[JOINT COMMITTEE PRINT]

IMPACT ON INTERNATIONAL COMPETITIVENESS OF REPLACING THE FEDERAL INCOME TAX

SCHEDULED FOR A HEARING

BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON JULY 18, 1996

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

JULY 17, 1996

U.S. GOVERNMENT PRINTING OFFICE

25-773 WASHINGTON : 1996 JCS-5-96

For sale by the U.S. Government Printing Office
Superintendent of Documents, Mail Stop: SSOP, Washington, DC 20402-9328
ISBN 0-16-052893-3

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104TH CONGRESS, 2D SESSION

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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on July 18, 1996, on issues relating to the impact on international competitiveness of replacing the Federal income tax. The hearing will focus on the effects of the following possible proposed replacement tax systems: (1) a national retail sales tax, (2) a value-added tax, (3) a consumption-based flat tax, (4) a cash flow tax, and (5) a "pure" income tax. Some of these proposals have been the subject of introduced legislation. On March 6, 1996, Messrs. Schaefer, Tauzin, Chrysler, Bono, Hefley, Linder, and Stump introduced H.R. 3039, the "National Retail Sales Tax Act of 1996." On May 26, 1994, Senators Boren and Danforth introduced S. 2160 (103rd Cong.), the "Business Transfer Tax," which is a subtraction-method, value-added tax. On July 19, 1995, Mr. Armey and Senator Shelby introduced H.R. 2060 and S. 1050, respectively. These bills provide for consumption-based flat taxes. On April 25, 1995, Senators Nunn and Domenici introduced S.722, the "USA Tax Act of 1995," which contains two consumption-based taxes—a cash flow tax on individuals and a subtraction-method, value-added tax on businesses. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes several aspects of present law and the various tax restructuring proposals with respect to U.S. persons doing business abroad and foreign persons doing business in the United States.

Part I of this pamphlet is an overview of the discussions contained in the remainder of the pamphlet. Part II provides a description of certain present-law income tax provisions that apply to U.S. persons doing business abroad and foreign persons doing business in the United States. Part III contains background and data relating to the taxation of international transactions. Part IV contains summary descriptions of the various proposed replacement tax systems. Part V is a discussion of particular issues related to the proposed replacement tax systems and the taxation of international transactions. The Appendix presents data used in Figures 1 through 7.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Impact on International Competitiveness of Replacing the Federal Income Tax* (JCS-5-96), July 17, 1996.

I. OVERVIEW

Under the present-law Federal income tax system, U.S. persons are subject to U.S. income tax on all income, whether derived in the United States or abroad. However, the United States generally allows a credit against the U.S. tax imposed on income derived from foreign sources for the foreign income tax imposed on such income. Foreign persons are subject to U.S. tax only on income that has a sufficient connection to the United States.

Within this basic framework, there are a variety of rules that affect the U.S. taxation of international transactions. Detailed rules govern the determination of the source of income and the allocation and apportionment of expenses between foreign-source and U.S. source income; such rules are relevant not only for purposes of determining the U.S. taxation of foreign persons (because foreign persons are subject to U.S. tax only on income that is from U.S. sources or otherwise has sufficient U.S. nexus), but also for purposes of determining the U.S. taxation of U.S. persons (because the U.S. tax on a U.S. person's foreign source income may be reduced or eliminated by foreign tax credits). Authority is provided for the reallocation of items of income and deduction between related persons in order to ensure the clear reflection of the income of each person and to prevent the evasion of tax; these rules are particularly important in the context of transactions between a U.S. person and a related foreign person, where manipulation of the terms of such transactions would permit the artificial shifting of income from the higher-tax jurisdiction to the lower-tax jurisdiction. Although U.S. tax generally is not imposed on a foreign corporation that operates abroad, several anti-deferral regimes apply to impose current U.S. tax on income from foreign operations of a U.S.-owned foreign corporation.

An international transaction potentially gives rise to tax consequences in two (or more) countries. The tax treatment in each country generally is determined under the tax laws of such country. However, an income tax treaty between the two countries may operate to coordinate the two tax regimes and minimize the double taxation of the transaction. In this regard, the United States' network of bilateral income tax treaties includes provisions affecting both U.S. and foreign taxation of both U.S. persons with foreign income and foreign persons with U.S. income.

This pamphlet describes five alternatives to replace the current income tax system. These are (1) a national retail sales tax, (2) a value-added tax, (3) a consumption-based flat tax, (4) a cash flow tax, and (5) a "pure" income tax. Other than the "pure" income tax, these alternative tax systems generally are consumption-based, rather than income-based, taxes. The major difference between a consumption-based tax and an income-based tax relates to the treatment of savings. Under an income-based tax, returns on savings (e.g., dividends, interest, and capital gains) generally are subject to tax; under a consumption-based tax, these returns generally are excluded from the tax base. This exclusion may be provided by taxing consumption directly, excluding investment income from the base, or providing a deduction for increased savings. The current

Federal "income" tax contains some features that are consumption-based (e.g., the treatment of qualified retirement plans).

The various alternatives to replace the current income tax system will have different effects upon international transactions. For example, many analysts believe that increased U.S. saving generated under a consumption-based tax would reduce the demand for imported goods and redress the current imbalance of imports over exports. The adoption of a consumption-based tax should increase U.S. investment by U.S. persons and may increase U.S. investment by foreign persons. The adoption of a pure income tax also should increase U.S. investment by U.S. persons. While the adoption of a replacement tax system would eliminate some of the complexities created by the current income tax provisions affecting international transactions, it is likely that new complexities would arise under any new system. One such difficult issue is the treatment of cross-border transactions involving the provision of services. An evaluation of the effect of a replacement of the U.S. tax system on cross-border transactions also must consider the impact of foreign tax laws. In this regard, the U.S. network of bilateral tax treaties, which treaties operate to coordinate the U.S. tax laws and those of the treaty partner with respect to transactions within the taxing jurisdiction of both countries, would be affected by a fundamental change in the U.S. tax system.

II. PRESENT LAW

A. U.S. Taxation of U.S. Persons with Foreign Income

1. Overview

The United States taxes U.S. citizens, residents, and corporations (collectively, U.S. persons) on all income, whether derived in the United States or elsewhere. By contrast, the United States taxes nonresident alien individuals and foreign corporations only on income with a sufficient nexus to the United States.

The United States generally cedes the primary right to tax income derived from sources outside the United States to the foreign country where such income is derived. Thus, a credit against the U.S. income tax imposed on foreign source taxable income is provided for foreign taxes paid on that income. In order to implement the rules for computing the foreign tax credit, the Code and the regulations thereunder set forth an extensive set of rules governing the determination of the source, either U.S. or foreign, of items of income and the allocation and apportionment of items of expense against such categories of income.

The tax rules of foreign countries that apply to foreign income of U.S. persons vary widely. For example, some foreign countries impose income tax at higher effective rates than those of the United States. In such cases, the foreign tax credit allowed by the United States is likely to eliminate any U.S. tax on income from a U.S. person's operations in the foreign country. On the other hand, operations in countries that have low statutory tax rates or generous deduction allowances or that offer tax incentives (e.g., tax holidays) to foreign investors are apt to be taxed at effective tax rates lower than the U.S. rates. In such cases, after application of the foreign tax credit, a residual U.S. tax generally is imposed on income from a U.S. person's operations in the foreign country.

Under income tax treaties, the tax that otherwise would be imposed under applicable foreign law on certain foreign source income earned by U.S. persons may be reduced or eliminated. Moreover, U.S. tax on foreign source income may be reduced or eliminated by treaty provisions that treat certain foreign taxes as creditable for purposes of computing U.S. tax liability.

2. Foreign operations conducted directly

The tax rules applicable to U.S. persons that control business operations in foreign countries depend on whether the business operations are conducted directly (through a foreign branch, for example) or indirectly (through a separate foreign corporation). A U.S. person that conducts foreign operations directly includes the income and losses from such operations on the person's U.S. tax return for the year the income is earned or the loss is incurred. Detailed rules are provided for the translation into U.S. currency of amounts with respect to such foreign operations. The income from the U.S. person's foreign operations thus is subject to current U.S. tax. However, the foreign tax credit may reduce or eliminate the U.S. tax on such income.

3. Foreign operations conducted through a foreign corporation

a. In general

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. persons that hold stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from those operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. The foreign tax credit may reduce the U.S. tax imposed on such income.

A variety of complex anti-deferral regimes impose current U.S. tax on income earned by a U.S. person through a foreign corporation. The anti-deferral regimes included in the Code overlap, such that a U.S. person may be subject to multiple sets of anti-deferral rules with respect to a particular investment in a foreign corporation. Detailed rules for coordination among the anti-deferral regimes are provided to prevent the U.S. person from being subject to U.S. tax on the same item of income under multiple regimes.

The Code sets forth the following anti-deferral regimes: the controlled foreign corporation rules of subpart F (secs. 951-964); the passive foreign investment company rules (secs. 1291-1297); the foreign personal holding company rules (secs. 551-558); the personal holding company rules (secs. 541-547); the accumulated earnings tax rules (secs. 531-537); and the foreign investment company rules (sec. 1246). The operation and application of these regimes are briefly described in the following sections.

b. Controlled foreign corporations

General rules

U.S. 10-percent shareholders of a controlled foreign corporation (a "CFC") are required to include in income for U.S. tax purposes currently certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders (sec. 951(a)(1)(A)). In effect, the Code treats the U.S. 10-percent shareholders of a CFC as having received a current distribution of their pro rata shares of the CFC's subpart F income. In addition, the U.S. 10-percent shareholders of a CFC are required to include in income for U.S. tax purposes their pro rata shares of the CFC's earnings to the extent invested by the CFC in U.S. property or in excess passive assets (sec. 951(a)(1)(B) and (C)). The amounts included in income by the CFC's U.S. 10-percent shareholders under these rules are subject to U.S. tax currently. The U.S. tax on such amounts may be reduced through foreign tax credits.

For this purpose, a U.S. 10-percent shareholder is a U.S. person that owns 10 percent or more of the corporation's stock (measured by vote) (sec. 951(b)). A foreign corporation is a CFC if U.S. 10-per-

cent shareholders own more than 50 percent of such corporation's stock (measured by vote or by value) (sec. 957).[2]

In determining stock ownership for purposes of the subpart F rules, a U.S. person generally is considered to own a proportionate share of stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or estate of which the U.S. person is a shareholder, partner, or beneficiary (sec. 958(a)). In addition, constructive ownership rules apply for purposes of determining whether a U.S. person is a U.S. 10-percent shareholder, whether a foreign corporation is a CFC, and whether two persons are related, but not for purposes of requiring the inclusion of amounts with respect to the CFC in a U.S. shareholder's gross income (secs. 958(b) and 318(a)).

Earnings and profits of a CFC that have been included in income by the U.S. 10-percent shareholders are not taxed again when such earnings are actually distributed to such shareholders (sec. 959(a)(1)). Similarly, such previously-taxed earnings are not included in income by the U.S. 10-percent shareholders in the event that such earnings are invested by the CFC in U.S. property or excess passive assets (sec. 959(a)(2) and (3)). In the event that stock in the CFC is transferred subsequent to an income inclusion by a U.S. 10-percent shareholder but prior to the actual distribution of previously taxed income, the transferee shareholder generally is similarly exempt from U.S. tax on the distribution.

Subpart F income

In general

Subpart F income typically is passive income or income that is relatively movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income (defined in sec. 954), insurance income (defined in sec. 953), and certain income relating to international boycotts and other violations of public policy (defined in sec. 952(a)(3)-(5)). Subpart F income does not include income of the CFC that is effectively connected with the conduct of a trade or business within the United States (on which income the CFC is subject to current U.S. tax) (sec. 952(b)).

The subpart F income of a CFC is limited to its current earnings and profits (sec. 952(c)). Under this rule, current deficits in earnings and profits in any income category reduce the CFC's subpart F income. In addition, accumulated deficits in a CFC's earnings and profits generated by certain activities in prior years may be used to reduce the CFC's subpart F income generated by similar activities in the current year.

Pursuant to a de minimis rule, generally none of a CFC's income for a taxable year is treated as foreign base company income or subpart F insurance income if the CFC's gross foreign base company income and gross subpart F insurance income total less than the lesser of 5 percent of the CFC's gross income or $1 million (sec. 954(b)(3)(A)). Pursuant to a full inclusion rule, if more than 70 percent of a CFC's gross income is foreign base company income and/or subpart F insurance income, generally all of the CFC's income

[2] A broader definition of CFC applies in the case of a foreign corporation engaged in certain insurance activities (see secs. 953(c) and 957(b)).

is treated as foreign base company income or subpart F insurance income (whichever is appropriate) (sec. 954(b)(3)(B)). Under an elective exception for income that is subject to high foreign taxes, foreign base company income and subpart F insurance income generally do not include items of income received by the CFC which the taxpayer establishes were subject to an effective foreign tax rate greater than 90 percent of the maximum U.S. corporate tax rate (sec. 954(b)(4)).

Foreign base company income

Foreign base company income includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil-related income (sec. 954(a)). In computing foreign base company income, income in these five categories is reduced by allowable deductions properly allocable to such income (sec. 954(b)(5)).

One major category of foreign base company income is foreign personal holding company income (sec. 954(c)). For subpart F purposes, foreign personal holding company income consists of interest, dividends, annuities, net gains from sales of property which does not generate active income, net commodities gains, net foreign currency gains, income equivalent to interest, and certain rents and royalties.

Subpart F foreign personal holding company income generally includes the excess of gains over losses from sales and exchanges of non-income producing property and property that gives rise to certain passive income (sec. 954(c)(1)(B)). However, an exclusion is provided for gains and losses from the sale or exchange of property that is inventory property in the hands of the CFC. Also excluded are gains and losses from the sale or exchange of property (including gains or losses arising out of bona fide hedging transactions) by a CFC that is a regular dealer in such property.

Subpart F foreign personal holding company income generally includes the excess of gains over losses from transactions (including futures, forward, and similar transactions) in any commodities (sec. 954(c)(1)(C)). However, exceptions are provided for gains and losses from certain bona fide hedging transactions and certain active business transactions.

Subpart F foreign personal holding company income generally includes the excess of foreign currency gains over foreign currency losses attributable to section 988 transactions (sec. 954(c)(1)(D)). An exception is provided for hedging and other transactions directly related to the business needs of the CFC.

Subpart F foreign personal holding company income does not include rents and royalties received by the CFC in the active conduct of a trade or business from unrelated persons (sec. 954(c)(2)(A)). Also generally excluded are dividends and interest received by the CFC from a related corporation organized and operating in the same foreign country in which the CFC was organized, and rents and royalties received by the CFC from a related corporation for the use of property within the country in which the CFC was organized (sec. 954(c)(3)). However, interest, rent, and royalty payments

do not qualify for this exclusion to the extent that such payments reduce subpart F income of the payor.

For purposes of the subpart F rules, a related person is defined as any individual, corporation, trust, or estate that controls or is controlled by the CFC, or any individual, corporation, trust, or estate that is controlled by the same person or persons that control the CFC (sec. 954(d)(3)). Control with respect to a corporation means ownership of more than 50 percent of the corporation's stock (by vote or value). Control with respect to a partnership, trust, or estate means ownership of more than 50 percent of the value of the beneficial interests of the partnership, trust, or estate. Indirect and constructive ownership rules apply.

Foreign base company income also includes foreign base company sales and services income. Foreign base company sales income generally consists of sales income of a CFC located in a country that is neither the origin nor the destination of the goods with respect to sales of property purchased from or sold to a related person (sec. 954(d)). Foreign base company services income consists of income from services performed outside the CFC's country of incorporation for or on behalf of a related party (sec. 954(e)).

In addition, foreign base company income includes foreign base company shipping income. Foreign base company shipping income consists of income derived from (1) the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, (2) the performance of services directly related to the use of any such aircraft or vessel, or (3) the sale, exchange or other disposition of any such aircraft or vessel (sec. 954(f)). Foreign base company shipping income also includes any income derived from certain space or ocean activities.

Finally, foreign base company income includes foreign base company oil-related income (i.e., income other than extraction income). Foreign base company oil-related income generally includes all oil-related income, other than income derived from a source within a foreign country in connection with either (1) oil or gas which was extracted from a well located in that foreign country, or (2) oil, gas, or a primary product of oil or gas which is sold by the CFC or a related person for use or consumption within that foreign country, or is loaded in that country on a vessel or aircraft as fuel for such vessel or aircraft (sec. 954(g)). An exception is available for any CFC that, together with related persons, does not constitute a large oil producer.

Insurance income

Subpart F insurance income includes any income attributable to the issuing (or reinsuring) of any insurance or annuity contract in connection with risks in a country other than the country in which the insurer is created or organized (sec. 953(a)).[3] For this purpose, a qualified insurance branch of a CFC may be treated as a corporation created or organized in the country of its location (sec. 964(d)). Instead of being subject to the subpart F rules, a CFC that is en-

[3] Subpart F insurance income also includes income attributable to an insurance contract in connection with same-country risks as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other-country risks.

gaged in the insurance business generally may elect to be treated as a U.S. corporation for U.S. tax purposes (sec. 953(d)).

If more than 75 percent of a foreign corporation's gross premium income is derived from the reinsurance or issuance of insurance or annuity contracts with respect to other-country risks, such corporation is treated as a CFC provided that more than 25 percent of its stock (measured by vote or by value) is owned by U.S. 10-percent shareholders (sec. 957(b)). This rules applies only for purposes of requiring the U.S. 10-percent shareholders to recognize currently their shares of the corporation's subpart F insurance income.

Subpart F insurance income that is related person insurance income generally is taxable under subpart F to an expanded category of U.S. persons (sec. 953(c)). For purposes of taking into account such income under the subpart F provisions, the U.S. ownership threshold for CFC status is 25 percent or more. Any U.S. person who owns (directly or indirectly) stock in the foreign corporation, whatever the degree of ownership, is taken into account in applying this 25-percent U.S. ownership threshold and is subject to current U.S. tax on the CFC's related person insurance income. Certain exceptions apply to these special subpart F rules with respect to related person insurance. For this purpose, related person insurance income is insurance income attributable to a policy of insurance or reinsurance where the insured is a U.S. shareholder of the CFC (or a related person to such shareholder).

