by a subsidiary, almost always in another tax jurisdiction. As a result, the former subsidiary becomes the parent company. The purpose for a corporate inversion is almost always for tax benefits or, more accurately stated, for tax avoidance. Certain Congressional committees have held hearings specifically on this topic. As a result, the Thomas bill adds Section 7874 to the Internal Revenue Code. This new section requires companies that invert their structure to a former subsidiary to pay the full U.S. tax on the transfer of U.S. assets.¹⁶⁰ It also imposes a 15 percent excise tax on stock-based compensation granted to those that participated in the performance of the inversion.¹⁶¹

¹⁵⁹ Mollison, Andrew. "Jobs Bill Approved by House: Buyout Aid Added for Tobacco Farmers." The Atlanta Journal-Constitution. 18 June 2004. LexisNexis Academic. LexisNexis Databases. University of Tennessee Libraries, Knoxville, TN. <http://www.lib.utk.edu/databases>

¹⁶⁰ H.R. 2896, sec. 2002.

¹⁶¹ *Ibid.*, sec. 2003.

Other Revenue Raisers

To provide many of the international tax reforms and benefits previously discussed, the Thomas bill includes measures to raise offsetting revenue. Many of the tax avoidance and tax shelter measures will help raise revenue. Other measures are listed in Subtitle B of Title III of the bill. Examples include a minimum holding period for foreign tax credit on withholding taxes on income other than dividends,¹⁶² a disallowance of certain partnership loss transfers,¹⁶³ no reduction of basis under Section 734 in stock held by partnership in corporate partner,¹⁶⁴ and the repeal of special rules for FASITs.¹⁶⁵

Discussion of the Bill's Effectiveness:

The Thomas bill was the best option for international tax reform in the House. Beyond repeal of the extraterritorial income exclusion to bring U.S. tax law into compliance with the WTO, the Thomas bill will benefit American companies with its many other reforms.

Global operators support the bill. Coca-Cola, Hewlett-Packard, Procter & Gamble, EDS, Pepsico, major car manufacturers, the American Bankers Association, the American Insurance Association, and large financial institutions were vocal in their support for the Thomas bill.¹⁶⁶ Procter & Gamble spokesperson Doug Shelton gave P&G's reasoning for its support. P&G is "not a major exporter, and thus the elimination of FSC/ETI would not have a major financial impact on us." However, the Thomas bill

¹⁶² Ibid., sec. 3022.

¹⁶³ Ibid., sec. 3024.

¹⁶⁴ Ibid., sec. 3025.

¹⁶⁵ Ibid., sec. 3026.

¹⁶⁶ Savage.

“would make important progress toward eliminating double taxation of profits from our international business activities.”¹⁶⁷

The most significant tax change of the Thomas bill is the reduced top corporate tax rate (to 32 percent). Taxpayers in that income bracket will welcome the rate reduction. The Thomas bill also effectively eliminates many of the concerns of double taxation of corporate profits – primarily due to the foreign tax credit and interest allocation. International companies will welcome the Subpart F reform. The bill extends depreciation and research credits. Companies also will benefit from AMT reform. The Thomas bill responds to the business community’s concerns over several tax matters. It resolves them accordingly.

Opponents of the Thomas bill complain that it benefits multinational companies over domestic companies. Major domestic manufacturers, such as Boeing, Caterpillar, and Microsoft support the Crane-Rangel bill. They will still benefit from the Thomas bill. Yet, the Thomas bill benefits a larger sector of the U.S. economy than just domestic manufacturing. In a letter supporting the Thomas bill, Glenn Hubbard, former chairman of President Bush's Council of Economic Advisors, stated that the Thomas bill “will allow U.S. firms to expand both domestically and internationally and will increase U.S. employment.”¹⁶⁸

The passage of the Thomas bill signals some of the most sweeping international tax reforms in years. The bill is not perfect, but it offers many international tax reforms to American businesses. The lower tax rate for corporations will increase American

¹⁶⁷ Nyberg.

¹⁶⁸ Hubbard, Glenn, Kevin Hassett, et. al. “Help U.S. Companies Compete Globally with New Tax Code.” The Heartland Institute. 10 October 2003. Published in *Budget and Tax News* on 1 December 2003. <http://www.heartland.org/Article.cfm?artId=13770>

corporate competitiveness. The reforms to Subpart F, interest allocation, the alternative minimum tax, and the foreign tax credit system will all help alleviate double taxation on corporate profits. These measures will help reduce the economic discrepancy caused by the U.S. tax system and will increase American competitiveness.

THE JUMPSTART OUR BUSINESS STRENGTH (JOBS) ACT

Overview:

The Jumpstart Our Business Strength (JOBS) Act is the Senate's effort to repeal ETI and reform international tax. The bill's stated purpose is "to amend the Internal Revenue Code of 1986 to comply with the World Trade Organization rulings on the FSC/ETI benefit in a manner that preserves jobs and production activities in the United States, and for other purposes."¹⁶⁹ Senate Finance Committee members Charles Grassley (R-IO) and Max Baucus (D-MT) drafted the bill and pushed for its support. However, due to the legislative process, Senate Majority Leader Bill Frist (R-TN) is listed as the official bill sponsor.