Other subpart F income

Subpart F income also includes three categories of income relating to international boycotts and other violations of public policy. The first category consists of the portion of the CFC's current income, other than amounts otherwise subject to current U.S. taxation, that is treated as attributable to participation in an international boycott (sec. 952(a)(3)). The second category consists of any illegal bribes, kickbacks, or other payments by or on behalf of the corporation directly or indirectly to an official, employee, or agent in fact of a government (sec. 952(a)(4)). The third category consists of income derived from any foreign country during a period in which the taxes imposed by that country are denied eligibility for the foreign tax credit pursuant to the implementation of U.S. foreign policy (sec. 952(a)(5)).

Treatment of investments in U.S. property and in excess passive assets

In general

As discussed above, the U.S. 10-percent shareholders of a CFC generally are subject to U.S. tax currently on their pro rata shares of the CFC's subpart F income. In addition, the U.S. 10-percent shareholders of a CFC are subject to U.S. tax currently on their pro rata shares of the CFC's earnings to the extent invested by the CFC in U.S. property or excess passive assets.

A shareholder's current income inclusion with respect to a CFC's investment in U.S. property for a taxable year is the shareholder's pro rata share of an amount equal to the lesser of (1) the CFC's average investment in U.S. property for such year, to the extent

that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis, or (2) the CFC's current or accumulated earnings and profits, reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property or in excess passive assets (secs. 956, 956A and 959). An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the CFC's earnings that have been previously taxed as subpart F income (secs. 951(a)(1)(B) and 959).

Similarly, a shareholder's current income inclusion with respect to a CFC's investment in excess passive assets for a taxable year is the shareholder's pro rata share of an amount equal to the lesser of (1) the CFC's average investment in excess passive assets for such year, to the extent that such investment exceeds the earnings and profits that were previously taxed on that basis, or (2) the CFC's current or accumulated earnings and profits, reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property or in excess passive assets (secs. 956A and 959). An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the CFC's earnings that have been previously taxed as subpart F income (secs. 951(a)(1)(C) and 959). Only earnings and profits accumulated in taxable years beginning after September 30, 1993 are taken into account under the excess passive assets provision.

Investments in U.S. property

The U.S. property held (directly or indirectly) by a CFC must be measured as of the close of each quarter in the taxable year (sec. 956(a)). The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the CFC's earnings and profits, reduced by any liability to which the property is subject.

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and the right to use certain intellectual property in the United States (sec. 956(c)(1)). Specified exceptions are provided for, among other things, obligations of the United States, U.S. bank deposits, certain export property, certain trade or business obligations, and stock or debt of certain unrelated U.S. corporations (sec. 956(c)(2)).

Investments in excess passive assets

For purposes of section 956A, a passive asset is any asset that either produces passive income or is held for the production of such income and that is not U.S. property within the meaning of section 956 (sec. 956A(c)(2)). Passive income, which is defined in the passive foreign investment company provisions (described in Part II.A.3.c. below), generally includes income that constitutes foreign personal holding company income for purposes of subpart F. However, passive income for this purpose does not include certain active-business banking, insurance or securities brokerage income or certain amounts that are received from a related party and are al-

locable to non-passive income of such related party (sec. 1296(b)(2) and (3)).

A CFC's excess passive assets for a taxable year is the excess, if any, of (1) the average of the amounts of passive assets held at the end of each quarter of the taxable year, over (2) 25 percent of the average of the amounts of total assets held at the end of each quarter of the taxable year (sec. 956A(c)(1)). Thus, the excess passive assets determination is made by comparing the CFC's average passive assets for the year to its average total assets for the year, rather than by making the comparison on a quarter by quarter basis and then taking the average. The excess passive assets calculation must be made using the adjusted bases of the CFC's assets as determined for the purpose of reporting the CFC's earnings and profits. The calculation cannot be made using the fair market values of the CFC's assets.

Certain look-through rules are applicable in determining a CFC's assets for purposes of section 956A (secs. 956A(c)(3)(A) and 1296(c)). Under these look-through rules, a CFC that directly or indirectly owns at least 25 percent (by value) of the stock of another corporation is treated as owning its proportionate share of that other corporation's income and assets. Therefore, a CFC that holds 25 percent or more of the stock of another corporation is deemed to hold a share of that corporation's assets proportionate to its percentage ownership of the corporation's stock.

In calculating a CFC's assets for purposes of section 956A, certain tangible property used, but not owned, by the CFC is included in the CFC's assets (secs. 956A(c)(3)(B) and 1297(d)). In addition, certain payments made by the CFC for research and development and for the license of certain intangible property are deemed to give rise to an increase in the CFC's assets (secs. 956A(c)(3)(C) and 1297(e)).

Tangible personal property of which the CFC is a lessee is treated as an asset of the corporation if the lease term is at least twelve months (sec. 1297(d)(1)). Under this rule, the adjusted basis of the leased property is deemed to be the unamortized portion of the present value of the payments under the lease (sec. 1297(d)(2)). However, leased property is not deemed to be an asset of the foreign corporation if the property is leased from a related person or if a principal purpose of the lease is to avoid either section 956A or the PFIC rules (sec. 1297(d)(3)).

Expenditures for research and development and certain payments made with respect to licensed intangible property are also treated as assets of a CFC (sec. 1297(e)(1)). The adjusted basis of a CFC's total assets is increased by an amount equal to its research and experimental expenditures paid or incurred during the taxable year and the preceding two taxable years. To the extent that the CFC is reimbursed for any research and experimental expenditures, it is not permitted to increase its total assets for such amounts.

The adjusted basis of a CFC's total assets is also increased to include an amount equal to 300 percent of the total payments made during the taxable year for the use of intangible property of which the CFC is a licensee and which is used by the CFC in the active conduct of a trade or business (sec. 1297(e)(2)(A)). This rule does

not apply, however, if the property is licensed from a foreign person that is a related person or if a principal purpose of the license is to avoid either section 956A or the PFIC provisions (sec. 1297(e)(2)(B)).

Section 956A contains special rules for allocating passive assets among several CFCs that are related by ownership. These rules are designed to prevent U.S. 10-percent shareholders from avoiding the application of section 956A by isolating passive assets in separate CFCs that have no current or accumulated earnings. Under these rules, the excess passive assets determination is made with respect to the "CFC group" as a whole (sec. 956A(d)(1)(A)). The amount of excess passive assets so determined is then allocated to the members of the group in proportion to each member's share of the relevant earnings and profits of the CFC group (sec. 956A(d)(1)(B)).

In general, a CFC group is one or more chains of CFCs connected through stock ownership; under the CFC group rules, the top-tier CFC must own directly more than 50 percent (by vote or by value) of the stock of at least one other CFC group member and more than 50 percent (by vote or by value) of the stock of each other CFC group member must be owned, directly or indirectly, by other CFC group members (sec. 956A(d)(2)). In making the excess passive assets computation for a CFC group, it is intended that stock owned by one group member in another group member and intercompany loans between group members generally be disregarded. Accordingly, the look-through rules described above do not apply within a CFC group. However, it is intended that the stock ownership of all members of the CFC group in a nongroup member be aggregated for purposes of determining whether the 25-percent ownership threshold is met in applying the look-through rules.

Gain from sales or exchanges of stock of certain foreign corporations

If a U.S. person sells or exchanges stock in a foreign corporation, or receives a distribution from a foreign corporation that is treated as an exchange of stock, and, at any time during the five-year period ending on the date of the sale or exchange, the foreign corporation was a CFC and the U.S. person was a U.S. 10-percent shareholder, the gain recognized on the sale or exchange generally is recharacterized as dividend income, to the extent of the earnings and profits of the foreign corporation accumulated during the period that the shareholder held stock while the corporation was a CFC (sec. 1248). For this purpose, earnings and profits of the foreign corporation do not include amounts that already were subject to U.S. tax (whether imposed on the foreign corporation itself or on the U.S. 10-percent shareholders)(sec. 1248(d)). Detailed rules govern the application of section 1248 in the case of (1) sales or exchanges of certain U.S. stock, (2) certain nonrecognition transactions involving a foreign corporation, and (3) certain indirect transfers of stock of a foreign corporation.

c. Passive foreign investment companies

General rules

The Tax Reform Act of 1986 established an anti-deferral regime applicable to U.S. persons that hold stock in a passive foreign investment company (a "PFIC"). A U.S. shareholder of a PFIC generally is subject to U.S. tax, plus an interest charge that reflects the value of the deferral of tax, upon receipt of a distribution from the PFIC or upon a disposition of PFIC stock. However, if a "qualified electing fund" election is made, the U.S. shareholder is subject to U.S. tax currently on the shareholder's pro rata share of the PFIC's total earnings; a separate election may be made to defer payment of such tax, subject to an interest charge, on income not currently received by the shareholder.

Constructive ownership rules apply in determining whether a U.S. person owns stock in a PFIC (sec. 1297(a)). Under these rules, a U.S. person generally is treated as owning such person's proportionate share of PFIC stock (1) owned by a partnership, trust or estate of which the person is a partner or beneficiary, (2) owned by a corporation of which the person is a 50-percent or greater shareholder (measured by value), or (3) owned by another PFIC of which the person is a shareholder.

Qualification as a PFIC

A foreign corporation is a PFIC if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average fair market value of its assets consists of assets that produce, or are held for the production of, passive income (sec. 1296(a)). In the case of a foreign corporation that is a CFC (and any other foreign corporation that so elects), the asset test for PFIC status is applied using the adjusted bases of the corporation's assets rather than their fair market value (sec. 1296(a)(2)).

For this purpose, passive income generally means income that satisfies the definition of foreign personal holding company income under the subpart F provisions (as discussed in Part II.A.3.b. above)(sec. 1296(b)). However, except as provided in regulations, passive income does not include certain active-business banking or insurance income. Also excluded from the definition of passive income is certain active-business securities income; this exception is applicable only in the case of the U.S. 10-percent shareholders of a PFIC that is also a CFC.

Certain leased property is treated as an asset held by the foreign corporation for purposes of the PFIC asset test (sec. 1297(d)). In measuring the assets of a CFC for purposes of the PFIC asset test, adjusted basis is modified to take into account certain research and experimental expenditures and certain payments for the use of intangible property that is licensed to the PFIC (sec. 1297(e)).[4]

Special exceptions from PFIC classification apply to start-up companies (sec. 1297(b)(2)) and corporations changing businesses during the taxable year (sec. 1297(b)(3)). In both such cases, the corporation may have a substantially higher proportion of passive

[4] These rules are described in Part II.A.3.b. above.

assets (and passive income, in some cases) than at other times in its history.

In determining whether a foreign corporation that owns a subsidiary is a PFIC, look-through treatment is provided in certain cases. A foreign corporation that owns, directly or indirectly, at least 25 percent of the value of the stock of another corporation is treated as owning a proportionate part of the other corporation's assets and income. Thus, amounts such as interest and dividends received from foreign or domestic subsidiaries are eliminated from the parent's income in applying the income test, and the stock or debt investment is eliminated from the parent's assets in applying the asset test. A special rule treats as active assets certain U.S. stock investments of a 25-percent owned U.S. corporation (sec. 1297(b)(8)). In addition to the rules applicable to 25-percent-owned subsidiaries, interest, dividends, rents, and royalties received from related persons are excepted from treatment as passive income to the extent that such amounts are allocable to income of the payor that is not passive income (sec. 1296(b)(2)(C)).[5]

Treatment of nonqualified funds

In the absence of a qualified electing fund election, a U.S. shareholder of a PFIC is subject to U.S. tax and an interest charge at the time the shareholder receives an "excess" distribution from the PFIC or disposes of stock in the PFIC (sec. 1291). Under this rule, gain recognized on receipt of an "excess" distribution or on disposition of PFIC stock generally is treated as ordinary income earned pro rata over the shareholder's holding period with respect to the PFIC stock, and is taxed at the highest applicable tax rate in effect for each respective year. Interest is imposed at the underpayment rate on the tax liability with respect to amounts allocated to prior taxable years. Special rules apply for purposes of computing foreign tax credits with respect to such distributions (sec. 1291(g)).

An "excess" distribution is any distribution during the current taxable year that exceeds 125 percent of the average amount of distributions received during the 3 preceding years (or, if shorter, the taxpayer's holding period prior to the current taxable year) (sec. 1291(b)). The determination of an excess distribution excludes from the 3-year average distribution base that part of a prior-year excess distribution that is considered attributable to deferred earnings. There are no excess distributions for the first year in the U.S. shareholder's holding period.

Treatment of qualified electing funds

A U.S. person that owns stock in a PFIC may elect that the PFIC be treated as a "qualified electing fund" with respect to that shareholder (sec. 1295). Under such election, the U.S. shareholder must include currently in gross income the shareholder's pro rata share of the PFIC's total earnings and profits (sec. 1293). This inclusion rule generally requires current payment of tax, absent a separate election to defer payment of the tax (sec. 1294).

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[5] For this purpose, related person is defined as under the subpart F provisions (described in Part II.A.3.b. above).

The amount currently included in the income of an electing shareholder is divided between the shareholder's pro rata share of the ordinary earnings of the PFIC and the shareholder's pro rata share of the net capital gain of the PFIC (sec. 1293(a)(1)). The characterization of income, and the determination of earnings and profits, generally is made pursuant to general Code rules (sec. 1293(e)).

Two modifications to the determination of the PFIC's earnings and profits apply only for purposes of determining the income inclusion of a U.S. 10-percent shareholder of a PFIC that is also a CFC (sec. 1293(g)(1)). Under the first modification, items of income that the U.S. 10-percent shareholder establishes were subject to an effective rate of foreign income tax greater than 90 percent of the maximum U.S. corporate tax rate are excluded from the ordinary earnings and net capital gain income of the PFIC. Under the second modification, U.S.-source income that is effectively connected with the PFIC's conduct of a U.S. trade or business is similarly excluded, provided that such income is not exempt from U.S. taxation (or subject to a reduced rate of tax) pursuant to a treaty.

A U.S. shareholder's pro rata share of income generally is determined by attributing the PFIC's income for the taxable year ratably over the days in such year (sec. 1293(b)). Electing shareholders include in income for the period in which they held stock in the PFIC an amount equal to the sum of their daily ownership interest in the PFIC multiplied by the income attributed to such day. If it is established that a PFIC maintains records determining its shareholders' pro rata shares of income more accurately than by allocating a year's income ratably on a daily basis, the shareholders' pro rata shares of income may be determined on that basis.

The distribution of earnings and profits that were previously included in the income of an electing U.S. shareholder under these rules is not taxed as a dividend to the shareholder (sec. 1293(c)). The basis of an electing U.S. shareholder's stock in a PFIC is increased by amounts currently included in income under these rules, and is decreased by any amount that is actually distributed but treated as previously taxed (sec. 1293(d)).

Special rules apply in cases where a U.S. shareholder makes the qualified electing fund election with respect to the PFIC after the beginning of the shareholder's holding period with respect to the PFIC (i.e., where the PFIC is a nonqualified fund with respect to the shareholder for some period before the shareholder makes the election) (sec. 1291(d)).

Foreign tax credits are allowed against U.S. tax on amounts included in income from a qualified electing fund to the same extent, and under the same rules, as in the case of income inclusions from a CFC (sec. 1293(f)). Special rules apply in characterizing such income inclusions from qualified electing funds for foreign tax credit purposes.

U.S. shareholders generally may elect to defer the payment of U.S. tax on amounts that are included currently in income but for which no current distribution has been received (sec. 1294). An election to defer tax is treated as an extension of time to pay tax for which a U.S. shareholder is liable for interest. The disposition of stock in a PFIC terminates all previous extensions of time to pay tax with respect to the earnings attributable to that stock. Any

transfer of ownership generally is treated as a disposition for this purpose, regardless of whether the transfer constitutes a realization or recognition event under general Code rules.

If an item of income would be includible in the gross income of a U.S. shareholder under both the subpart F rules and the rules applicable to qualified electing funds, that item of income is required to be included only under the subpart F rules (sec. 951(f)).

d. Foreign personal holding companies

The foreign personal holding company rules are aimed at preventing U.S. persons from accumulating income tax-free in foreign "incorporated pocketbooks." If a foreign corporation qualifies as a foreign personal holding company, all the U.S. shareholders of the corporation are subject to U.S. tax currently on their pro rata share of the corporation's undistributed foreign personal holding company income.

A foreign corporation is a foreign personal holding company if it satisfies both a stock ownership requirement and a gross income requirement (sec. 552(a)). The stock ownership requirement is satisfied if, at any time during the taxable year, more than 50 percent (measured by vote or by value) of the stock of the corporation is owned by or for five or fewer individual citizens or residents of the United States. Indirect and constructive ownership rules apply for purposes of the stock ownership requirement (sec. 554). The gross income requirement is satisfied initially if at least 60 percent of the corporation's gross income is foreign personal holding company income. Once the corporation qualifies as a foreign personal holding company, however, the gross income threshold for each subsequent year is only 50 percent, until the expiration of either one full taxable year during which the stock ownership requirement is not satisfied or three consecutive taxable years for which the gross income requirement is not satisfied at the 50-percent threshold (sec. 552(a)(1)).

Foreign personal holding company income generally includes passive income such as dividends, interest, certain royalties, and certain rents (sec. 553(a)). It also includes, among other things, gains (other than gains of dealers) from stock and securities transactions, gains (other than gains from bona fide hedging transactions) from commodities transactions, and amounts received with respect to certain personal services contracts. Look-through rules apply for purposes of characterizing certain dividends and interest received from related persons (sec. 552(c)).