The Senate bill is a revenue-neutral approach to the ETI issue. It follows Treasury requests that any new international tax bill be of little or no cost to the Treasury.

Proposals:

The JOBS Act is broad with many different facets. It has several sections devoted to international tax reform. The components most relative to the ETI dispute and increasing the competitiveness of American companies abroad will now be discussed.

¹⁶⁹ U.S. Senate. Jumpstart Our Business Strength Act. 108th Cong., 2nd sess., S. 1637.

ETI Repeal

The first section of the JOBS bill repeals the extraterritorial income exclusion.¹⁷⁰ The bill protects binding contracts that were in effect on September 17, 2003, allowing full ETI benefits to be claimed for these contracts until their termination. For all other qualified income, the Senate bill phases out the ETI regime over three years. The following table demonstrates the phase-out percentages.

	<u>2004</u> ¹⁷¹	<u>2005</u>	<u>2006</u>	<u>2007 and beyond</u>
Phase-out Percentage	80%	80%	60%	0%

Income Tax Rate Reduction for Manufacturers

The JOBS bill lowers the tax rate for manufacturers from 35 percent to 32 percent for qualified production activities income. “Such income is generally defined as the taxpayer’s gross receipts from items manufactured, produced, grown, or extracted by the taxpayer within the United States or its possessions, reduced by the sum of: (1) the cost of goods sold allocable to such gross receipts; (2) other deductions, expenses, or losses that are directly allocable to such receipts; and (3) a proper share of other deductions, expenses, or losses that are not directly allocable to such receipts.”¹⁷² The new deduction applies to C corporations, S corporations, partnerships, estate or trusts, other “pass-thru entities,” and individuals. The bill creates these new regulations by establishing new Section 199 in the Internal Revenue Code.¹⁷³ However, non-manufacturing corporations and income that is not considered qualified production income will not be affected by this

¹⁷⁰ S. 1637, sec. 101.

¹⁷¹ In 2004, the phase-out percentage pertains only to events after the Act’s enactment. The phase-out percentage is 100 percent for days before enactment and 80 percent for the days after enactment.

¹⁷² U.S. Senate Republican Policy Committee. Legislative Notice. “S. 1637 – Jumpstart Our Business Strength (JOBS) Act.” 1 March 2004. Calendar No. 381.

¹⁷³ S. 1637, sec. 102.

rate reduction and will be subject to the existing 35 percent maximum tax rate. The following table explains the phase-in schedule for the domestic production rate reduction.¹⁷⁴

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
Manufacturing Deduction Percentage	1%	2%	3%	6%	6%	9%	9%	9%	9%	9%
Manufacturing Tax Rate Reduction	0.35%	0.70%	1%	2%	2%	3%	3%	3%	3%	3%
Resulting Tax Rate ¹⁷⁵	34.65%	34.3%	34%	33%	33%	32%	32%	32%	32%	32%

The new deduction is limited by a factor ratio of domestic manufacturing income to worldwide manufacturing income, which effectively reduces the deduction for multinational companies and foreign corporations manufacturing in the United States. This limitation will be phased out by 2013.¹⁷⁶ The following table displays the phase-out of the limitation:

	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
Phase-out of Limited Deduction Amount	25%	50%	75%	100%

International Tax Provisions - Foreign Tax Credit Reform

The JOBS bill exerts a considerable amount of effort in improving the foreign tax credit system. The goal of these efforts is to reduce or eliminate the double taxation of certain foreign-earned corporate income. Multinational companies will benefit from these measures. Highlights from the reforms include the following:

¹⁷⁴ Legislative Notice.

¹⁷⁵ "Figures assume income subject to the maximum 35% corporate tax rate."

¹⁷⁶ S. 1637, sec. 102.

- The JOBS bill extends the foreign-tax credit carryforward period from 5 years to 20 years. It also reduces the carryback period from two years to one year.¹⁷⁷
- The bill repeals the 90 percent limitation on foreign tax credits in the computation of the alternative minimum tax.¹⁷⁸
- The bill applies “look-thru” rules to dividends from noncontrolled Section 902 corporations, often referred to as 10/50 companies.¹⁷⁹
- The Senate bill recharacterizes an overall domestic loss so that there is a separation between foreign-earned income and domestic income. This provision ends the current situation in which domestic losses limit the foreign tax credits.¹⁸⁰
- The bill reforms interest expense allocation rules so that a company can elect to allocate interest on a worldwide basis. As a result, interest expenses of the domestic members can be allocated to other members of the multinational group. Foreign assets are also taken into consideration. Consequently, the foreign tax credit of the overall group potentially increases.¹⁸¹
- For income that is not taxed under U.S. law but is taxed under a foreign tax regime, a company may elect to claim this foreign tax for foreign tax credit purposes.¹⁸²

¹⁷⁷ Ibid., sec. 201.

¹⁷⁸ Ibid., sec. 203.

¹⁷⁹ Ibid., sec. 202.