If a foreign corporation is a foreign personal holding company, its undistributed foreign personal holding company income is treated as distributed as a dividend on a pro-rata basis to all of its U.S. shareholders (sec. 551(b)). The undistributed foreign personal holding company income that is deemed distributed is treated as recontributed by the shareholders to the foreign personal holding company as a contribution to capital. Accordingly, the earnings and profits of the corporation are reduced by the amount of the deemed distribution (sec. 551(d)), and each shareholder's basis in his or her stock in the foreign personal holding company is increased by the shareholder's pro rata portion of the deemed distribution (sec. 551(e)). If an item of income of a foreign corporation would be in-

cludible in the gross income of a U.S. shareholder under both the subpart F rules and the foreign personal holding company rules, that item of income is required to be included only under the subpart F rules (sec. 951(d)).

e. Personal holding companies

In addition to the corporate income tax, a tax is imposed at the rate of 39.6 percent on the undistributed personal holding company income of a personal holding company (sec. 541). This tax substitutes for the tax that would have been incurred by the shareholders on dividends actually distributed by the personal holding company.

A corporation generally is a personal holding company if (1) at least 60 percent of its adjusted gross income for the taxable year is personal holding company income, and (2) at any time during the last half of the taxable year more than 50 percent (by value) of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals (sec. 542(a)). The definition of a personal holding company is very similar to that of a foreign personal holding company, discussed above, but does not depend on the U.S. citizenship or residence status of the shareholders. However, specified exceptions to the definition of a personal holding company preclude the application of the personal holding company tax to, among others, any foreign personal holding company, most foreign corporations owned solely by nonresident alien individuals, and any PFIC (sec. 542(c)(5), (7), and (10)). Notwithstanding these exceptions, the personal holding company tax is potentially applicable to a small class of closely-held foreign corporations.

f. Accumulated earnings tax

In addition to the corporate income tax, a tax is imposed at the rate of 39.6 percent on the accumulated taxable income of a corporation formed or availed of for the purpose of avoiding income tax with respect to its shareholders (or the shareholders of any other corporation), by permitting its earnings and profits to accumulate instead of being distributed (secs. 531, 532(a)). The fact that the earnings and profits of the corporation are allowed to accumulate beyond the reasonable needs of the business generally is determinative of the required tax-avoidance motive (sec. 533). Like the personal holding company tax, the accumulated earnings tax acts as a substitute for the tax that would have been incurred by the shareholders on dividends actually distributed by the corporation.

The accumulated earnings tax does not apply to any personal holding company, foreign personal holding company, or PFIC (sec. 532(b)). These exceptions, along with the current inclusion of subpart F income in the gross incomes of the U.S. 10-percent shareholders of a CFC, result in only a very limited application of the accumulated earnings tax to foreign corporations.

g. Foreign investment companies

A foreign corporation generally is a foreign investment company if (1) the corporation is registered as a management company or as a unit investment trust or is engaged primarily in the business of

investing, reinvesting, or trading in securities or commodities or any interest in securities or commodities and (2) 50 percent or more (measured by vote or by value) of the stock of the corporation is held (directly or indirectly) by U.S. persons (sec. 1246(b)). Gain on a sale or exchange (or a distribution that is treated as an exchange) of stock in a foreign investment company generally is treated as ordinary income to the extent of the taxpayer's ratable share of the undistributed earnings and profits of the foreign investment company (sec. 1246(a)). This rule operates not to prevent deferral of U.S. tax, as do the foregoing sets of rules, but to prevent the use of a foreign corporation to convert ordinary income into capital gain.

4. Transfer pricing rules

In the case of a multinational enterprise that includes at least one U.S. corporation and at least one foreign corporation, the United States taxes all of the income of the U.S. corporation, but only so much of the income of the foreign corporation as is determined to have sufficient nexus to the United States. The determination of the amount that properly is the income of the U.S. member of a multinational enterprise and the amount that properly is the income of a foreign member of the same multinational enterprise thus is critical to determining the amount of income the United States may tax (as well as the amount of income other countries may tax).

Due to the variance in tax rates and tax systems among countries, a multinational enterprise may have a strong incentive to shift income, deductions, or tax credits among commonly controlled entities in order to arrive at a reduced overall tax burden. Such a shifting of items between commonly controlled entities could be accomplished by setting artificial transfer prices for transactions between group members.

As a simple illustration of how transfer pricing could be used to reduce taxes, assume that a U.S. corporation has a wholly-owned foreign subsidiary. The U.S. corporation manufactures a product domestically and sells it to the foreign subsidiary. The foreign subsidiary, in turn, sells the product to unrelated third parties. Due to the U.S. parent's control of its subsidiary, the price which is charged by the parent to the subsidiary theoretically could be set independently of ordinary market forces. If the foreign subsidiary is established in a jurisdiction that subjects its profits from the sale of the product to an effective rate of tax lower than the effective U.S. tax rate, then the U.S. corporation may be inclined to undercharge the foreign subsidiary for the product. By doing so, a portion of the combined profits of the group from the manufacture and sale of the product would be shifted out of a high-tax jurisdiction (the United States) and into a lower-tax jurisdiction (the foreign corporation's home country).[6] The ultimate result of this process would be a reduced worldwide tax liability of the multinational enterprise.

[6] By contrast, U.S. companies owning foreign subsidiaries that are located in countries with effective tax rates that are higher than the U.S. rates may have an incentive to overcharge for sales from the U.S. parent to the foreign subsidiary in order to shift profits, and the resulting tax, into the United States.

Under section 482, the Secretary of the Treasury is authorized to redetermine the income of an entity subject to U.S. taxing jurisdiction, when it appears that an improper shifting of income between that entity and a commonly controlled entity in another country has occurred. This authority is not limited to reallocations of income between different taxing jurisdictions; it permits reallocations in any common control situation, including reallocations between two U.S. entities. However, it has significant application to multinational enterprises due to the incentives for taxpayers to shift income to obtain the benefits of significantly different effective tax rates.

Section 482 grants the Secretary of the Treasury broad authority to allocate income, deductions, credits or allowances between any commonly controlled organizations, trades, or businesses in order to prevent evasion of taxes or clearly to reflect income. The statute generally does not prescribe any specific reallocation rules that must be followed, other than establishing the general standards of preventing tax evasion and clearly reflecting income. Treasury regulations adopt the concept of an arm's length standard as the method for determining whether reallocations are appropriate. Thus, the regulations attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length. The regulations contain extremely complex rules governing the determination of an arm's-length charge for various types of transactions. The regulations generally attempt to prescribe methods for identifying the relevant comparable unrelated party transaction and for providing adjustments for differences between such transactions and the related party transactions in question. In some instances, the regulations also provide safe harbors.

Determinations under section 482 that result in the allocation of additional income to the United States might theoretically subject a taxpayer to double taxation, if both the United States and another country imposed tax on the same income and the other country did not agree that the income should be reallocated to the United States. Tax treaties generally provide mechanisms to attempt to resolve such disputes in a manner that may avoid double taxation if both countries agree. Such mechanisms include the designation of a "competent authority" by each country, to act as that country's representative in the negotiation attempting to resolve such disputes. However, such competent authority procedures do not guarantee that double tax may not be imposed in a particular case.

One method for addressing the issue of double taxation is through the recently-developed advance pricing agreement ("APA") procedure. An APA is an advance agreement establishing an approved transfer pricing methodology entered into between the taxpayer, the Internal Revenue Service, and a foreign tax authority. The taxpayer generally is required to use the approved transfer pricing methodology for the duration of the APA. The IRS and the foreign tax authority generally agree to accept the results of such approved methodology. An APA also may be negotiated between just the taxpayer and the IRS; such an APA establishes an approved transfer pricing methodology for U.S. tax purposes. The APA process may prove to be particularly useful in cases involving

industries such as financial products and services for which transfer pricing determinations are especially difficult.

5. Foreign tax credit rules

a. In general

Because the United States taxes U.S. persons on their worldwide income, Congress enacted the foreign tax credit in 1918 to prevent U.S. taxpayers from being taxed twice on their foreign source income: once by the foreign country where the income is earned and again by the United States. The foreign tax credit generally allows U.S. taxpayers to reduce the U.S. income tax on their foreign income by the foreign income taxes they pay on that income. The foreign tax credit does not operate to offset U.S. income tax on U.S. source income.

A credit against U.S. tax on foreign income is allowed for foreign taxes paid or accrued by a U.S. person (sec. 901). In addition, a credit is allowed to a U.S. corporation for foreign taxes paid by certain foreign subsidiary corporations and deemed paid by the U.S. corporation upon a dividend received by, or certain other income inclusions of, the U.S. corporation with respect to earnings of the foreign subsidiary (the "deemed-paid" or "indirect" foreign tax credit) (sec. 902).

The foreign tax credit provisions of the Code are elective on a year-by-year basis. In lieu of electing the foreign tax credit, U.S. persons generally are permitted to deduct foreign taxes (sec. 164(a)(3)). For purposes of the alternative minimum tax, foreign tax credits generally cannot be used to offset more than 90 percent of the U.S. person's pre-foreign tax credit tentative minimum tax (sec. 59(a)).

A foreign tax credit limitation, which is calculated separately for various categories of income, is imposed to prevent the use of foreign tax credits to offset U.S. tax on U.S. source income. Detailed rules (discussed in Part II.B.3.a. below) are provided for the allocation of expenses against U.S.-source and foreign-source income. Special rules apply to require the allocation of foreign losses in one category of income for a taxable year to offset foreign income in the other categories for such year and to require the recharacterization of foreign income for a year subsequent to a foreign loss year from one income category to another or from foreign source to U.S. source (sec. 904(f)).

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back to the two immediately preceding taxable years and carried forward to the first five succeeding taxable years, and credited in such years to the extent that the taxpayer otherwise has excess foreign tax credit limitation for those years (sec. 904(c)). For purposes of determining excess foreign tax credit limitation amounts, the foreign tax credit separate limitation rules apply.

b. Deemed-paid foreign tax credit

U.S. corporations owning at least 10 percent of the voting stock of a foreign corporation are treated as if they had paid a share of

the foreign income taxes paid by the foreign corporation in the year in which that corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder (sec. 902(a)). This is the "deemed-paid" or "indirect" foreign tax credit. A U.S. corporation may also be deemed to have paid taxes paid by a second or third tier foreign corporation (sec. 902(b)). Foreign taxes paid below the third tier are not eligible for the deemed-paid credit. In addition, a deemed-paid credit generally is available with respect to subpart F inclusions (sec. 960(a)). Moreover, a deemed-paid credit generally is available with respect to inclusions under the PFIC provisions by U.S. corporations meeting the requisite ownership threshold (secs. 1291(g) and 1293(f)).

The amount of foreign tax eligible for the indirect credit is added to the actual dividend or inclusion (the dividend or inclusion is said to be "grossed-up") and is included in the U.S. corporate shareholder's income; accordingly, the shareholder is treated as if it had received its proportionate share of pre-tax profits of the foreign corporation and paid its proportionate share of the foreign tax paid by the foreign corporation (sec. 78)).

For purposes of computing the deemed-paid foreign tax credit, dividends (or other inclusions) are considered made first from the post-1986 pool of all the distributing foreign corporation's accumulated earnings and profits (sec. 902(c)(6)(B)).[7] Accumulated earnings and profits for this purpose include the earnings and profits of the current year undiminished by the current distribution (or other inclusion) (sec. 902(c)(1)). Dividends in excess of the accumulated pool of post-1986 undistributed earnings and profits are treated as paid out of pre-1987 accumulated profits and are subject to the ordering principles of pre-1986 Act law (sec. 902(c)(6)).

c. Foreign tax credit limitation

A premise of the foreign tax credit is that it should not reduce the U.S. tax on a taxpayer's U.S. source income but should only reduce the U.S. tax on the taxpayer's foreign source income. Permitting the foreign tax credit to reduce U.S. tax on U.S. income would in effect cede to foreign countries the primary right to tax income earned from U.S. sources.

In order to prevent foreign taxes from reducing U.S. tax on U.S. source income, the foreign tax credit is subject to an overall limitation and a series of separate limitations. Under the overall limitation, the total amount of the credit may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income bears to the taxpayer's worldwide taxable income for the taxable year (sec. 904(a)). In addition, the foreign tax credit limitation is calculated separately for various categories of income (sec. 904(d)). Under these separate limitations, the total amount of the credit for foreign taxes on income in each category may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income in that category bears to the taxpayer's worldwide taxable income for the taxable year.

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[7] Earnings and profits computations for these purposes are to be made under U.S. concepts. *Goodyear Tire & Rubber Co. v. United States*, 493 U.S. 132 (1989).

The separate limitation categories are passive income, high withholding tax interest income, financial services income, shipping income, dividends received by a corporation from each noncontrolled section 902 corporation, dividends from a domestic international sales corporation (DISC) or former DISC, certain distributions from a foreign sales corporation (FSC) or former FSC, and taxable income of a FSC attributable to foreign trade income (sec. 904(d)). Income not in a separate limitation category is referred to in the regulations as "general limitation income." A special limitation applies to the credit for taxes imposed on foreign oil and gas extraction income (sec. 907(a)).

Dividends, interest, rents, royalties, and subpart F income inclusions received from CFCs by their U.S. 10-percent shareholders generally are subject to the general limitation or to the various separate limitations (as the case may be) in accordance with look-through rules that take into account the extent to which the income of the payor is itself subject to one or more of these limitations (sec. 904(d)(3)).

6. Foreign sales corporations

Under special tax provisions that provide an export incentive, portion of the export income of an eligible foreign sales corporation ("FSC") is exempt from U.S.income tax. In addition, a U.S. corporation is not subject to U.S. tax on dividends distributed from the FSC out of earnings attributable to certain export income. Thus, there generally is no corporate level tax imposed on a portion of the income from exports of a FSC.[8]

Typically, a FSC is owned by a U.S. corporation that produces goods in the United States. The U.S. corporation either supplies goods to the FSC for resale abroad to unrelated persons or pays the FSC a commission in connection with its sales to unrelated persons. Therefore, the income of the FSC, a portion of which is exempt from U.S. tax under the FSC rules, equals the FSC's gross markup or gross commission income, less the expenses incurred by the FSC.

Under the rules of the General Agreement on Tariffs and Trade ("GATT"), an exemption from tax on export income is permitted only if the economic processes which give rise to the income take place outside the United States. In conformity with these rules, a FSC must have a foreign presence, it must have economic substance, and activities that relate to its export income must be performed by the FSC outside the U.S. customs territory. Furthermore, the income of the FSC must be determined according to specified transfer pricing rules which are intended to comply with GATT's requirement of arm's-length prices.

A FSC generally is not subject to U.S. tax on its exempt foreign trade income. To achieve this result, the exempt foreign trade in-

[8] Two recent export incentives preceded the enactment of the FSC provisions. Under provisions enacted in 1962, CFCs that qualified as export trade corporations were permitted to reduce their subpart F income by the amount of certain export trade income (secs. 970 and 971). No CFC may qualify as an export trade corporation unless it so qualified as of 1971. Under provisions enacted in 1971, domestic international sales corporations ("DISCs") were permitted to defer U.S. tax on certain export receipts (secs. 991–997). Upon enactment of the FSC provisions in 1984, a special rule permitted any DISC to transfer its deferred earnings to a FSC. An interest charge is now imposed on the deferral of tax on the earnings of any remaining DISC (sec. 995(f)).

come of a FSC is treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States (sec. 921(a)).

Foreign trade income other than exempt foreign trade income, as well as investment income, generally is treated as U.S. source income effectively connected with the conduct of a trade or business conducted through a permanent establishment within the United States (sec. 921(d)). Thus, income other than exempt foreign trade income generally is subject to U.S. tax currently and is treated as U.S. source income for purposes of the foreign tax credit limitation.

Foreign trade income of a FSC is defined as the FSC's gross income attributable to foreign trading gross receipts (sec. 923(b)). Foreign trading gross receipts generally are the gross receipts of any FSC that are attributable to the following types of transactions: the sale of export property; the lease or rental of export property; services related and subsidiary to such a sale or lease of export property; engineering and architectural services for projects outside the United States; and export management services (sec. 924(a)). Investment income and carrying charges are excluded from the definition of foreign trading gross receipts (sec. 924(f)(2)).

The term "export property" generally means property (1) which is manufactured, produced, grown or extracted in the United States by a person other than a FSC, (2) which is held primarily for sale, lease, or rental in the ordinary course of trade or business for direct use or consumption outside the United States, and (3) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States (sec. 927(a)). The term "export property" does not include property leased or rented by a FSC for use by any member of a controlled group of which the FSC is a member, patents and other intangibles, oil or gas (or any primary product thereof), or products the export of which is prohibited. Export property also excludes property designated by the President as being in short supply.

If export property is sold to a FSC by a related person (or a commission is paid by a related person to a FSC with respect to export property), the income with respect to the export transactions must be allocated between the FSC and the related person. The taxable income of the FSC and the taxable income of the related person are computed based upon a transfer price determined under an arm's-length pricing approach or under one of two formulae which are intended to approximate arm's-length pricing.

The portion of a FSC's foreign trade income that is treated as exempt foreign trade income depends on the pricing rule used to determine the income of the FSC. If the amount of income earned by the FSC is based on arm's-length pricing between unrelated parties, or between related parties under the rules of section 482, the exempt foreign trade income generally is 30 percent of the foreign trade income the FSC derives from a transaction (secs. 923(a)(2) and (6) and 291(a)(4)). If the income earned by the FSC is determined under one of the special formulae specified in the FSC provisions, the exempt foreign trade income generally is 15/23 of the foreign trade income the FSC derives from the transaction (secs. 923(a)(3) and (6) and 291(a)(4)).

A FSC is not required or deemed to make distributions to its shareholders. Actual distributions are treated as being made first out of earnings and profits attributable to foreign trade income, and then out of any other earnings and profits (sec. 926(a)). Any distribution made by a FSC out of earnings and profits attributable to foreign trade income to a foreign shareholder is treated as U.S.-source income that is effectively connected a business conducted through a permanent establishment of the shareholder within the United States (sec. 926(b)). Thus, the foreign shareholder is subject to U.S. tax on such a distribution.