¹⁸⁰ Ibid., sec. 204.

¹⁸¹ Ibid., sec. 205.

¹⁸² Ibid., sec. 225.

International Tax Provisions – Subpart F Reform

The JOBS bill also significantly revises the Subpart F anti-deferral regime. This area of the international tax regime is one that most needs reform. The following list summarizes the chief points of interest in the bill regarding Subpart F.

- The bill repeals the foreign personal holding company rules and foreign investment company rules.¹⁸³ It creates a new category of Subpart F income for personal services income.
- The bill increases the \$1 million de minimis rule of Subpart F to \$5 million.¹⁸⁴
- Active aircraft and vessel leasing income will not be considered Subpart F income.¹⁸⁵ This provision will be of use specifically to Boeing, who was the largest ETI beneficiary.
- For payments between related controlled foreign corporations, the bill creates “look-thru” treatment under foreign personal holding company income rules. As a result, these dividends, interest, rents and royalties will not be treated as foreign personal holding company income.¹⁸⁶
- The bill grants “look-thru” treatment under Subpart F to sales of partnership interests.¹⁸⁷
- The bill include modifies exceptions under subpart F for active financing.¹⁸⁸

¹⁸³ Ibid., sec. 211.

¹⁸⁴ Ibid., sec. 212.

¹⁸⁵ Ibid., sec. 221.

¹⁸⁶ Ibid., sec. 222.

¹⁸⁷ Ibid., sec. 223.

¹⁸⁸ Ibid., sec. 226.

Additional International Tax Provisions

- The bill defines how partnership stock ownership is to be allocated for Section 902 and Section 960 credits. Stock ownership is considered to be owned proportionately by its partners and will flow through the tax structure to the partners for indirect foreign tax claims.¹⁸⁹
- The uniform capitalization rules (UNICAP) will not apply to taxpayers that are not U.S. “persons” and that capitalize inventory for financial reporting purposes.¹⁹⁰
- The bill repeals withholding tax on dividends from certain foreign corporations.¹⁹¹
- A company may elect to use a spot exchange rate instead of the average exchange rate for foreign tax paid in a foreign currency.¹⁹²
- The bill provides equal treatment for interest paid by foreign partnerships and foreign corporations.¹⁹³

Foreign Repatriation

The JOBS bill proposes a temporary rate deduction for income repatriated back to the United States. A parent corporation may elect to repatriate income from CFCs in excess of their qualified foreign distribution amount. This excess income will be taxed at a 5.25 percent rate.¹⁹⁴

¹⁸⁹ Ibid., sec. 213.

¹⁹⁰ Ibid., sec. 214.

¹⁹¹ Ibid., sec. 215.

¹⁹² Ibid., sec. 224.

¹⁹³ Ibid., sec. 228.

¹⁹⁴ Ibid., sec. 231.

Domestic Manufacturing and Business Provisions

JOBS includes several complementary provisions for American manufacturers beyond the income tax rate reduction and includes industry-specific benefits for timber and film-production. Title III of the JOBS bill also includes a few frivolous sections, such as the modification of the taxation of imported archery products. The following list highlights the general business provision that will have the most widespread benefit on American competitiveness.

- The bill expands the small business expensing limitation on Section 179 expensing. The phase-out threshold currently is \$400,000 of purchases (adjusted for inflation) for Section 179 expenses beyond which a deduction is not allowed for any amount over this threshold. The JOBS bill proposes to allow a 50 percent expensing deduction for purchases over the \$400,000 threshold.¹⁹⁵
- For net operating losses incurred in 2003, the bill lengthens carryback rules from the current two year carryback period to a three year carryback period. Furthermore, the bill repeals the limitation on NOLs in the computation of the alternative minimum tax.¹⁹⁶
- The bill expands the qualified small-issue bond program.¹⁹⁷ As a result, the total capital expenditure limitation increases from \$10 million to \$20 million.¹⁹⁸
- The bill allows expensing of broadband equipment.¹⁹⁹ However, some expenses, including the launching of new satellites, still must be capitalized.²⁰⁰

¹⁹⁵ Ibid., sec. 310.

¹⁹⁶ Ibid., sec. 311.

¹⁹⁷ Ibid., sec. 301.

¹⁹⁸ Legislative Notice.

¹⁹⁹ S. 1637, sec. 302.

²⁰⁰ S. 1637, sec. 302.

- The bill extends the research tax credit for one and a half years, from June 30, 2004 to December 31, 2005.²⁰¹ The scope of the credit is expanded to include more taxpayers.²⁰² Moreover, the bill increases the alternative incremental credit and offers an “alternative simplified credit.” This alternative credit is equal to 12 percent of the amount greater than 50 percent of average qualified research expenses (QRE) for three out of the last five years – excluding the two years in which the QRE is the largest and the smallest.²⁰³
- The bill creates a manufacturer’s jobs credit to help manufacturers increase employment. A 50 percent credit for the increase in W-2 wages paid in the taxable year over the previous year is one of the options included under the credit.²⁰⁴

Tax Shelters and Corporate Governance

The JOBS bill removes many current tax shelters. Much of the revenue from the credits and deductions listed above are financed by the removal of these tax shelters. Key elements in this section are presented in the following.