A U.S. corporation generally is allowed a 100 percent dividends-received deduction for amounts distributed from a FSC out of earnings and profits attributable to foreign trade income (sec. 245(c)(1)(A)). Thus, there generally is no corporate level U.S. tax on exempt foreign trade income and only a single level of U.S. corporate tax (at the FSC level) on nonexempt foreign trade income. However, the 100 percent dividends-received deduction is not allowed for nonexempt foreign trade income determined under arm's-length principles (sec. 245(c)(2)).

B. U.S. Taxation of Foreign Persons with U.S. Income

1. Overview

The United States imposes tax on nonresident alien individuals and foreign corporations (collectively, foreign persons) only on income that has a sufficient nexus to the United States. In contrast, the United States imposes tax on U.S. persons on all income, whether derived in the United States or in a foreign country.

Foreign persons are subject to U.S. tax on income that is "effectively connected" with the conduct of a trade or business in the United States, without regard to whether such income is derived from U.S. sources or foreign sources. Such income generally is taxed in the same manner and at the same rates as income of a U.S. person. In addition, foreign persons generally are subject to U.S. tax at a 30-percent rate on certain gross income derived from U.S. sources.

Pursuant to an applicable tax treaty, the 30-percent gross-basis tax imposed on foreign persons may be reduced or eliminated. In addition, an applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign person to cases where the business is conducted through a permanent establishment in the United States.

2. Source of income rules

The source of income for U.S. tax purposes is determined based on various factors. The relevant factors include the location or nationality of the payor, the location or nationality of the recipient, the location of the recipient's activities that generate the income, and the location of the assets that generate the income. The rules for determining the source of specific types of income are described briefly below.

Interest

Interest income generally is treated as U.S.-source income if it is from obligations of the United States or the District of Columbia or from interest-bearing obligations of U.S. residents or U.S. corporations (sec. 861(a)(1)). Under a special rule, interest paid by certain U.S. persons that conduct active foreign businesses is treated as foreign source income in whole or in part (sec. 861(c)). Other exceptions from the general rule treating interest paid by U.S. persons as U.S.-source income apply to interest on deposits with foreign commercial banking branches of U.S. corporations or partnerships and certain other amounts paid by foreign branches of domestic financial institutions (sec. 861(a)(1)(B)).

Dividends

Dividends from U.S. corporations generally are treated as U.S.-source income (sec. 861(a)(2)(A)). Under a special rule, dividends from certain foreign corporations that conduct U.S. businesses are treated in part as U.S.-source income (sec. 861(a)(2)(B)).

Rents and royalties

Rents or royalties from property located in the United States, and rents or royalties for the use of or privilege of using intangible property in the United States, generally are treated as U.S.- source income (sec. 861(a)(4)).

Income from sales of personal property

Subject to significant exceptions, income from the sale of personal property is sourced on the basis of the residence of the seller (sec. 865(a)). For this purpose, the term "nonresident" is defined to include any foreign corporation (sec. 865(g)). The term "nonresident" also is defined to include any nonresident alien who does not have a "tax home" in the United States.

Several exceptions to the general rule result in income from sales of property by nonresidents being treated as U.S.-source income. Gain of a nonresident on the sale of inventory property may be treated as U.S. source income if title to the property passes in the United States or if the sale is attributable to an office or other fixed place of business maintained by the nonresident in the United States (secs. 865(b) and (e) and 861(a)(6)). If the inventory property is manufactured in the United States by the person that sells the property, a portion of the income from the sale of such property in all events is treated as U.S.-source income (sec. 863(b)). Gain of a nonresident on the sale of depreciable property is treated as U.S.-source income to the extent of prior U.S. depreciation deductions (sec. 865(c)). Payments received on sales of intangible property are sourced in the same manner as royalties to the extent the payments are contingent on the productivity, use, or disposition of the intangible (sec. 865(d)).

Personal services income

Compensation for labor or personal services performed in the United States generally is treated as U.S.-source income, subject to an exception for amounts that meet certain de minimis criteria (sec. 861(a)(3)).

Insurance income

Underwriting income from issuing insurance or annuity contracts generally is treated as U.S.-source income if the contract involves property in, liability arising out of an activity in, or the lives or health of residents of, the United States (sec. 861(a)(7)).

Transportation income

Generally, 50 percent of income attributable to transportation which begins or ends in the United States is treated as U.S.-source income (sec. 863(c)).

Income from space or ocean activities or international communications

In the case of a foreign person, generally no income from a space or ocean activity is treated as U.S.-source income (sec. 863(d)). The same holds true for international communications income unless the foreign person maintains an office or other fixed place of business in the United States, in which case the income attributable to such fixed place of business is treated as U.S.- source income (sec. 863(e)).

3. Net-basis taxation

a. Income from a U.S. business

The United States taxes on a net basis the income of foreign persons that is "effectively connected" with the conduct of a trade or business in the United States (secs. 871(b) and 882). Any gross income earned by the foreign person that is not effectively connected with the person's U.S. business is not taken into account in determining the rates of U.S. tax applicable to the person's income from such business (secs. 871(b)(2) and 882(a)(2)).

U.S. trade or business

A foreign person is subject to U.S. tax on a net basis if the person is engaged in a U.S. trade or business. In this regard, partners in a partnership and beneficiaries of an estate or trust are treated as engaged in the conduct of a trade or business within the United States if the partnership, estate or trust is so engaged (sec. 875).

The question of whether a foreign person is engaged in a U.S. trade or business has generated a significant body of case law. Basic issues involved in the determination include whether the activity constitutes business rather than investing, whether sufficient activities in connection with the business are conducted in the United States, and whether the relationship between the foreign person and persons performing functions in the United States with respect to the business is sufficient to attribute those functions to the foreign person.

The Code contains specific rules with respect to the application of the trade or business standard to certain activities. Pursuant to section 864(b), the term "trade or business within the United States" expressly includes the performance of personal services within the United States. However, an exception is provided in the case of a nonresident alien individual's performance of services for a foreign employer, where both the total compensation received for

such services during the year and the period in which the individual is present in the United States are de minimis (sec. 864(b)(1)). In addition, detailed rules govern the determination of whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business (sec. 864(b)(2)). Under these rules, trading in stock or securities or commodities by a foreign person through an *independent* agent generally is not treated as the conduct of a U.S. trade or business, if the foreign person does not have an office or other fixed place of business in the United States through which such transactions are effected. Trading in stock or securities or commodities for the foreign person's own account also generally is not treated as the conduct of a U.S. business, provided that the foreign person is not a dealer in stock or securities or commodities, as the case may be; this exclusion is not applicable, however, to a foreign corporation engaged in trading in stock or securities for its own account if the corporation's principal business is such trading and its principal office is in the United States.

Effectively-connected income

A foreign person that is engaged in the conduct of a trade or business within the United States is subject to U.S. net-basis taxation on the income that is "effectively connected" with such business. Specific statutory rules govern the determination of whether income is so effectively connected (sec. 864(c)).

In the case of U.S.-source capital gain or loss and U.S.-source income of a type that would be subject to gross basis U.S. taxation, the factors taken into account in determining whether the income, gain or loss is effectively connected with a U.S. trade or business include whether the amount is derived from assets used in or held for use in the conduct of the U.S. trade or business and whether the activities of the trade or business were a material factor in the realization of the amount (sec. 864(c)(2)). In making this determination, due regard is given to whether the asset or income, gain, or loss was accounted for through the U.S. trade or business. In the case of any other U.S.-source income, gain, or loss, such amounts are all treated as effectively connected with the conduct of the trade or business in the United States (sec. 864(c)(3)).

Foreign-source income of a foreign person that is effectively connected with the conduct of a trade or business in the United States may also be taxed by the United States, subject to a credit for any foreign income taxes (secs. 864(c)(4) and 906). However, only specific types of foreign-source income are considered to be effectively connected with a U.S. trade or business (sec. 864(c)(4)(A)). Foreign-source income of a type not specified generally is exempt from U.S. tax.

Foreign-source income, gain, or loss generally is considered to be effectively connected with a U.S. business only if the person has an office or other fixed place of business within the United States to which such income, gain, or loss is attributable and such income falls into one of the three categories described below (sec. 864(c)(4)(B)). The first category consists of rents or royalties for the use of patents, copyrights, secret processes or formulas, good will, trade-marks, trade brands, franchises, or other like intangible properties derived in the active conduct of the U.S. trade or busi-

ness (sec. 864(c)(4)(B)(i)). The second category consists of interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account (sec. 864(c)(4)(B)(ii)). Notwithstanding the foregoing, foreign-source income consisting of dividends, interest, or royalties is not treated as effectively connected if the items are paid by a foreign corporation in which the recipient owns, directly, indirectly, or constructively, more than 50 percent of the total combined voting power of the stock (sec. 864(c)(4)(D)(i)). The third category consists of income, gain, or loss derived from the sale or exchange of inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of the trade or business where the property is sold or exchanged outside the United States through the foreign person's U.S. office or other fixed place of business (sec. 864(c)(4)(B)(iii)). Such amounts are not treated as effectively connected if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer in a foreign country participated materially in the sale or exchange.

In determining whether a foreign person has a U.S. office or other fixed place of business, the office or other fixed place of business of an agent generally is disregarded. The place of business of an agent other than an independent agent acting in the ordinary course of business is not disregarded, however, if either the agent has the authority (regularly exercised) to negotiate and conclude contracts in the name of the foreign person or the agent has a stock of merchandise from which he regularly fills orders on behalf of the foreign person (sec. 864(c)(5)(A)). Assuming that an office or other fixed place of business does exist, income, gain, or loss is not considered attributable to such office unless the office was a material factor in the production of the income, gain, or loss and the office regularly carries on activities of the type from which the income, gain, or loss was derived (sec. 864(c)(5)(B)). Finally, in the case of any inventory property sales that are foreign-source income effectively connected with a U.S. business, the income, gain, or loss treated as attributable to the U.S. office cannot be more than the amount of U.S. source income that would have been produced had the sale or exchange been made in the United States (sec. 864(c)(5)(C)).

Special rules apply for purposes of determining the effectively-connected income of an insurance company. The foreign-source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code is treated as effectively connected, provided that such income is attributable to its United States business (sec. 864(c)(4)(C)).

Income, gain, or loss for a particular year generally is not treated as effectively connected if the foreign person is not engaged in a U.S. trade or business in that year (sec. 864(c)(1)(B)). However, if income or gain taken into account for a taxable year is attributable to the sale or exchange of property, the performance of services, or any other transaction which occurred in a prior taxable year, the determination whether such income or gain is taxable on a net basis is required to be made as if the income were taken into ac-

count in the earlier year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the later taxable year (sec. 864(c)(6)). Also, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States and the property is disposed of within 10 years after the cessation, the determination of whether any income or gain attributable to the disposition of the property is taxable on a net basis is required to be made as if the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a trade or business in the United States and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the taxable year for which the income or gain is taken into account (sec. 864(c)(7)).

Allowance of deductions

Effectively connected taxable income is computed taking into account deductions to the extent that they are associated with income that is effectively connected with the conduct of a U.S. trade or business. For this purpose, the issue of the proper apportionment and allocation of deductions generally is addressed in detailed regulations. The regulations applicable to deductions other than interest expense set forth general guidelines for allocating deductions among classes of income and apportioning deductions between effectively-connected and non-effectively-connected income, providing that, in appropriate cases, deductions may be allocated on the basis of units sold, gross sales or receipts, costs of goods sold, profits contributed, expenses incurred, assets used, salaries paid, space utilized, time spent, or gross income received. More specific guidelines are provided for the allocation of research and experimental expenditures, legal and accounting fees, income taxes, losses on dispositions of property, and net operating losses. Interest deductions are subject to a detailed regulatory regime for the allocation and apportionment to effectively-connected income.

b. Investments in U.S. real property

Special U.S. tax rules apply to gains of foreign persons attributable to dispositions of interests in U.S. real property. The rules governing the imposition and collection of tax on such dispositions are contained in a series of provisions that were enacted in 1980 and that are collectively referred to as the Foreign Investment in Real Property Tax Act ("FIRPTA") (secs. 897, 1445, 6039C, and 6652(f)). Prior to the enactment of the FIRPTA provisions, foreign persons could invest in U.S. real property without being subject to U.S. tax upon the eventual disposition of such property.

Imposition of tax

Section 897(a) provides that gain or loss of a foreign person from the disposition of a U.S. real property interest is taken into account for U.S. tax purposes as if such gain or loss were effectively connected with a trade or business within the United States during the taxable year. Accordingly, foreign persons generally are subject to U.S. tax on any gain from a disposition of a U.S. real property

interest at the same rates that apply to similar income received by U.S. persons.

In the case of nonresident alien individuals, the alternative minimum tax applies to the lesser of the individual's alternative minimum taxable income or the individual's net real property gains (sec. 897(a)(2)(A)). Losses of nonresident alien individuals are taken into account under the FIRPTA provisions only to the extent that such losses would be taken into account under Code section 165(c), which limits loss deductions to business losses, losses on transactions entered into for profit, and certain casualty or theft losses (sec. 897(b)).

In the case of foreign corporations, the gain from a disposition of a U.S. real property interest may also be subject to the branch profits tax at a 30-percent rate (or a lower treaty rate). If a foreign corporation that holds a U.S. real property interest is entitled to nondiscriminatory treatment with respect to such interest under an applicable treaty, the foreign corporation may elect to be treated as a U.S. corporation for purposes of the FIRPTA provisions (sec. 897(i)). This election may be made only if all shareholders of the corporation consent to the election and specifically agree that any gain upon the disposition of the interest that would be taken into account under the FIRPTA provisions will be taxable even if such taxation would be contrary to a treaty. This election to be treated as a domestic corporation is the exclusive remedy for any person claiming treaty protection against discriminatory treatment as a result of the FIRPTA provisions.

Definition of U.S. real property interest

Under the FIRPTA provisions, U.S. tax is imposed on gains from the disposition of an interest in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the U.S. Virgin Islands. The term "interest in real property" includes, with respect to both land and improvements thereon, (1) fee ownership and co-ownership, (2) leaseholds, (3) options to acquire, and (4) options to acquire leaseholds (sec. 897(c)(6)(A)). Moreover, the term includes partial interests in real property, such as life estates, remainders, and reversions. In addition, the term includes any direct or indirect right to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, U.S. real property.

Also included in the definition of a U.S. real property interest is any interest (other than an interest solely as a creditor) in any domestic corporation, unless the taxpayer establishes that the corporation was not a U.S. real property holding corporation ("USRPHC") at any time during the five-year period ending on the date of the disposition of the interest (sec. 897(c)(1)(A)(ii)). This general rule does not apply to investments in a publicly-traded USRPHC. Under a special rule, USRPHC stock of a class that is regularly traded on an established securities market is treated as a U.S. real property interest only in the case of a foreign person that, at some time during the five-year period described above, held more than 5 percent of that class of stock (sec. 897(c)(3)). Rules similar to this special rule apply to treat an interest in a publicly-traded partnership as a U.S. real property interest.

A corporation is a USRPHC if the fair market value of such corporation's U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of (1) its U.S. real property interests, (2) its interests in foreign real property, plus (3) any other of its assets which are used or held for use in a trade or business (sec. 897(c)(2)). For purposes of this asset test, a corporation that is a partner in a partnership or a beneficiary of an estate or trust generally takes into account its proportionate share of all assets of such partnership, estate or trust (sec. 897(c)(4)(B)). Look-through rules also apply to a controlling interest (50 percent or more of the fair market value of all classes of stock) held by a corporation in another corporation, whether foreign or domestic (sec. 897(c)(5)).

Special rules applicable to certain transactions

Gain recognized by a foreign person on the disposition of an interest in a partnership, trust, or estate generally is subject to tax under the FIRPTA provisions to the extent that the gain is attributable to any appreciation in the value of any U.S. real property interests of the entity (sec. 897(g)).

As a general rule, nonrecognition provisions apply under the FIRPTA provisions only in the case of an exchange of a U.S. real property interest for an interest the sale of which would be taxable under the Code (sec. 897(e)). This rule is designed to prevent a foreign person from escaping U.S. tax by exchanging a taxable asset for a nontaxable asset in an exchange which would otherwise qualify for nonrecognition treatment under the Code. Specific rules apply to require gain recognition in certain cases. In this regard, foreign corporations are required in certain circumstances to recognize gain upon the distribution (including a distribution in liquidation or redemption) to their shareholders of appreciated U.S. real property interests (sec. 897(d)(1)). Moreover, gain generally is recognized by a foreign person under the FIRPTA provisions on the transfer of a U.S. real property interest to a foreign corporation if the transfer is made as paid-in surplus or as a contribution to capital.

Withholding on dispositions by foreign persons of U.S. real property interests

The Code generally imposes a withholding obligation when a U.S. real property interest is acquired from a foreign person (sec. 1445). The withholding obligation generally is imposed on the transferee; however, in certain limited circumstances, an agent of the transferor or transferee is required to withhold. Any tax imposed on a foreign person under the FIRPTA provisions in excess of the amount withheld remains the liability of the foreign person.

The amount required to be withheld on the sale by a foreign person of a U.S. real property interest generally is 10 percent of the amount realized on the transaction (i.e., the gross sales price) (sec. 1445(a)). However, a certificate for reduced withholding may be issued by the IRS such that the amount required to be withheld will not exceed the transferor's maximum tax liability (sec. 1445(c)(1)).

There are several exemptions from the obligation to withhold on a disposition of a U.S. real property interest. First, withholding by

the transferee generally is not required if the transferor furnishes to the transferee an affidavit stating, under penalty of perjury, that the transferor is not a foreign person and providing the transferor's taxpayer identification number (sec. 1445(b)(2)). Second, withholding is not required on the disposition of an interest in a domestic corporation if the corporation furnishes an affidavit to the transferee stating, under penalty of perjury, that the corporation is not a USRPHC and has not been a USRPHC during the five-year period ending on the date of disposition (sec. 1445(b)(3)). Third, withholding may be reduced or eliminated if the transferee receives a qualifying statement issued by the IRS that the transferor is exempt from tax or either the transferor or the transferee has provided adequate security (or has made other arrangements for payment of the tax) (sec. 1445(b)(4)). Fourth, withholding is not required if the transferee intends to use the transferred real property as a residence, and the amount realized by the transferor on the disposition of the property is $300,000 or less (sec. 1445(b)(5)). Fifth, withholding is not required on a disposition of stock of a class that is regularly traded on an established securities market (sec. 1445(b)(6)).

Special withholding rules apply in the case of certain dispositions of U.S. real property interests by partnerships, trusts, and estates; certain distributions by foreign or domestic corporations, partnerships, trusts and estates; and certain dispositions of interests in partnerships, trusts, and estates.

4. Gross-basis taxation

a. Withholding tax

In the case of U.S. source interest, dividends, rents, royalties, or other similar types of income (known as fixed or determinable, annual or periodical gains, profits and income), the United States generally imposes a flat 30-percent tax on the gross amount paid to a foreign person if such income or gain is not effectively connected with the conduct of a U.S. trade or business (secs. 871(a) and 881). This tax generally is collected by means of withholding by the person making the payment to the foreign person receiving the income (secs. 1441 and 1442). Accordingly, the 30-percent gross-basis tax is generally referred to as a withholding tax. In most instances, the amount withheld by the U.S. payor is the final tax liability of the foreign recipient, and thus the foreign recipient files no U.S. tax return with respect to this income.

The United States generally does not tax capital gains of a foreign corporation that are not connected with a U.S. trade or business. Capital gains of a nonresident alien individual that are not connected with a U.S. business generally are subject to the 30-percent gross-basis tax only if the individual was present in the United States for 183 days or more during the year (sec. 871(a)(2)). Also subject to tax at a flat rate of 30 percent are any foreign person's gains from the sale or exchange of patents, copyrights, trademarks, and other like property, or of any interest in such property, to the extent the gains are from payments that are contingent on the productivity, use, or disposition of the property or interest sold or exchanged (secs. 871(a)(1)(D) and 881(a)(4)).

As discussed in Part II.B.3.b. above, gains of a foreign individual or corporation on the disposition of U.S. real property interests are taxed on a net basis under FIRPTA, even if they are not otherwise effectively connected with a U.S. trade or business. Similarly, rental and other income from U.S. real property may be taxed, at the election of the taxpayer, on a net basis at graduated rates (secs. 871(d) and 882(d)).

Although payments of U.S. source interest that is not effectively connected with a U.S. trade or business generally are subject to the 30-percent withholding tax, there are significant exceptions to that rule. For example, interest from certain deposits with banks and other financial institutions is exempt from tax (secs. 871(i)(2)(A) and 881(d)). Original issue discount on obligations maturing in six months or less is also exempt from tax (secs. 871(a)(1)(A) and (C) and 881(a)(1)(3)). An additional exception is provided for certain interest paid on portfolio obligations (secs. 871(h) and 881(c)). Portfolio interest generally is defined as any U.S. source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (1) on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) that is not received by a 10-percent shareholder (sec. 871(h)). This exception is not available for any interest received either by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), or by a controlled foreign corporation from a related person (sec. 881(c)(3)). Moreover, this exception is not available for certain contingent interest payments (sec. 871(h)(4)).

b. Excise tax on insurance premiums paid to foreign insurers

The United States imposes an excise tax on policies of insurance, indemnity bonds, annuity contracts, and policies of reinsurance issued by a foreign insurer or reinsurer (1) to or for (or in the name of) a domestic corporation or partnership or a U.S. resident individual with respect to risks wholly or partly within the United States, or (2) to or for (or in the name of) any foreign person engaged in business within the United States with respect to risks within the United States (secs. 4371 and 4372). The excise tax is 4 percent of the premiums paid on a policy of casualty insurance or an indemnity bond, and generally 1 percent on all other premiums (sec. 4371). The excise tax does not apply to an amount effectively connected with the conduct of a trade or business in the United States (unless such amount is exempt from net basis U.S. tax under a treaty) (sec. 4373).

c. Branch level taxes

A U.S. corporation owned by foreign persons is subject to U.S. income tax on its net income. In addition, the earnings of the U.S. corporation are subject to a second tax, this time at the shareholder level, when dividends are paid. As discussed above, when the shareholders are foreign, the second-level tax is imposed at a flat rate and collected by withholding. Similarly, as discussed above, interest payments made by a U.S. corporation to foreign creditors are subject to a U.S. withholding tax in certain circumstances. Pursu-

ant to the branch tax provisions, the United States taxes foreign corporations engaged in a U.S. trade or business on amounts of U.S. earnings and profits that are shifted out of, or amounts of interest deducted by, the U.S. branch of the foreign corporation. The branch level taxes are comparable to these second-level taxes. In addition, where a foreign corporation is not subject to the branch profits tax as the result of a treaty, it may be liable for withholding tax on actual dividends it pays to foreign shareholders.

The United States imposes a tax of 30 percent on a foreign corporation's "dividend equivalent amount" (sec. 884(a)). The "dividend equivalent amount" generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected with a U.S. trade or business (sec. 884(b)). The following earnings and profits attributable to income effectively connected with a U.S. trade or business are excluded from the imposition of branch profits tax: (1) certain earnings derived by FSC; (2) certain foreign transportation earnings; (3) earnings derived from the sale of any interest in U.S. real property holding corporations; (4) earnings derived by certain corporations organized in a U.S. possession; and (5) earnings derived by certain captive insurance companies (sec. 884(d)(2)).

In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted to reflect changes in a branch's U.S. net equity (i.e., the excess of the branch's assets over its liabilities, taking into account only amounts treated as connected with its U.S. trade or business) (sec. 884(b)). The first adjustment reduces the dividend equivalent amount to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities). The second adjustment increases the dividend equivalent amount to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation.

Interest paid by a U.S. trade or business of a foreign corporation generally is treated as if paid by a U.S. corporation and therefore is subject to U.S. 30-percent withholding tax (if the interest is paid to a foreign person) (sec. 884(f)(1)(A)). Certain "excess interest" of a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation to a foreign parent and therefore is subject to U.S. 30-percent withholding tax (sec. 884(f)(1)(B)). For this purpose, excess interest is the excess of the interest deduction allowed with respect to the U.S. trade or business over the amount of interest paid by such trade or business.

If the branch profits tax otherwise would be applicable but is prohibited by a treaty between the United States and the country of residence of a foreign corporation, then 30-percent withholding tax may be imposed on dividends paid by the foreign corporation.

C. Income Tax Treaties

1. In general

In addition to the U.S. and foreign statutory rules for the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the

other treaty partner. Treaties also contain provisions governing the creditability of taxes imposed by the treaty country in which income was earned in computing the amount of tax owed to the other country by its residents with respect to such income. Treaties further provide procedures under which inconsistent positions taken by the treaty countries with respect to a single item of income or deduction may be mutually resolved by the two countries.

The preferred tax treaty policies of the United States have been expressed from time to time in model treaties and agreements. The Organisation for Economic Co-operation and Development (the "OECD") also has published model tax treaties. In addition, the United Nations has published a model treaty for use between developed and developing countries. The Treasury Department, which together with the State Department is responsible for negotiating tax treaties, last published a proposed model income tax treaty in June 1981 (the "U.S. model"). The Treasury Department's current working model includes provisions different from those in the 1981 model, in part due to the substantial changes in U.S. statutory international tax provisions. The OECD last published a model income tax treaty in 1992 ("the OECD model"). The United Nations last published a model income tax treaty in 1980 ("the U.N. model").

Many of the U.S. income tax treaties currently in effect diverge in one or more respects from the U.S. model treaty. These divergences may reflect the age of a particular treaty or the particular balance of interests between the United States and the treaty partner. Other countries' preferred tax treaty policies may differ from those of the United States, depending on their internal tax laws and depending upon the balance of investment and trade flows between those countries and their potential treaty partners. For example, certain capital importing countries may be interested in imposing relatively high tax rates on interest, royalties, and personal property rents paid to residents of the other treaty country. Consequently, treaties with such countries may have higher withholding rates on dividends, interest, royalties, and personal property rents. As another example, the other country may demand other concessions in exchange for agreeing to requested U.S. terms. Countries that impose income tax on certain local business operations at a relatively low rate (or a zero rate) in order to attract manufacturing capital may seek to enter into "tax-sparing" treaties with capital exporting countries. In other words, the country may seek to enter into treaties under which the capital exporting country gives up its tax on the income of its residents derived from sources in the first country, regardless of the extent to which the first country has imposed tax with respect to that income. While other capital exporting countries have agreed to such treaties, the United States has rejected proposals by certain foreign countries to enter into such tax-sparing arrangements.

The OECD, the U.N., and the U.S. models reflect a standardization of terms that serves as a useful starting point in treaty negotiations. However, issues may arise between the United States and a particular country that of necessity cannot be addressed with a model provision. Because a treaty functions as a bridge between two actual tax systems, one or both of the parties to the negotia-

tions may seek to diverge from the models to account for specific features of a particular tax system.

2. Model income tax treaty provisions

Significant features of the model income tax treaties are described briefly below.

Residence

The U.S. model generally treats as a resident of a treaty country any person who, under the laws of that country, is liable to tax therein by reason of its domicile, residence, citizenship, place of management, place of incorporation, or any other similar criterion. However, the concept of resident excludes any person who is liable to tax in a country solely in respect of income from sources in that country or capital located there.

Business profits attributable to a permanent establishment

Under the U.S. model, one treaty country may not tax the business profits of an enterprise of a qualified resident of the other treaty country through a permanent establishment in that country. The U.S. model describes in detail the characteristics relevant to determine whether a place of business is a permanent establishment. The term includes a place of management, a branch, an office, a factory, a worship, a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

The U.S. model provides that the business profits to be attributed to the permanent establishment include only the profits derived from the assets or activities of the permanent establishment. The U.N. model adds a limited "force of attraction rule" which would allow the country in which the permanent establishment is located to attribute to the permanent establishment sales in that country of goods or merchandise of the same or similar kind as those sold through the permanent establishment, and to attribute to the permanent establishment other business activities carried on in that country of the same or similar kind as those effected through the permanent establishment.

The U.S., OECD, and U.N. models expressly provide for the allocation of worldwide executive and general administrative expenses in determining business profits attributable to a permanent establishment. The U.S. model also provides for the allocation of research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part of the enterprise that includes the permanent establishment).

Dividends

The U.S. model permits taxation of dividends by the residence country of the payor, but limits the rate of such tax in cases in which the beneficial owner of the dividends is a resident of the other treaty country. In such cases, the U.S. model allows not more than a 5-percent gross-basis tax if the beneficial owner is a company which owns at least 10 percent of the payor's voting stock, and not more than a 15-percent gross-basis tax in any other case. Under the OECD model, the 5-percent rate is not available unless the beneficial owner of the dividends is a company other than a

partnership which holds directly at least 25 percent of the capital of the dividend payor. The U.N. model expressly leaves to case-by-case bilateral negotiation the particular percentage limit to be imposed on source country taxation of dividends.

Interest and royalties

The U.S. model generally allows no tax to be imposed by a treaty country on interest or royalty income derived and beneficially owned by a resident of the other treaty country. By contrast, the OECD model would permit up to 10-percent gross-basis taxation of interest by the treaty country in which the interest arises. The U.N. model expressly leaves to case-by-case bilateral negotiation the particular percentage limit to be imposed on source country taxation of interest or royalties.

Other income

The U.S. model provides that items of income, wherever arising, that are not dealt with in the articles of the treaty are taxable only by the recipient's country of residence. By contrast, the U.N. model states that items of income of a resident of a treaty country not dealt with in the other treaty articles and arising in the other treaty country may also be taxed in that other country.

Relief from double taxation

The U.S. model obligates the United States to allow its residents and citizens as a credit against U.S. income tax: (a) income taxes paid to the treaty country by the U.S. person, and (b) in the case of a U.S. company owning at least 10 percent of the voting stock of a company resident in the treaty country, and from which the U.S. company receives dividends, the treaty country income tax paid by the distributing company with respect to the profits out of which the dividends are paid. However, the U.S. model preserves U.S. internal law by subjecting this right to the foreign tax credit to the provisions and limitations of U.S. law as it may be amended from time to time without changing the general principle of the model provision. The U.S. model states that credits allowed for treaty country taxes shall not in any taxable year exceed that proportion of the U.S. tax on income which taxable income arising in the treaty country bears to total taxable income.

A standard article in treaties specifies the U.S. and foreign taxes covered by the treaty. The U.S. model treaty provides that such covered taxes shall be considered income taxes for purposes of the credit article, and contemplates the possibility that such a tax might be creditable solely by reason of the treaty.

Nondiscrimination

The U.S. model treaty provides that nationals of a treaty country, wherever they may reside, shall not be subjected in the other country to any taxation (or any requirement connected therewith) which is other or more burdensome than the taxation and connected requirements to which nationals of that other country in the same circumstances are or may be subjected. Similarly, the taxation of a permanent establishment which an enterprise of a treaty country resident has in the other country generally shall not be

less favorably levied in the source country than the taxation levied on enterprises of source country residents carrying on the same activities. Further, an enterprise of a source country resident, the capital of which is wholly or partly owned or controlled by residents of the other country, shall not be subjected in the source country to any taxation (or any requirement connected therewith) which is other or more burdensome than the taxation and connected requirements to which other similar source country enterprises are or may be subjected. Finally, the model generally provides (subject to certain arm's length standards) that interest, royalties, and other disbursements paid by a treaty country resident to a resident of the other country shall, for the purposes of determining the taxable profits of the payor, be deductible under the same conditions as if they had been paid to a resident of the source country.

Mutual agreement procedures

The U.S. model provides for a treaty country resident or national to obtain relief, from the competent authority of the person's home country, from actions of either or both countries that are considered to result in taxation in violation of the treaty. The model requires the competent authorities to endeavor to resolve such a case by mutual agreement where the home country authority cannot do so unilaterally.

III. BACKGROUND AND DATA RELATING TO THE TAXATION OF INTERNATIONAL TRANSACTIONS

This part presents background data relating to the scope of the international trade sector in the United States economy. This part discusses the economic relationship between trade deficits, capital inflows, investment, and savings in the economy. It briefly reviews trends in both the current account (the trade surplus or deficit) and the capital account (U.S. investment abroad and foreign investment in the United States). This part also presents data related to present-law taxation of foreign-source income.

A. Trade Deficits and Cross Border Capital Flows

National income accounting

In popular discussion of trade issues, much attention is given to the trade deficit or surplus, that is, the difference between the exports and imports of the economy. In the late 1980s, there was also attention given to inflows of capital from abroad. Capital inflows can take the form of foreign purchases of domestic physical assets, of equity interests, or of debt instruments. These two phenomena, trade balances and capital inflows, are not independent, but are related to each other. Trade deficits, capital inflows, investment, savings, and income are all connected in the economy. The connection between these economic variables can be examined through the national income and product accounts, which measure the flow of goods and services and income in the economy.[9]

The value of an economy's total output must be either consumed domestically (by private individuals and government), invested domestically, or exported abroad. If an economy consumes and invests more than it produces, it must be a net importer of goods and services. If the imports were all consumption goods, in order to pay for those imports, the country must either sell some of its assets or

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[9] The national income and product accounts measure the flow of goods and services (product) and income in the economy. The most commonly reported measure of national economic income is gross domestic product (GDP). Related to GDP is gross national product (GNP). GNP is GDP plus the net factor income received by residents of United States from abroad. Thus, wages earned by a U.S. resident from temporary work abroad constitutes part of GNP but not GDP. Similarly, the returns from investment abroad constitute part of GNP but not GDP. To help understand the connection between trade deficits and cross border capital flows, in the following it is useful to use GNP, which includes cross border returns to investment, rather than the more commonly reported GDP concept. The GNP of the economy is the total annual value of goods and services produced by the economy and may be measured in several ways. One way to measure GNP is by expenditures on final product. By this measure,

(1) GNP = C + I + G + (X-M) + NI.

Equation (1) is an accounting identity which states that gross national product equals the sum of private consumption expenditures (C), private investment expenditures on plant, equipment, inventory, and residential construction (I), government purchases of goods and services (G), net exports (exports less imports of goods and services and net interest payments to foreigners, or X-M), plus net investment income (the excess of investment income received from abroad over investment income sent abroad or NI).

An alternative is to measure GNP by the manner in which income is spent. By this measure,

(2) GNP = C + S + T.

Equation (2) is another accounting identity which states that gross national product equals the sum of private consumption expenditures (C), saving by consumers and businesses (S), and net tax payments to the government (T) (net tax payments are total tax receipts less transfer, interest, and subsidy payments made by all levels of government).

Because both measures of GNP are simple accounting identities, the right hand side of equation (1) must equal the right hand side of equation (2). From this observation can be derived an additional national income accounting identity:

(3) I = S + (T - G) + (M - X) - NI

Equation (3) states that private investment equals private saving (S), plus public saving (T-G) and net imports (M - X), less net investment income.

borrow from foreigners. If the imports were investment goods, foreign persons would own the investments. Thus, an economy that runs a trade deficit will also experience foreign capital inflows as foreign persons purchase domestic assets, make equity investments or lend funds (purchase debt instruments).

For example, when the United States imports more than it exports, the United States pays for the imports with dollars. If foreigners are not buying goods with the dollars, then they will use the dollars to purchase U.S. assets. (An alternate way of viewing these relationships is that dollars flowing out of the U.S. economy in order to purchase goods or to service foreign debt must ultimately return to the economy as payment for exports or as capital inflows.)

The previous discussion focuses on the disposition of the economy's output. If the economy is a net importer, it must attract capital inflows to pay for those imports. If the economy is a net exporter, it must have capital outflows to dispose of the payments it receives for its exports. Another way of looking at the connection between capital flows and the goods and services in the economy is to concentrate on the sources of funds for investment. Because domestic investment must be financed either through saving or foreign borrowing, net capital inflows must also equal the difference between domestic investment and saving.