- The bill codifies the economic substance doctrine, which states that “a transaction has economic substance only if it changes in a meaningful way (apart from federal tax effects) the taxpayer’s economic position, the taxpayer has a substantial nontax purpose for entering into such transaction, and the transaction is a reasonable means of accomplishing such purpose.”²⁰⁵

²⁰¹ Ibid., sec. 311.

²⁰² Ibid., sec. 312.

²⁰³ Ibid., sec. 311.

²⁰⁴ Ibid., sec. 313.

²⁰⁵ Ibid., sec. 401.

- The bill increases penalties concerning listed and reportable transactions, declarations of such, and financial reporting.²⁰⁶
- The bill creates regulations for those that practice before the Department of the Treasury²⁰⁷ and modifies penalties for those who promote tax shelters.²⁰⁸ Also, the maximum criminal fraud penalty for individuals is increased to the amount of the tax at issue.²⁰⁹
- The Chief Executive Officer must now sign a corporation's tax return.²¹⁰
- Certain fines, penalties, settlements,²¹¹ and punitive damages may not be deducted from taxes.²¹²

Enron-Related Tax Shelter Provisions

The Enron scandal has caused many corporate reforms. The JOBS bill continues some of the corporate reforms as more is learned about the Enron debacle. The bill limits the transfer and importation of built-in losses.²¹³ It prohibits a reduction of basis of stock held by a member of the partnership.²¹⁴ Special rules for FASITs are repealed.²¹⁵ The disallowance of a deduction on the interest on convertible debt is expanded.²¹⁶ JOBS grants more authority to the Secretary of the Treasury to disallow tax benefits created by gaining control of a corporation for tax evasion or avoidance purposes.²¹⁷

²⁰⁶ Ibid., sec. 402-413.

²⁰⁷ Ibid., sec. 414.

²⁰⁸ Ibid., sec. 415.

²⁰⁹ Ibid., sec. 425.

²¹⁰ Ibid., sec. 422.

²¹¹ Ibid., sec. 423.

²¹² Ibid., sec. 424.

²¹³ Ibid., sec. 431.

²¹⁴ Ibid., sec. 432.

²¹⁵ Ibid., sec. 433.

²¹⁶ Ibid., sec. 434.

²¹⁷ Ibid., sec. 435.

Provisions against Corporate Inversions

As stated earlier, the regulation of corporate inversions is one of Congress's short-term goals. The JOBS bill sets forth several new guidelines for the treatment of these inversions. For example, an inverted corporation will be treated as a domestic corporation.²¹⁸ Furthermore, all property will be marked-to-market for individuals who expatriate. Any gain on the inversion will be determined by the fair market value of assets.²¹⁹ In addition, any stock compensation granted to an individual considered an "insider" in a corporate inversion will be subject to a 20 percent excise tax.

International Tax Clarifications

The JOBS bill incorporates several other international tax clarifications. Included in this section are a clarification of banking business for purposes of determining investment of earnings in U.S. property,²²⁰ an explanation that effectively connected income will include certain foreign source income,²²¹ and the method of recapture of overall foreign losses on the sale of controlled foreign corporation stock.²²²

Additional Provisions and Revenue Raising Proposals

JOBS includes several other attached acts that are not entirely related to the ETI issue. Such measures include the "Protection of United States Workers from Competition of Foreign Workforces," "Other Provisions," "Extension of Certain Expiring Provisions," "Energy Tax Incentives," "Homestead Preservation Act," and "Office of Federal Procurement Policy Act Improvements."

²¹⁸ Ibid., sec. 441.

²¹⁹ Ibid., sec. 442.

²²⁰ Ibid., sec. 451.

²²¹ Ibid., sec. 454.

²²² Ibid., sec. 455.

Other than the removal of a multitude of tax shelters, the Senate bill contains several other revenue raising proposals. Sections 461 through 497 of the bill discuss these revenue raisers. Examples of the provisions include the application of earnings-stripping rules to partnerships and S corporations,²²³ the modification of straddle rules,²²⁴ a clarification of the definition of nonqualified preferred stock,²²⁵ an expansion of the limitation on expensing of sport utility vehicles,²²⁶ an extension of IRS user fees from December 31, 2004 to September 30, 2013,²²⁷ and a limitation on the deduction for charitable contributions of patents and similar property.²²⁸

Other interesting aspects of the bill are a reformed Whistleblower Office that awards those that inform the IRS of corporate fraud with 15 to 30 percent of the collected proceeds,²²⁹ protection of overtime pay,²³⁰ and an increase in the minimum age from 14 to 18 of minor children whose unearned income is taxed as if the parent's income.²³¹

Discussion of the Bill's Effectiveness:

The JOBS bill is a strong effort to reform the international tax structure. It accomplishes its main goal in repealing ETI. However, it does not abandon former ETI beneficiaries. The DISC, FSC, and ETI regimes were attempts to neutralize the economic discrepancy with competing tax systems. This bill forsakes the export subsidy method of resolving the economic discrepancy and institutes several broader, more effective

²²³ Ibid., sec. 462.

²²⁴ Ibid., sec. 464.

²²⁵ Ibid., sec. 467.

²²⁶ Ibid., sec. 473.

²²⁷ Ibid., sec. 482.

²²⁸ Ibid., sec. 495.

²²⁹ Ibid., sec. 488.

²³⁰ Ibid., sec. 489, 490.

²³¹ Ibid., sec. 495.

reforms. These reforms are a more effective approach to diminishing the competitive hindrances of the U.S. tax structure.

Businesses should expect many new benefits from the JOBS bill. Importantly, the tax rate for domestic production activities is reduced. Furthermore, the JOBS bill successfully reforms both the foreign tax credit system and Subpart F income. Much of the double taxation on foreign income should be eliminated with the foreign tax credit reforms. Within the foreign tax credit system, the interest allocation rules are rectified. Subpart F is simplified and applies to fewer forms of income. These four areas alone should have a great impact on companies that export or have foreign income.

Some doubted whether the JOBS bill would make it to a vote in the Senate. Over 300 amendments were drafted for this bill.²³² Also, some worried that debate on the bill would not be limited and that it would never come to a vote. Election-year agendas and politics caused the bill to be pulled from the floor when it was first presented.²³³ However, the Senate was able to overcome the political maneuvering and pass a very important bill for American businesses.

AUTHOR'S VIEWPOINT ON THE ECONOMIC DISCREPANCY

The United States has tried three different tax regimes to resolve the economic discrepancy caused by the different treatment of worldwide and territorial tax regimes. In my opinion, the United States must reform and simplify its international tax system and,

²³² "Daily Tax Update: Multitude of Non-Germane Amendments Bog Down Senate FSC/ETI Act Repeal Bill." Stephoe & Johnson. 29 March 2004. LexisNexis Academic. LexisNexis Databases. University of Tennessee, Knoxville, TN. <http://www.lib.utk.edu/databases>

²³³ Bourge.

presently, is in a rare position to do so. ETI replacement legislation is a rare opportunity to enhance the new global economy. The following details some of my views concerning aspects of international tax reform and reconciling the economic discrepancy.

A Global American Economy – Tax Treatment of Foreign Income

As stated by the Deputy Secretary of the Treasury Kenneth Dam, “Our economy is truly global.”²³⁴ This is the basic premise of the ETI issue. No one will dispute that globalization and information technology rapidly changed how business is conducted. The United States has embraced and benefited from globalization and will continue to become more dependent on the international economy. Any measure brought by Congress to replace ETI must recognize this global economy. Both U.S.-based multinational companies and domestic companies should benefit from replacement legislation. The importance of multinational companies to the economy and as employers has already been presented. In my opinion, any proposed legislation must confer benefits to all U.S.-based companies.

The value of goods imported to and exported from the United States grew more than three times the rate of the gross domestic product (GDP) growth between 1960 and 2000, rising to more than 20 percent of GDP. The following table represents both the trend of globalization, as seen in the growth in cross-border investment, and increased competition, evidenced by the relative percentage decline of cross-border investment.

Cross-Border Investment As a Percentage of GDP²³⁵			Cross-Border Investment Held by U.S. MNCs²³⁶	
	<u>1960</u>	<u>2000</u>		<u>1967</u> <u>1996</u>
Percent of GDP	1.10%	15.90%	Percent Held by U.S. MNCs	50% 25%

²³⁴ Dam.

²³⁵ Ibid.

²³⁶ Merrill

In the past, U.S. companies enjoyed success from selling products at home and exporting them abroad. Today's global marketplace has changed. Presently, the 21,000 foreign affiliates of U.S. multinationals compete with about 260,000 foreign affiliates of foreign multinationals.²³⁷ The United States is no longer the world's dominant exporter. Nevertheless, the greatest potential for growth of U.S. businesses lies beyond U.S. borders. According to Peter Merrill, Principal and Director of the National Economic Consulting Group of PricewaterhouseCoopers and a Consultant to the International Tax Policy Forum, "Today, almost 80 percent of world income and purchasing power lies outside of U.S. borders. Opportunities for U.S. companies to grow their businesses increasingly lie overseas. From 1986 to 1997, foreign sales of S&P 500 companies grew 10 percent a year, compared to domestic sales growth of just 3 percent annually."²³⁸ Globalization requires that U.S. companies be competitive both in foreign markets and at home.²³⁹ The U.S. tax structure must be adjusted accordingly.

Corporate Sensitivity to Taxes

The decision-making and competitiveness of U.S. corporations are affected by taxes. Tax savings are essential to corporations as they strive to be profitable and efficient. Because our economy is global, American companies must now compete against international companies for profits. The U.S. tax structure restricts U.S. companies when compared to the tax structure of their competitors' host nations.

In addition, this competitive disadvantage has effects beyond the profitability of the exporting firm. A multinational company naturally will invest more in the countries in which it receives the highest returns. For a U.S.-based manufacturer and exporter, it may

²³⁷ Ibid.

²³⁸ Ibid.