These relationships can be summarized as follows (the equation ignores relatively small unilateral transfers such as foreign aid and assumes, without loss of generality, that the government budget is balanced):

$$\text{Net Foreign Borrowing} = \text{Investment} - \text{Saving} = (\text{Imports} - \text{Exports}) - \text{Net Investment Income}.$$

For this purpose, imports and exports include both goods and services, and net investment income is equal to the excess of investment income received from abroad over investment income sent abroad.[10] The excess of imports over exports is called the trade deficit in goods and services. Net investment income can be viewed as payments received on previously-acquired foreign assets (foreign investments) less payments made to service foreign debt.

If the investment in an economy is larger than that country's saving, the country must either be running a trade deficit or the economy is increasing its foreign borrowing. Similarly, a country cannot run a trade surplus without also exporting capital, either by increasing its foreign investments, or by servicing previously-acquired foreign debt. Because the level of net investment income in any year is fixed by the level of previous foreign investment (except for changes in interest rates), changes in investment or saving that are associated with capital inflows will have a negative impact on a country's trade balance.

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[10] This equation in the text can be seen from equation (3) in footnote 9 above if the government budget is assumed to be balanced, that is, if G = T. It follows that if the government runs a deficit, that is, if G>T, for a given level of investment, saving, and net investment income, net foreign borrowing must be greater.

Economic implications of trade deficits

A trade deficit is not necessarily undesirable. What is important is the present and future consumption possibilities of the economy. That will depend in part on whether the trade deficit is financing consumption or investment. For example, if a country uncovers profitable investment opportunities, then it will be in that country's interest to obtain funds from abroad to invest in these profitable projects.[11] If the economy currently does not have enough domestic saving to invest in these projects, it could reduce its consumption (generating more domestic saving) or look to foreign sources of funds (thus allowing investment without reducing current consumption). For example, suppose new oil reserves that could be profitably recovered through increased investment are discovered in the United States. The investment may be financed by foreigners. In order to invest in U.S. assets, foreigners will have to buy dollars, thus increasing the value of the dollar. This dollar appreciation makes U.S. goods more expensive to foreigners, thereby reducing their demand for U.S. exports. At the same time, the dollar appreciation makes foreign goods cheaper for U.S. residents, increasing the demand for imports and resulting in a trade deficit. Eventually, the flow of capital will be reversed, as the U.S. demand for new investment falls, and foreigners receive interest and dividend payments on their previous investments.

The foreign borrowing in the above example was used to finance investment. This borrowing did not reduce the living standards of current or future U.S. residents, because the interest and dividends that were paid to foreigners came from the return from the new investment. If foreign borrowing finances consumption instead of investment, there are no new assets created to generate a return that can support the borrowing. When the debt eventually is repaid, the repayments will come at the expense of future consumption. For instance, consider a situation in which the domestic supply of funds for investment decreases because domestic saving rates fall. Foreign borrowing in this case is not associated with increased investment, but instead is devoted to investment that was previously financed with domestic savings. Because the foreign borrowing is not associated with increased investment, future output does not increase, and interest and dividends on the investment will be paid to foreign persons at the expense of future domestic consumption. In this case, there may be an increase in the standard of living for current U.S. residents at the expense of a decrease in the standard of living of future residents.

During the period that foreign borrowing finances U.S. consumption, the United States runs a trade deficit. Although the United States could service its growing foreign debt by increased borrowing, and hence larger trade deficits, in the long run trade deficits cannot keep growing. In fact, the United States must eventually run a trade surplus. If the United States imported more goods than it exported every year, there also would be an inflow of foreign capital every year. This capital inflow would be growing with the increasing costs of servicing the foreign debt. Eventually, foreigners

[11] This scenario describes the experience of the United States in the mid to late 1800s, when foreign capital inflows financed much of the investment in railroads and other assets.

would be unwilling to continue lending to the United States, and the value of the dollar would fall. The fall in the dollar would eliminate the trade deficit, and the United States would eventually run a trade surplus, so that the current account deficit (the sum of the trade deficit in goods and services and the net interest on foreign obligations) would be small enough for foreigners to be willing to lend again to the United States.

Even when foreign investment finances domestic consumption, trade deficits and capital inflows themselves should not necessarily be viewed as undesirable, because the foreign capital inflows help to keep domestic investment, and hence labor productivity, from falling. For instance, the large inflow of foreign capital to the United States in the 1980s is widely viewed to be a result of low U.S. saving rates. If the mobility of foreign capital had been restricted (through capital or import controls, for example), then the low saving rate could have led to higher domestic interest rates and lower rates of investment. That decreased investment would have led to decreases in future living standards because the lower growth rate of the capital stock would have resulted in lower growth rates of U.S. labor productivity. The fact that foreign capital was not restricted and did finance U.S. investment helped mitigate the negative effects on economic growth of low domestic saving.

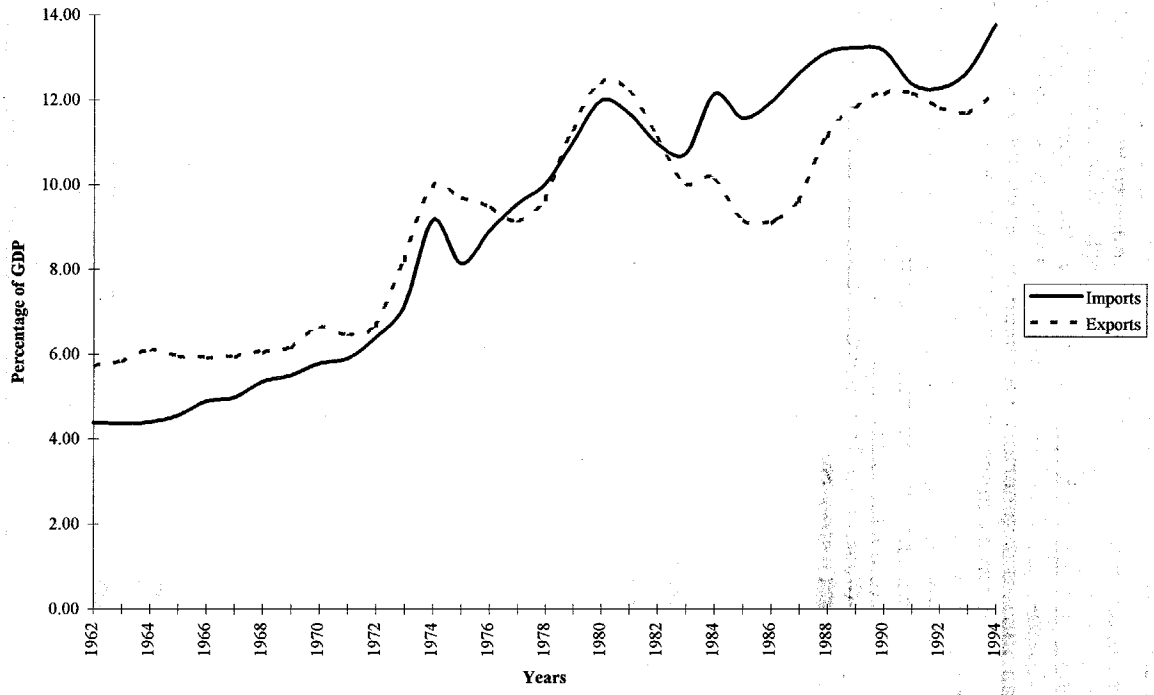
The above observations support the argument that the trade deficit does not in itself provide a useful measure of international competitiveness, since trade deficits and trade surpluses can be either good or bad for the United States. The example of oil discovery discussed above shows that even increases in a country's stock of exportable goods can have ambiguous effects on the trade deficit. If the discovery of oil also increases the demand for investment, then the trade deficit may actually increase in the short run. Increases in natural resources, advances in technology, increases in worker efficiency, and other wealth-enhancing innovations have ambiguous effects on the trade deficit in the short and medium run. Because these innovations increase the productivity of U.S. workers and lower production costs, they increase the attractiveness of U.S. goods, and may result in increased exports. To the extent these innovations increase the demand for investment, however, they can have the opposite effect on the trade deficit. Nonetheless, each of these innovations increases the output of the economy, and hence the incomes of U.S. residents.

B. Trends in the United States' Balance of Payments

Foreign trade has become increasingly important to the United States economy. Figure 1 presents the value of exports from the United States and imports into the United States as a percentage of GDP for the period 1962–1994.[12] As depicted in Figure 1, exports and imports each have risen from less than six percent of GDP in 1962 to more than 11 percent in 1994. Figure 1 also shows that the United States generally was a net exporter of goods and services prior to 1982. Since that time, the United States has been a net importer of goods and services.

[12] Data for Figure 1 are from the U.S. Commerce Department, Bureau of Economic Analysis and are reprinted in Appendix Tables A.1. and A.2.

Figure 1.-- Exports and Imports as a Percentage of United States GDP, 1962-1994

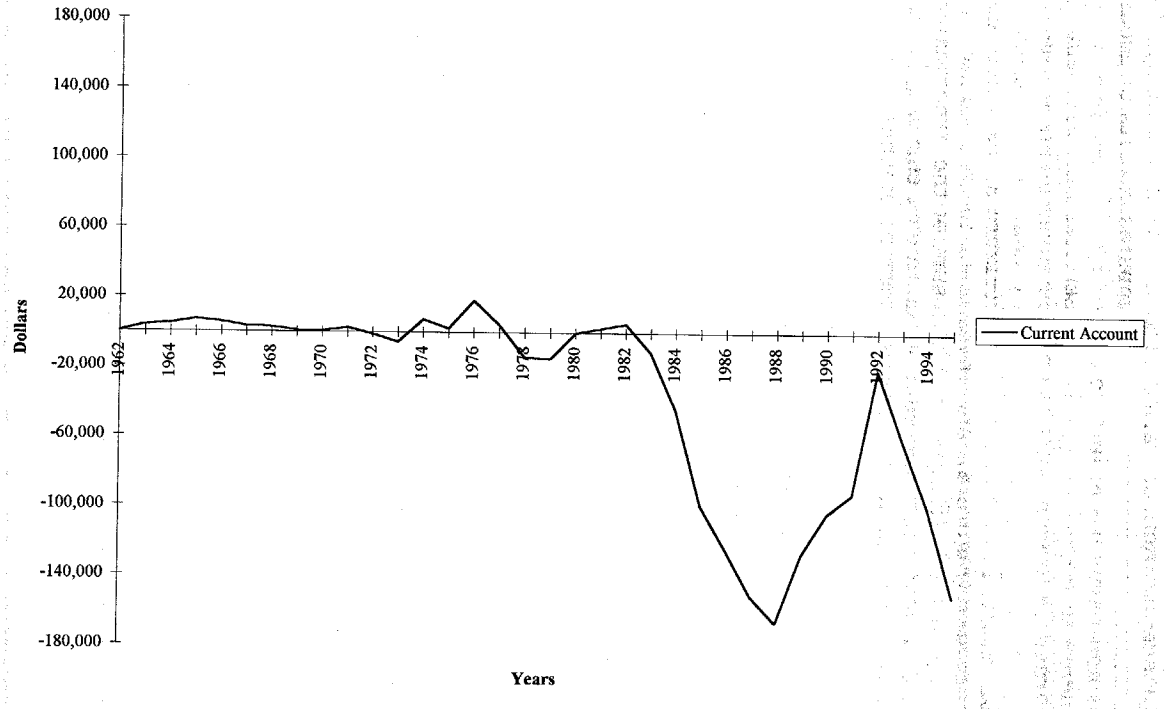


Source: Department of Commerce, Bureau of Economic Analysis

The net trade position of a country is commonly summarized by its current account. The U.S. current account as a whole, which compares exports of goods and services and income earned by U.S. persons on foreign investments to imports of goods and services and income earned by foreign persons on their investments in the United States (plus unilateral remittances), was positive as recently as 1981, but generally has been in deficit by over $90 billion per year nine times since 1984. Figure 2 reports the current account balance of the United States for the period 1962 through 1994 in nominal (non-inflation-adjusted) dollars.[13] Figure 2, like Figure 1, shows the United States' change in status from net exporter to net importer since the early 1980s. Figure 2 reflects a substantial reduction in the current account deficit for 1992. In that year, the United States received substantial payments from abroad related to the Persian Gulf war.

[13] Data for Figure 2 are from the U.S. Commerce Department, Bureau of Economic Analysis and are reprinted in Appendix Table A.1.

Figure 2.--United States Current Account Balance, 1962-1994
[millions nominal dollars]

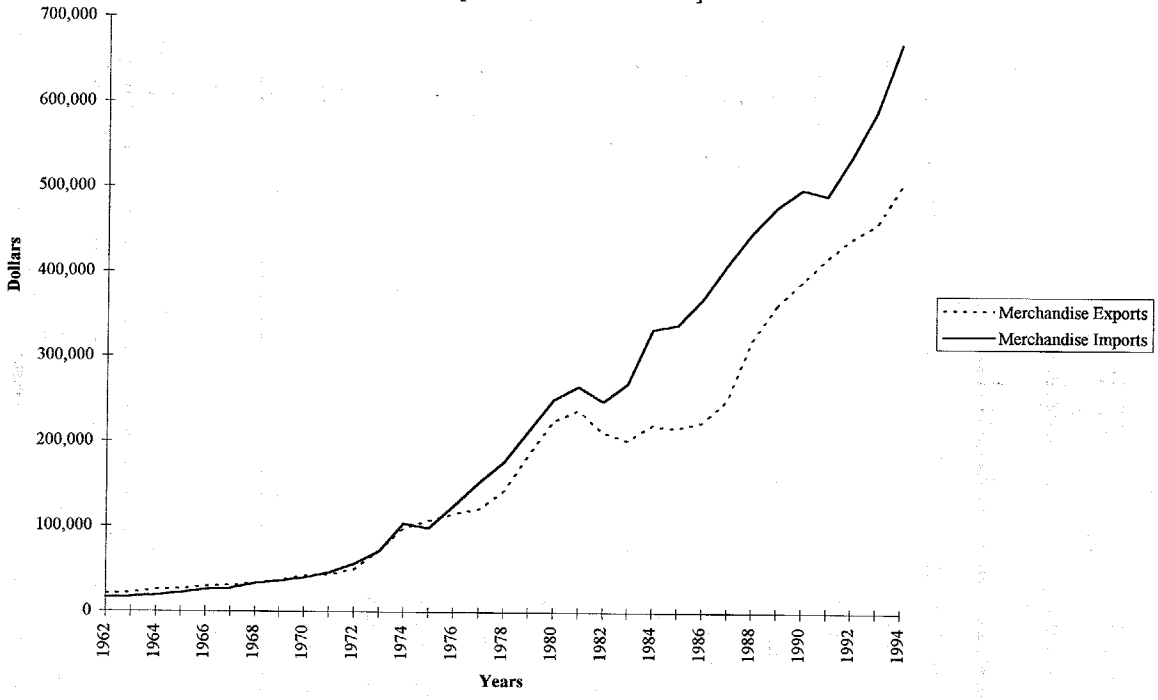


Source: Department of Commerce, Bureau of Economic Analysis

The aggregate data reported in Figures 1 and 2 mask differences in the trade position of various sectors of the economy. As explained above, the current account compares exports of goods and services and payments of income earned by U.S. persons on foreign investments to imports of goods and services and payments of income earned by foreign persons on their investments in the United States. Figures 3, 4, and 5 separately chart the nominal dollar value of exported and imported goods (Figure 3), exported and imported services (Figure 4), and investment income earned by U.S. and foreign persons (Figure 5).[14] The sum of the export curves in Figures 3, 4, and 5 less the sum of the import curves (plus unilateral remittances) equals the current account balance curve of Figure 2.

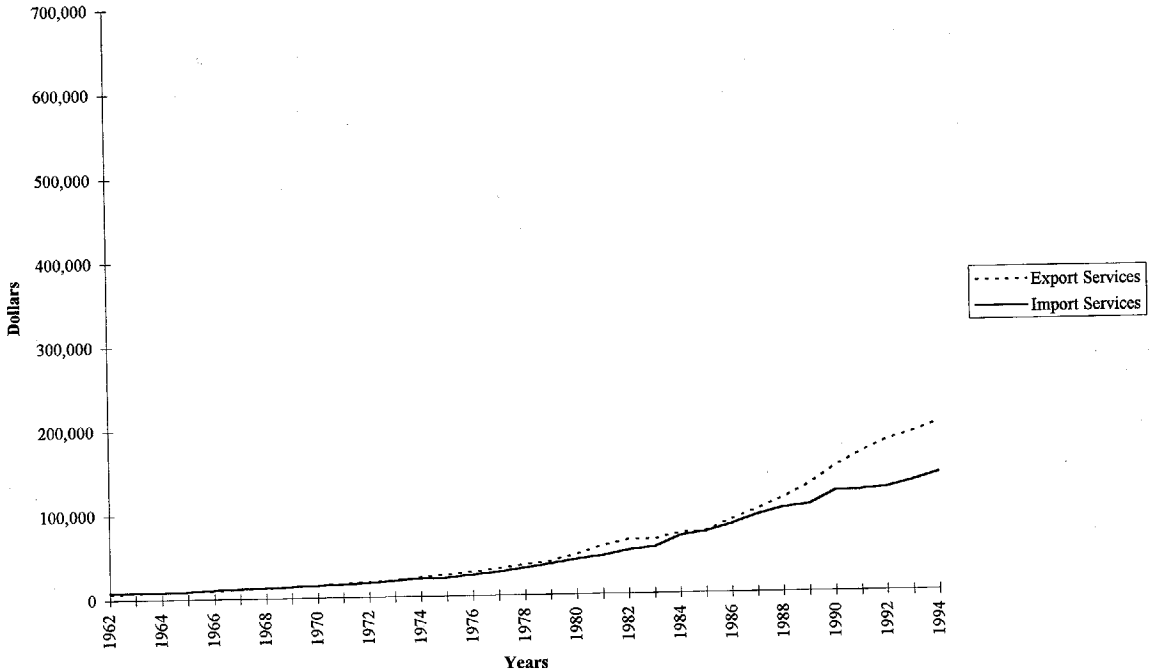
[14] Data for Figures 3, 4, and 5 are from the U.S. Commerce Department, Bureau of Economic Analysis and are reprinted in Appendix Table A.1.