²³⁹ Dam.

be more profitable to move operations outside the United States if the United States tax structure impairs its profitability. When this movement occurs, the United States loses valuable jobs and tax revenue. Moreover, a wake effect to the rest of the economy occurs as other businesses that used to supply the firm or service the employees of the firm suffer losses.

Furthermore, using data collected from more than 500 multinational tax returns, Grubert and Mutti found that “average effective tax rates have a significant effect on the choice of locations and the amount of capital invested there. A lower tax rate that increases the after-tax return to capital by one percent is associated with about 3 percent more real capital invested if the country has an open trade regime.” Acknowledging their findings, Grubert and Mutti predicted that “19 percent of U.S. capital abroad would be in a different location in the absence of any effect of taxes.”²⁴⁰

Gordon and Hines condensed the research on MNCs and international taxation. They found that “the reported profitability of multinational firms is inversely related to local tax rates, a relationship that is at least partly the consequence of tax-motivated use of debt financing, the pricing of intrafirm transfers, royalty payments, and other methods.”²⁴¹

In short, businesses are sensitive to taxes. If international tax laws are not reformed, companies incorporated in the United States will continue to suffer.

²⁴⁰ Grubert, Harry and John Mutti. “Do Taxes Influence Where U.S. Corporations Invest?” National Tax Journal. vol LIII, no. 4, part 1. December, 2000: 825-839.

²⁴¹ Gordon, Roger and James Hines, Jr. “International Taxation.” NBER Working Paper Series. Working Paper 8854. April 2002. National Bureau of Economic Research: Cambridge.
<http://www.nber.org/papers/w8854>

Troubling Effects of the Current System

The United States is experiencing the adverse effects of an out-dated tax code. One of these reactions is corporate inversions. While Congress is attempting to limit corporate inversions, they must also fix the stimulus for such action – the international tax laws. Another troubling reaction is the migration of multinational companies out of the United States. Of the world's 20 largest corporations, the number headquartered in the United States has declined from 18 in 1960 to just eight in 1996.²⁴² Part of this trend is due to increased international competition. Nonetheless, more new ventures may be incorporated offshore to avoid the U.S. penalties on foreign-source income. If a U.S. company merges with a foreign company, a choice must be made as to where the new entity will be headquartered. The alarming trend is that the mergers are structured as foreign acquisitions of U.S. companies. According to Merrill, “Measured by deal value, over the 1998-2000 period, between 73 and 86 percent of large cross-border transactions involving U.S. companies have been structured so that the merged company is headquartered abroad.”²⁴³ Occasionally merging outside of the United States has a legitimate business cause. However, the U.S. tax code may be the underlying cause for many of the mergers to be headquartered outside of U.S. borders. Specifically, Merrill cited the Daimler-Chrysler testimony before the Senate Finance Committee in which taxes were explicitly stated as a reason the merger was located abroad.²⁴⁴

Merrill stated his concerns, “While some have suggested that reducing the U.S. tax burden on foreign source income could lead to a movement of manufacturing

²⁴² Merrill.

²⁴³ Ibid.. Merrill also cited recent examples of AEGON-Transamerica, BP-Amoco, Daimler-Chrysler, Deutsche Bank-Bankers Trust, and Vodafone-AirTouch.

²⁴⁴ Cited in Merrill. *See* Loffredo, John L. “Testimony before the Senate Finance Committee” (11 March 1999) regarding the Daimler-Chrysler transaction.

operations out of the United States (“runaway plants”), an alternative scenario is that a noncompetitive U.S. tax system will lead to a migration of multinational headquarters outside the United States.”²⁴⁵ The American jobs and domestic investments provided by MNCs have been well documented. Losing MNCs is a legitimate concern for the U.S. economy.

MY SPECIFIC RECOMMENDATIONS

Simplification

Not only are U.S. tax laws anti-competitive, they are complicated. Compliance to the tax laws is complex and expensive. Based upon a survey that returned 1,329 responses by what are considered IRS-audit “large firms,” Slemrod and Blumenthal observed the following concerning the compliance costs related to U.S. international tax laws.

	International Tax Compliance Costs As Percentage of Overall Tax Compliance Costs	Non-U.S. Component of:		
		Assets	Sales	Employment
General	39.2%	21.1%	24.1%	24.1%
Fortune 500	43.7%	27.8%	30.1%	26.2%

Slemrod and Blumenthal agreed that the compliance costs related to U.S. international tax laws are “disproportionately high relative to the companies’ foreign activities.”²⁴⁶

Cleary, U.S. tax rules for international taxation are complex. For example, Dow Chemical’s 2001 tax return totaled 7,800 pages – 6,100 of which concerned international

²⁴⁵ Ibid.

²⁴⁶ Slemrod, Joel and Marsha Blumenthal. “The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications.” The Taxation of Multinational Corporations. ed. Joel Slemrod. Reprinted from International Tax and Public Finance, May 1995. Kluwer: Boston, 1996. p. 33-49.

issues.²⁴⁷ In reforming its international tax structure, the United States must establish simplification as one of its guiding principles. This is a broad guiding principle that will be evidenced in reduced record-keeping burdens. Reducing the number of income baskets, expansion of the de minimis rules for Subpart F and AMT, and reformation of the interest allocation rules are examples of simplifications to the tax code that will reduce record-keeping burdens and benefit U.S. companies.

Reduction of Corporate Income Tax Rate

If the greatest potential for U.S. economic growth is in foreign markets, our tax structure should mirror this reality. Unfortunately, it does not. For example, according to a study published by the European Commission in 2001, when U.S.-based MNCs invest into the EU, they are subject to a higher effective tax rate of 3 to 5 percentage points than the effective tax rate to which EU MNCs are subject.²⁴⁸

Effective Average Tax Rate for Investment into EU

Investment for MNC based in:	Financing of foreign subsidiary			
	Retained earnings	New Equity	Debt	Average
EU	30.1%	30.4%	30.2%	30.2%
US	33.2%	35.7%	34.7%	34.5%

Furthermore, the U.S. corporate tax rate is one of the highest in the developed world. As a result of the Tax Reform Act of 1986, the United States lowered its corporate tax rate from 46 percent to 34 percent. At that time, the United States was thought to be a low-tax jurisdiction for corporations. Today, the top corporate tax rate is 35 percent. Thus, the United States is no longer a low-tax jurisdiction compared to its international competitors. As of 2001, the average central government corporate tax rate in

²⁴⁷

²⁴⁸ Table cited from Merrill. Information cited in Merrill. Commission of the European Communities, "Towards and Internal Market without Obstacles," Com(2001)582, Brussels, October 23, 2001.

Organization for Economic Cooperation and Development (OECD) member states had decreased to 30.5 percent.²⁴⁹ The following table, adapted from research cited by Merrill, displays how the U.S. rate is 4.5 percentage points higher than the average.²⁵⁰

Central Government Corporate Income Tax Rates, 1986-2001				
Country	1986	1991	1995	2001
United States	46.0%	34.0%	35.0%	35.0%
<i>Unweighted Averages</i> ²⁵¹				
EU	42.8%	35.9%	34.4%	31.8%
OECD	41.4%	35.0%	32.0%	30.5%

It is my opinion that the U.S. corporate tax rate must be lowered in order to keep American companies competitive abroad.

Research and Development Credits

The key to growth in the American economy is no longer the production of tangible goods. Rather, the key to growth is research and development and the expansion of the American knowledge base. In the past, America's abundant natural resources drove its economic expansion. In contrast, according to Deputy Secretary Dam, "Today, America's strength is its ability to innovate: to create new technologies and to react faster and smarter to the commercialization of these technologies."

In 1999, non-financial U.S. multinational companies (MNCs) carried out more than two thirds of all the research and development expenditures executed within the

²⁴⁹ Merrill further stated that the disparity between the U.S. and OECD rates would be even greater "if corporate income taxes imposed by subnational levels of government" (i.e. state and local taxes) were taken into account.

²⁵⁰ Table adapted from Merrill. Information cited by Merrill. Jeffrey Owens, *Tax Reform for the 21st Century*, Tax Notes International. 2001 data from American Council for Capital Formation, "The Role of Federal Tax Policy and Regulatory Reform in Promoting Economic Recovery and Long-Term Growth," November 28, 2001.

²⁵¹ Midpoint tax rate used for countries with multiple rates.

United States.²⁵² MNCs recognize the value of developing competencies in the United States and then exporting that knowledge abroad. For the United States to forge ahead as the global economic leader, it should create more incentives for research and development. It is my opinion that the United States should create more permanent and extensive research and development tax credits.

Subpart F Reform

The original intent of lawmakers when enacting Subpart F in 1962 was to limit deferral of income from certain business activities. Subpart F also target transfer pricing abuses.²⁵³ However, the due to an increased ability to contest transfer pricing abuses and more published guidance by the IRS, the profits of a U.S.-based MNC and its subsidiaries are more likely to be appropriately apportioned amongst the group.²⁵⁴ As a result, Subpart F is no longer as relevant as it once was. In fact, it is quite onerous. The reasons for this irrelevance were explained in earlier sections.

Subpart F must be reformed. The de minimis rule should be increased in order to reduce record-keeping burdens on smaller firms. Both the Thomas and Senate bills propose well-designed reforms to alleviate many companies from Subpart F. Certain forms of income that were included as passive income under Subpart F are now free from Subpart F. The best benefit for companies is that this income will not be taxed by the United States in the year it is earned. Rather, it will be taxed in the year it is repatriated to the U.S. parent. This deferral will aid the competitiveness of CFCs of a U.S.-based MNC and will ultimately aid the United States.

²⁵² Dam.

²⁵³ "Simplifying U.S. Taxation of Foreign Activities Through Subpart F Reform." Silicon Valley Tax Directors Group. http://www.svtdg.org/t_simp_tax.html

²⁵⁴ Ibid.