Figure 3.--U.S. Merchandise Trade, 1962-1994
[millions nominal dollars]



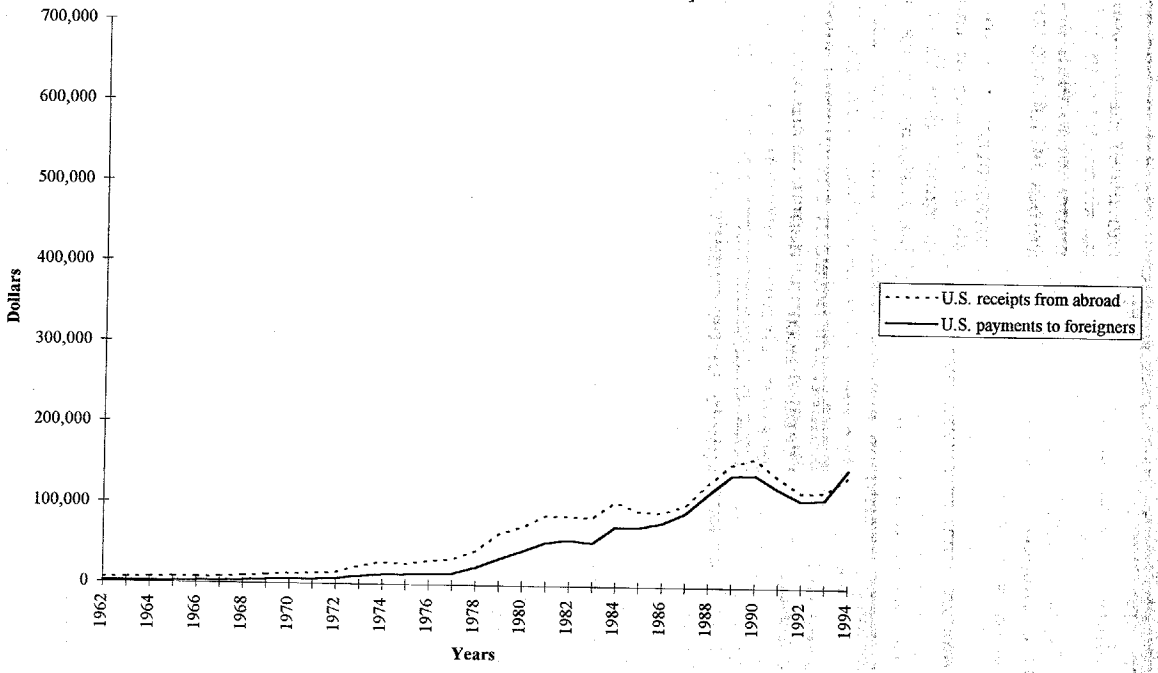
Source: Department of Commerce, Bureau of Economic Analysis

Figure 4.--Trade in Services, 1962-1994
[millions nominal dollars]



Source: Department of Commerce, Bureau of Economic Analysis

Figure 5.--U.S. Receipts of Income from Abroad and U.S. Payments to Foreign Persons, 1962-1994
[millions nominal dollars]



Source: Department of Commerce, Bureau of Economic Analysis

Figures 3, 4, and 5 reveal different trends. As has been widely reported, the merchandise (goods only) trade deficit has been over $100 billion per year since 1984. On the other hand, the United States has been a net exporter of services since the mid-1970s (Figure 4). Only in 1994 did payments of income to foreign persons on their U.S. investments exceed U.S. receipts of income on investments abroad (Figure 5).

The balance of payments accounts, presented in Table 1, are analogous to a sources and uses of funds statement of the United States with the rest of the world. As demonstrated in Part III.A. above, the current account balance, which consists primarily of the trade balance, should be exactly offset by the capital account balance, which measures the net inflow or outflow of capital to or from the United States. The difference between the current account surplus or deficit and the capital account deficit or surplus is recorded as a statistical discrepancy. Serious problems of measurement cause the accounts to be somewhat mismatched in practice, but basic patterns are unlikely to be significantly distorted by these problems.

Table 1.—International Transactions of the United States, Selected Years

[In billions of nominal dollars]

	1975	1980	1985	1990	1994
Current Account Balance	**18.1**	**2.3**	**−124.2**	**−92.7**	**−151.2**
Exports of Goods and Services	157.9	344.4	382.7	697.4	838.8
Merchandise	107.1	244.3	215.9	389.3	502.5
Services	25.5	47.6	73.2	147.8	198.7
Receipts from U.S. assets abroad	25.4	72.6	93.7	160.3	137.6
Imports of Goods and Services	132.7	333.8	484.0	756.7	954.3
Merchandise	98.2	249.8	338.1	498.3	668.6
Services	22.0	41.5	72.9	118.8	138.8
Payments on foreign-owned U.S. assets	12.6	42.5	73.1	139.6	146.9
Unilateral Transfers	7.1	8.3	23.0	33.4	35.8
Capital Account Balance	**−24.0**	**−27.7**	**101.3**	**48.2**	**165.5**
Foreign Investment in the U.S.	15.7	58.1	141.2	122.2	291.4
Direct Investment	2.6	16.9	20.0	47.9	49.4
Private non-direct investment	6.0	25.7	122.3	40.4	202.5
Official	7.0	15.5	−1.1	33.9	39.4
U.S. Investment Abroad	39.7	87.0	39.9	74.0	125.9

Table 1.—International Transactions of the United States, Selected Years—Continued

[In billions of nominal dollars]

	1975	1980	1985	1990	1994
Direct Investment	14.2	19.2	14.1	30.0	49.4
Private non-direct investment	21.1	54.4	19.1	44.2	81.5
Increase in government assets	4.3	13.3	6.7	−0.1	−5.0
Allocation of Special Drawing Rights	.....	1.2	.....	.....	.....
Statistical Discrepancy	**5.9**	**25.4**	**23.0**	**44.5**	**−14.3**

Source: Douglas B. Weinberg, "U.S. International Transactions, First Quarter 1995," *Survey of Current Business,* U.S. Department of Commerce, Bureau of Economic Analysis, June 1995, pp. 76–117.

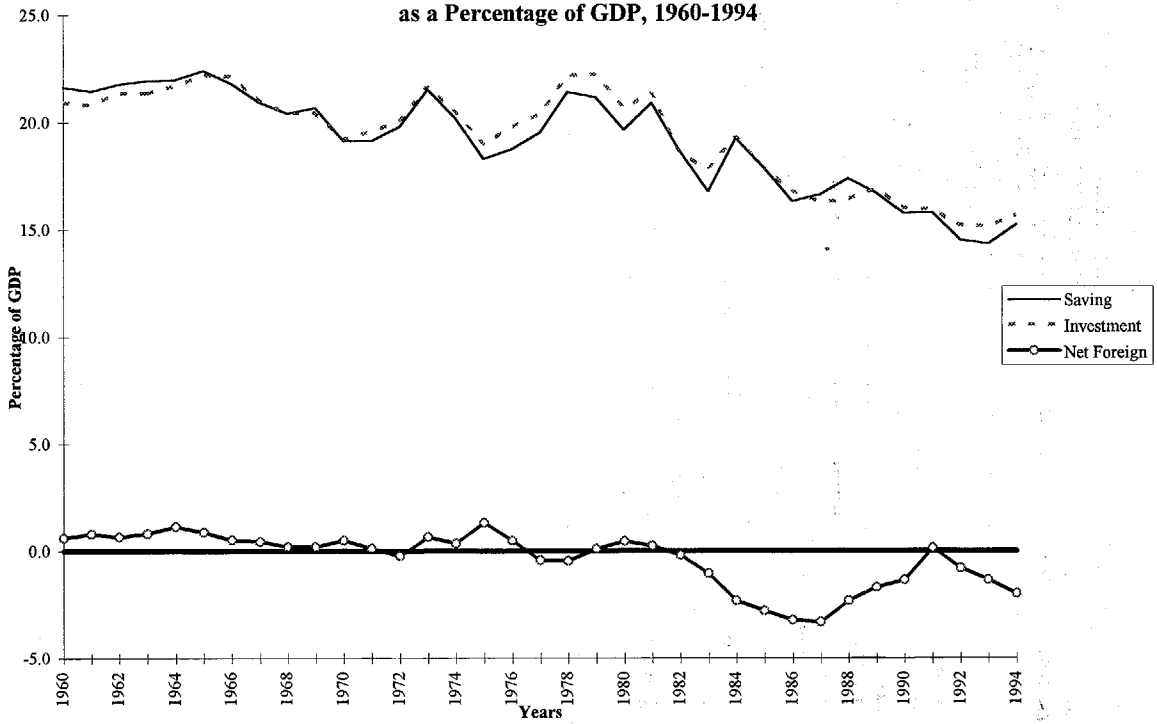
C. Trends in the United States' Capital Account

Overview of the United States' capital account

As explained in III.A. above, when the United States imports more than it exports, the dollars the United States uses to buy the imports must ultimately return to the United States as payment for U.S. exports or to purchase U.S. assets. As Figure 2 and Table 1 document the United States' current account has been in deficit since the early 1980s. Figure 6 plots gross (before depreciation) U.S. investment and gross U.S. saving as a percentage of GDP for the period 1962–1994.[15] Figure 6 also plots net foreign investment as a percentage of GDP. In Figure 6, when the United States is a net exporter of capital, net foreign investment is measured as a positive number and when the United States is a net importer of foreign capital net foreign investment is measured as a negative number. Net foreign investment became a larger proportion of the economy since 1982. At the same time, the United States changed from being a modest exporter of capital in relation to GDP to being a large importer of capital. Net foreign investment has become a larger proportion of the economy and a more significant proportion of total domestic investment than in the past. In 1994, gross investment in the United States was $1,087 billion and net foreign investment was $140 billion, or 12.8 percent of gross domestic investment. In 1993, net foreign investment comprised 8.9 percent of gross domestic investment.

[15] Data for Figure 6 are from the U.S. Department of Commerce, Bureau of Economic Analysis and are reprinted in Appendix Table A.2.

Figure 6.--Saving, Investment, and Net Foreign Investment as a Percentage of GDP, 1960-1994

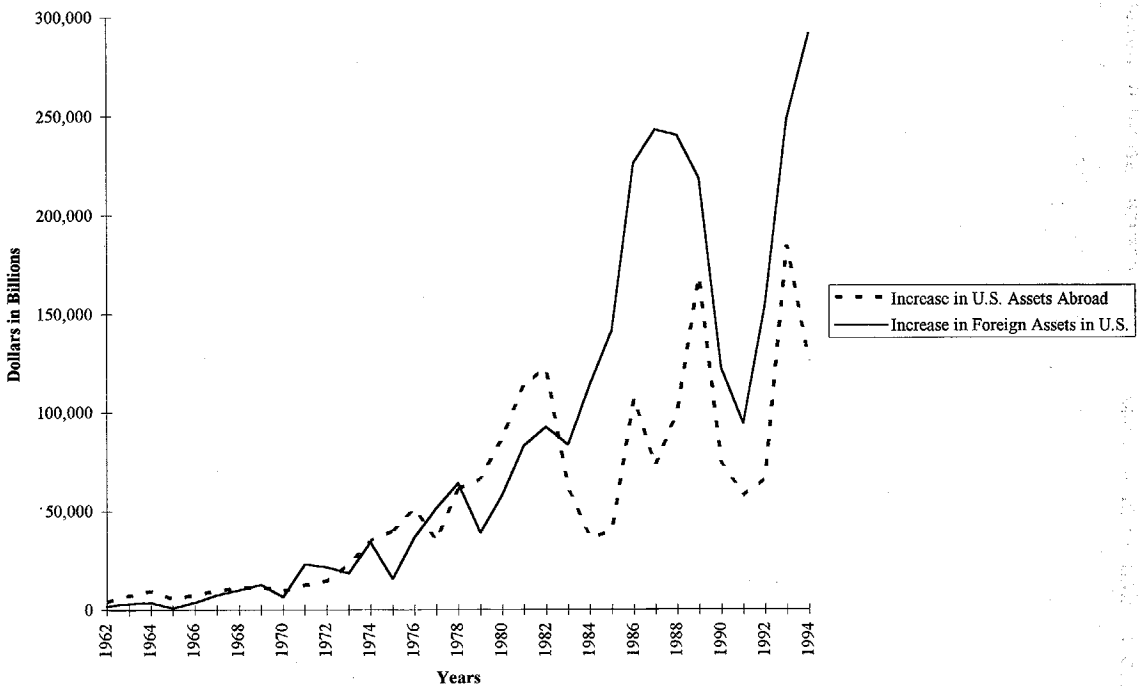


Source: Department of Commerce, of Economic Analysis

The net foreign investment in the United States is measured by the United States' capital account. The capital account measures the increase in U.S. assets abroad compared to the increase in foreign assets in the United States. Figure 7 plots the annual increase of U.S. assets abroad and of foreign assets in the United States in nominal dollars for the period 1962-1994.[16]

[16] Data for Figure 7 are from the U.S. Department of Commerce, Bureau of Economic Analysis and are reprinted in Appendix Table A.3.

Figure 7.--Annual Increases in U.S. Assets Abroad and in Foreign Assets in U.S., 1962-1994



Source: Department of Commerce, Bureau of Economic Analysis

Growth in foreign-owned assets in the United States[17]

The amount of foreign-owned assets in the United States grew more than 700 percent between 1975 and 1988 and more than 300 percent between 1980 and 1988.[18] The total amount of foreign-owned assets in the United States exceeded $3.1 trillion by the end of 1994.[19] The recorded value of U.S.-owned assets abroad grew less rapidly during the same period. The Department of Commerce reports that in 1975 the amount of U.S.-owned assets abroad exceeded foreign-owned assets in the United States by $74 billion. By the end of 1988, however, the situation had reversed, so that the amount of foreign-owned assets in the United States exceeded U.S.-owned assets abroad by $532 billion.[20] By 1994, the amount of foreign-owned assets in the United States exceeded U.S.-owned assets abroad by $681 billion. These investments are measured by their book value. Some argue that the market value of U.S.-owned assets abroad is similar to, or greater than, the market value of foreign-owned assets in the United States, if market values were measured accurately.[21] Figures 8 and 9 display the value of U.S.-owned assets abroad and foreign-owned assets in the United States for selected recent years measured under both current (or book) cost and based on estimates of current market values. Whether this argument is correct with respect to the current net investment position, it is clear that foreign-owned U.S. assets are growing more rapidly than U.S.-owned assets abroad as depicted in Figure 7.

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[17] For a more complete discussion of issues relating to foreign investment in the United States, see Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS–1–90), January 23, 1990.

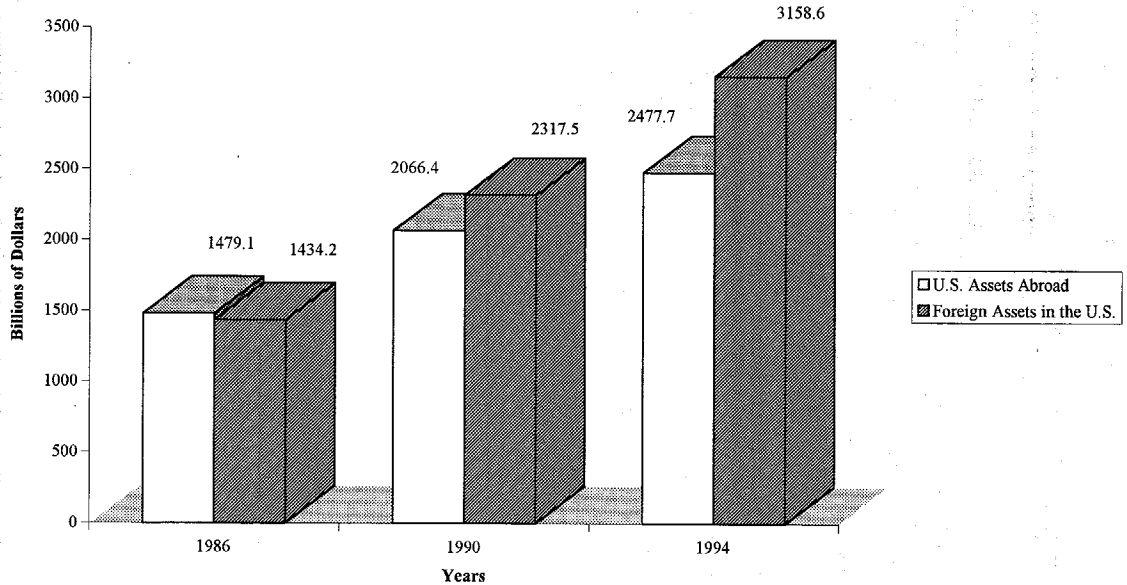
[18] Russell B. Scholl, "The International Investment Position of the United States in 1988," *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis, June 1989, p. 43.

[19] Russell B. Scholl, "The International Investment Position of the United States in 1994," *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis, June 1995, pp. 52-60.