Foreign Tax Credit

Both the Thomas and JOBS bills sufficiently reform the foreign tax credit system. In my opinion, removing the reduction of credits due to a domestic loss, extending the carryforward period, reducing the number of income baskets, and applying look-through rules to partnerships were the most essential reforms. The reduction of income baskets will simplify the foreign tax credit and will reduce record-keeping costs. Applying look-through rules to partnerships will allow individuals to claim an indirect foreign tax credit. Reforming the treatment of a domestic loss to where it allows the full utilization of the foreign tax credit is logical. Domestic and foreign income should be treated separately and should not limit the other. The proposals set forth by both the Thomas and JOBS bill adequately reform this area of international tax.

Interest Allocation

This dissertation previously discussed the interest allocation rules. In my opinion, they should be reformed so that interest from the U.S. parent is properly allocated to subsidiaries based on the level in which the U.S. interest supported foreign activities. The current rules ignore the fact that a U.S. subsidiary may be completely externally financed on its own. Both the Thomas and JOBS bills offer improved systems for interest allocation. Neither of the proposals is perfect, but they are drastic improvements on the current system. The allocation of interest on a worldwide basis or an asset basis will not reduce the foreign tax credit in the manner that the current system reduces it.

Alternative Minimum Tax Reform

The alternative minimum tax is a great concern for many companies. I advocate its complete removal but understand that some arguments justify its existence. If it must

remain in effect, the 90 percent limitation on the foreign tax credit and the 90 percent limit on net operating losses must be removed. The limit on depreciation expense should be reduced. Furthermore, the minimum threshold for AMT consideration should be increased considerably. The AMT threshold has not been properly indexed for inflation. As a result, individuals and small businesses are increasingly punished by the AMT.

Double Taxation of Corporate Dividends

Another highly debated tax reform is the double taxation of corporate dividends. Currently, corporate income is taxed before the distribution of dividends. Then, shareholders are taxed on their investment income. International investors do not necessarily face this same penalty. Only three of the 30 OECD member states do not provide relief from the double taxation of corporate dividends. The United States is one of those countries.²⁵⁵ This double tax increases the minimum rate of return on a potential investment, which affects foreign investment and American competitiveness.²⁵⁶ The United States should institute an exclusion on an individual level for corporate dividends.

Repatriation

The repatriation of income is a popular economic theme in politics. Though both the Thomas and JOBS bills propose a period of repatriation at a reduced tax rate, I disagree. I understand its purposes as a short-term revenue raiser and to entice income back to the United States that may otherwise never be repatriated. However, I believe it calls into question the fundamental issue of fairness. This reduced tax rate on repatriation punishes companies that have been repatriating income all along. The current proposals do not offer any credit for following the letter of the law. Yet, the bills propose to now

²⁵⁵ Merrill.

²⁵⁶ Dam.

reward those that have withheld repatriations. Accordingly, I disagree with a repatriation measure.

Fight Direct vs. Indirect Tax Classification

As a last recommendation, I believe the United States should return to the origin of the entire ETI dispute. The classification of direct and indirect taxes is flawed. Taxation has changed significantly since the 1800's, when a clear distinction existed between direct and indirect taxes. In fact, most tax systems cannot clearly be defined as a direct or indirect tax. This blurry area is what has made the current ETI dispute particularly onerous to the United States. I believe the United States should challenge the very distinction of a tax as a direct or indirect tax.

Furthermore, the classification of a VAT as an indirect tax by GATT is what has caused the economic discrepancy between tax systems. Hufbauer observed that "VAT actually is a combination of three direct taxes: a tax on wages, a tax on interest and rent, and a tax on corporate profits."²⁵⁷ I believe the United States should challenge the VAT consideration as an indirect tax as well.

A compelling argument must be made by the United States to achieve change. All nations that have benefited from the classification of VAT as an indirect tax will fight against losing its benefits. Nevertheless, the United States should focus on the issue, particularly in the upcoming WTO Doha economic negotiations. A ruling from an international body will be required to make any changes to the judgment of taxes as direct or indirect. The United States will face a tough road as changes will have to overturn precedents set in previous conflicts. Furthermore, a backlash should be expected from other nations, and it could cause more WTO complaints against the United States.

²⁵⁷ Hufbauer.

However, I believe the United States must make the economic discrepancy an international issue. Inasmuch as I believe in the sovereignty of nations and their right to formulate their own tax system, I believe the current distinction between indirect taxes and direct taxes is inherently incorrect.

CONCLUSION

In conclusion, the United States is in the process of repealing the extraterritorial income exclusion. The House passed the Thomas bill and the Senate passed the JOBS bill in response to the issue. Both bills offer significant international tax reforms. The business community should welcome these changes. The next step in the legislative process is the reconciliation of the two bills in a Joint Committee. Then, they can be enacted as law. Neither of these two bills is perfect. However, both are seizing the opportunity to reform the U.S. international tax structure. Instead of dealing with the economic discrepancy with another export subsidy, the United States will reform its international tax laws to increase competitiveness in terms of tax systems. I expect the benefits of the approved reforms to extend much further than the boundaries of the extraterritorial income exclusion. The international tax reforms included in the Thomas bill and the JOBS bill will reduce the economic discrepancy and will promote American competitiveness.