[20] *Ibid.*

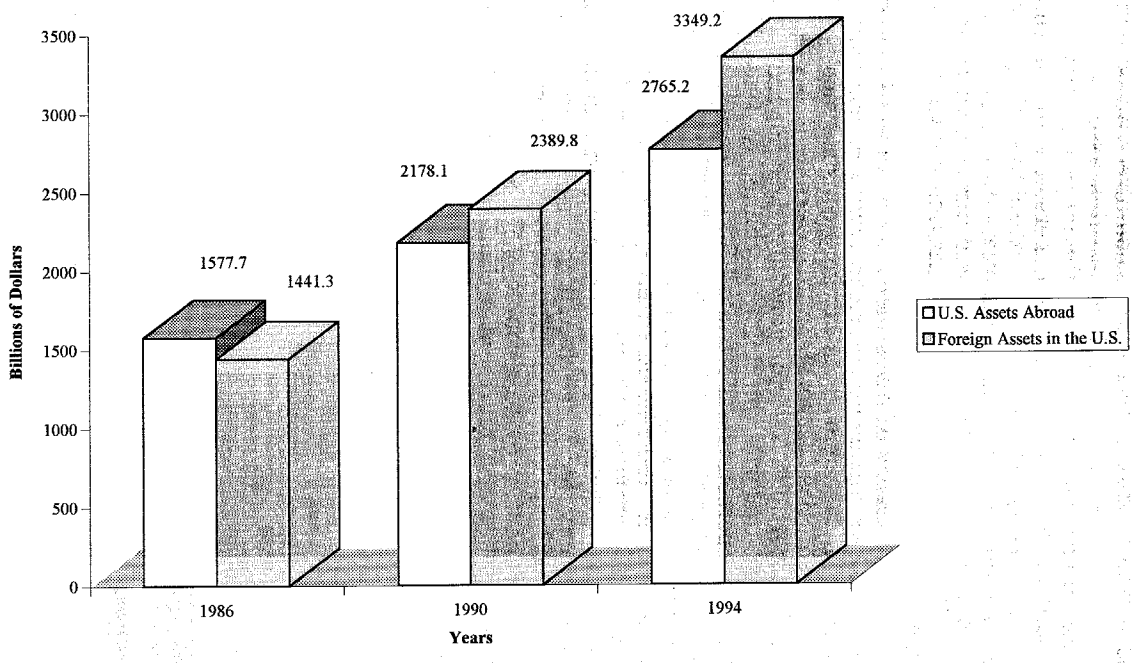
[21] Some commentators also have observed that the statistical discrepancies in the trade data are becoming large enough to question any conclusions which might be drawn from such data. See "Statistical Discrepancy" in Table 1 above. The distinction between book valuation and market valuation is only relevant for the category of investment labeled "direct investment," not for "portfolio investment." The distinction between direct and portfolio investment is explained in the text below.

Figure 8.--International Investment Position of the United States, 1986, 1990, and 1994
(direct investment at current cost)



Source: Department of Commerce, Bureau of Economic Analysis

Figure 9.--International Investment Position of the United States, 1986, 1990, 1994
(direct investment at market value)



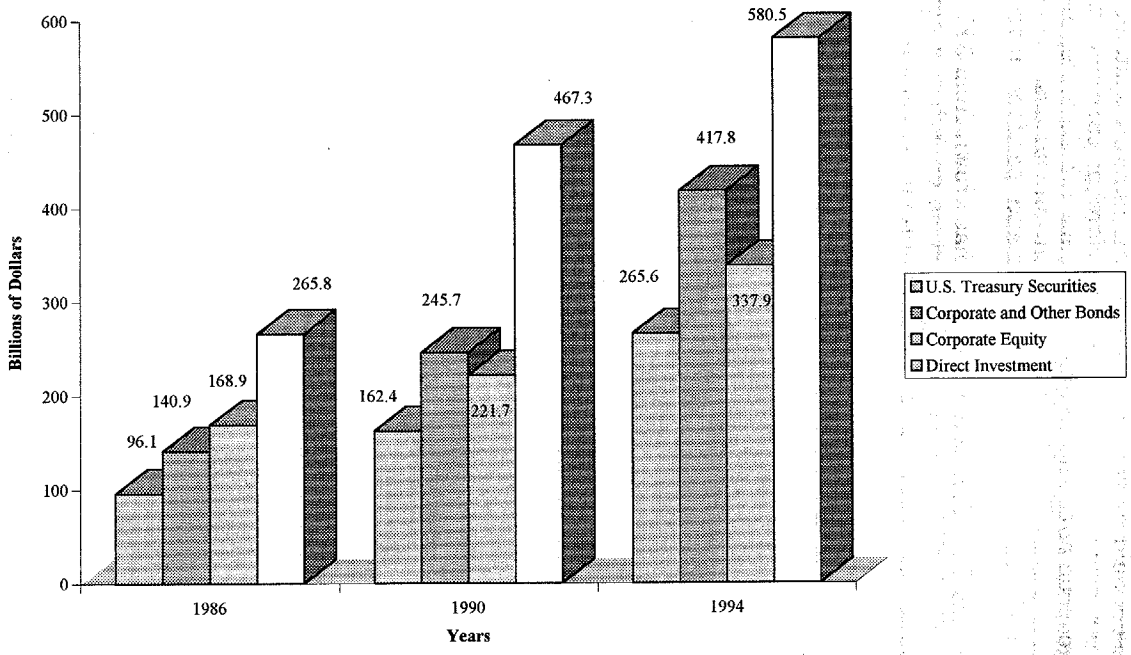
Source: Department of Commerce, Bureau of Economic Analysis

Foreign assets in the United States (and U.S. assets abroad) can be categorized as direct investment, non-direct investment, and official assets. Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interests in an unincorporated business. Foreign persons held direct investments of $581 billion in the United States in 1994, having grown from $83 billion in 1980.[22]

The largest category of investment is non-direct investment held by private (non-governmental) foreign investors, commonly referred to as portfolio investment. This category consists mostly of holdings of corporate equities, corporate and government bonds, and bank deposits. The portfolio investor generally does not have control over the assets that underlie the financial claims. In 1994, portfolio assets of foreign persons in the United States were more than triple the recorded value of direct investment, $2,033 billion compared to $581 billion, respectively.[23] Bank deposits account for over one-third of this total, and reflect, in part, the increasingly global nature of banking activities. Figure 10 reports the dollar value of foreign holdings of selected U.S. assets, both portfolio investment and direct investment, for three recent years. Foreign investment in bonds, corporate equities, and bank deposits, like other types of financial investment, provide a source of funds for investment in the United States but also represent a claim on future U.S. resources.

[22] Scholl, "The International Investment Position of the United States in 1994."
[23] *Ibid.*

Figure 10.--Selected Nongovernmental Foreign Holdings of United States' Assets, Both Portfolio and Direct Investments, 1986, 1990, 1994
(direct investment at current cost)



Source: Department of Commerce, Bureau of Economic Analysis

The final category of foreign-owned U.S. assets is official assets: U.S. assets held by governments, central banking systems, and certain international organizations. The foreign currency reserves of other governments and banking systems, for example, are treated as official assets. Levels of foreign-held official assets have grown more slowly than foreign-held direct and portfolio investment of private investors.

Investment by U.S. persons abroad has grown from $295.1 billion in 1980 to $2,477.7 billion in 1994.[24] This growth has not been as rapid as the growth in investment by foreign persons in the United States.

[24] Ibid.

D. Data Relating to Present-Law Taxation of International Transactions

The prior two sections have demonstrated that international transactions are becoming more important to the U.S. economy. As explained in Part II above, under present law income earned abroad by a U.S. person generally is subject to U.S. tax. However, if the foreign country in which the income is earned imposes a tax on that income, the U.S. person generally may claim a credit against the U.S. tax on such income for foreign income taxes paid on such income. One measure of the importance of the international sector is the magnitude of foreign tax credits claimed by U.S. persons. Table 2 documents the growth in foreign tax credits claimed for selected years since 1975 in nominal dollars. In 1993, individuals and corporations claimed more than $25 billion in foreign tax credits. While $25 billion is a substantial figure, it is less than the comparable figure for 1980 and it represents less than half of what the 1975 figure would be if it were to have grown at the rate of inflation. The smaller real value of foreign tax credits claimed in 1993 compared to 1975 is due to substantial changes in tax rates, tax bases, and foreign tax credit rules over the past two decades. Table 2 also documents that the vast majority of foreign tax credits are claimed by large corporations (with assets exceeding $250 million).

Table 2.—Distribution of Foreign Tax Credits Claimed by Individuals and Corporations, Selected Years, 1975–1994

[In millions of nominal dollars]

	1975	1980	1985	1990	1991	1992	1993	1994
Individuals	382	1,342	783	1682	2047	2047	2,218	1,982
Corporations (total)	19,988	24,848	24,264	24,990	21,095	21,522	22,896	(1)
Corporations with less than $25 million of assets	(1)	184	476	293	115	90	106	(1)
Corporations with assets between $25 million and $100 million	(1)	302	195	259	168	210	158	(1)
Corporations with assets between $100 and $250 million	(1)	573	564	685	621	366	334	(1)
Corporations with assets of $250 million or greater	(1)	23,789	23,029	23,753	20,191	20,856	22,298	(1)

[1] Data not available.

Source: Joint Committee on Taxation staff tabulations of Internal Revenue Service, *Statistics of Income* data.

While present law subjects income earned by U.S. persons on foreign investments to U.S. tax, the tax generally is not imposed until the income is repatriated, that is, until the income is paid into the United States. U.S. income tax is deferred while income is left abroad. The staff of the Joint Committee on Taxation estimates that the value of such deferral will be worth $1.1 billion for 1996. Table 3 presents the staff of the Joint Committee on Taxation's estimates of the tax expenditure created by deferral for the years 1996–2000.

Table 3.—Tax Expenditure Estimates Related to the Present-Law Income Taxation of Foreign-Source Income of Domestic Corporations, 1996–2000

[In billions of dollars]

Tax expenditure	1996	1997	1998	1999	2000
Exclusion of income of foreign sales corporations (FSCs)	1.5	1.5	1.5	1.6	1.6
Deferral of income of controlled foreign corporations	1.1	1.1	1.2	1.2	1.2
Inventory property sales source rule exception	3.6	3.7	3.7	3.8	3.8

Source: Joint Committee on Taxation estimates.

Table 3 also presents the staff of the Joint Committee on Taxation's estimates of the tax expenditures for the years 1996–2000 arising from the present-law income tax's exclusion of income of foreign sales corporations (FSCs) and the inventory property sales source rules that permit certain businesses with excess foreign tax credits effectively to exempt a portion of the income earned from export manufacture and sale from U.S. taxation.

IV. DESCRIPTIONS OF TAX RESTRUCTURING ALTERNATIVES

The press release by the House Committee on Ways and Means announcing this set of tax restructuring hearings asked all witnesses to comment on the impact of certain basic tax reform proposals. These basic alternatives to replace the current tax system are: (1) a national retail sales tax; (2) a value-added tax; (3) a consumption-based flat tax; (4) a cash flow tax; and (5) a "pure" income tax.

This part of the pamphlet provides brief descriptions of these alternative tax systems. In some cases, the descriptions include summaries of introduced legislation; in other cases, the descriptions are based upon theoretical models of the tax systems. These descriptions provide a summary of the alternative systems and are not intended to provide detailed analyses of specific aspects of the proposed systems. Such analyses will be provided in pamphlets to be prepared for separate hearings.[25]

Other than the "pure" income tax, the alternative tax systems discussed in this section are consumption-based, rather than income-based, taxes. The major difference between a consumption-based tax and an income-based tax generally involves the treatment of savings. Under an income-based tax, returns to savings (e.g., dividends, interest, and capital gains) generally are subject to tax. Under a consumption-based tax, returns to savings generally are excluded from the tax base. Such exclusion may be achieved by taxing consumption directly, excluding investment income from the tax base, or providing a deduction for increased savings.[26]

[25] See Joint Committee on Taxation, *Impact on Small Business of Replacing the Federal Income Tax* (JCS–3–96), April 23, 1996, and Joint Committee on Taxation, *Impact on State and Local Governments and Tax-Exempt Organizations of Replacing the Federal Income Tax* (JCS–4–96), April 30, 1996. Additional analysis can be found in Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS–18–95), June 5, 1995, and Martin A. Sullivan, *Flat Taxes and Consumption Taxes: A Guide to the Debate*, American Institute of Certified Public Accountants, December 1995.

[26] For a further discussion of the distinctions between consumption-based taxes and income-based taxes and the equivalence among different types of consumption taxes, see Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax,* and the citations contained therein.

A. National Retail Sales Tax

1. In general

As the name implies, a retail sales tax is a tax imposed on the retail sales price (i.e., sales to consumers, but not sales of inputs to businesses) of taxable goods or services.

The Federal government currently imposes excise taxes on various products and services.[27] However, these taxes generally apply to a narrowly defined class of goods and services, and generally are not imposed at the retail level. Rather, the present-law Federal excise taxes generally are imposed upon manufacturers (as in the case of the alcohol and tobacco excise taxes) or some other intermediate (pre-retail) stage of the distribution of a product (as in the case of the highway motor fuels tax), or are imposed upon both the consumers and business users of a good or service (as in the case of the communications services tax ("telephone tax") or the currently-expired air passenger ticket tax).

Most States and many local governments impose general sales taxes within their jurisdictions,[28] and all States impose some form of excise-type tax on specified goods or services. Although the typical State sales tax is familiar to most consumers and appears simple on its face, several issues may arise in the application of such a tax. State sales taxes generally are designed to apply to most tangible personal property and selected services purchased by consumers.[29] Certain sales to persons other than consumers (i.e., businesses) may be exempted from the tax in a variety of ways. Exemptions may be provided for goods acquired as "sales for resale," or for articles for use in manufacture, fabrication, or the processing of personal property for resale, if the articles become incorporated in such property. Thus, persons who are not consumers may be subject to the sales tax in certain instances. For example, a furniture maker may be exempt from tax on lumber acquired to manufacture chairs, but would not be exempt from tax on a truck purchased to deliver the chairs to customers. Controversies often arise as to whether articles or services (such as packaging or utility services) are incorporated into goods.[30] Most States also provide exemptions for acquisitions by the State and its political subdivisions, and charitable, religious, and educational organizations.[31] In order to address the regressivity of sales taxes, most States exempt most food, but impose a tax on candy, soda and prepared meals, thus requiring subtle distinctions between taxable and tax-exempt items. Similarly, most States do not tax sales of intangible property, raising issues as to whether a particular item represents taxable tan-

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[27] See Joint Committee on Taxation, *Schedule of Present Federal Excise Taxes (As of January 1, 1994)* (JCS–5–94), June 28, 1994, for a description the various Federal excise taxes.

[28] It has been reported that there are approximately 50,000 separate sales tax jurisdictions in the United States. *Wall Street Journal*, April 18, 1990, p. A1. Alaska, Delaware, Montana, New Hampshire, and Oregon currently do not have broad-based sales taxes. The District of Columbia has a sales tax.

[29] For a detailed discussion of State and local sales taxes, see Jerome R. Hellerstein and Walter Hellerstein, *State Taxation (Vol. II: Sales and Use, Personal Income, and Death and Gift Taxes)* (Warren, Gorham, Lamont: Boston, MA) 1992.

[30] See, for example, *Sta-Ru v. Mahin*, 64 Ill. 2d 330 (1976), and *Burger King v. State Tax Commission*, 51 N.Y. 614 (1980) (whether paper and plastic cups and similar items purchased by a fast-food restaurant were subject to State sales taxes.)

[31] See John Due and J. Mikesell, *Sales Taxation: State and Local Structure and Administration* (1983), pp. 78–80.

gible or tax-exempt intangible property.[32] Moreover, most States provide broad taxation of personal property, but only limited taxation of services, raising issues whenever a business provides both taxable goods and tax-exempt services to a customer. For example, an automotive repair shop typically provides both goods (replacement parts) and services (labor on installation of the parts) when it repairs an automobile. Further, a State's sales tax generally does not apply to goods shipped to out-of-State customers.[33] In such cases, the customer likely is subject to a complementary "use" tax in his or her State of residence. However, there are significant compliance problems with State use taxes.[34] Several States mail use tax forms to all State income taxpayers and rely upon voluntary reporting of taxable out-of-State purchases.

2. Description of the "National Retail Sales Tax Act of 1996" (H.R. 3039)

Recently, there has been interest in replacing the U.S. income tax system with a Federal retail sales tax.[35] On March 6, 1996, Messrs. Schaefer, Tauzin, Chrysler, Bono, Hefley, Linder, and Stump, introduced H.R. 3039, the "National Retail Sales Tax Act of 1996". Following is a discussion of the bill.

In general

The bill would impose a tax at a rate of 15 percent on gross payments for the use, consumption, or enjoyment in the United States of any taxable property or service, whether produced or rendered within or without the United States. In general, the tax would be imposed and remitted by the seller of the taxable item. "Taxable property or service" would mean (1) any property (including leaseholds of any term or rents with respect to such property other than intangible property), and (2) any service (including any financial intermediation services). The tax would be due when payment for the taxable item is received, even if received pursuant to an installment method. Alternatively, the seller may elect to adopt an accrual method of accounting.

Tax would not be imposed upon any property or service: (1) purchased for resale; (2) purchased to produce taxable property or services; (3) exported from the United States for use, consumption, or enjoyment outside the United States; or (4) with respect certain de minimis amounts. Tuition for general primary, secondary, or university level education and job-related training courses would be

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[32] See, for example, Robert W. McGee, *Software Taxation*, National Association of Accountants, 1984, chapters 1 and 3, for a discussion of the issues involved in the application of State sales taxes to transfers of computer software.

[33] Thus, most State sales and use taxes are based on a "destination principle." The destination principle is discussed in detail in the following part of this pamphlet.

[34] The ability of one State to require an out-of-State retailer to collect that State's sales or use tax on sales into the State (generally through mail-order catalog sales) is restricted by the Commerce Clause of the U.S. Constitution where the retailer has no physical presence in the State. See *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1976), and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[35] Senator Richard Lugar had proposed that the current Federal taxes be repealed and replaced with a retail sales tax that would be collected by the States on behalf of the Federal Government. *Washington Post*, April 20, 1995. For a discussion of similar proposals, see Laurence J. Kotlikoff, "Economic Impact of Replacing Federal Income Taxes with a Sales Tax," published by the Cato Institute in December 1992, and Stephen Moore, "The Economic and Civil Liberties Case for a National Sales Tax," published for a Hoover Institution conference on May 11, 1995.

treated as purchased to produce taxable property or services. Special rules would apply to property or services purchased for a dual use (i.e., both a taxable and tax-exempt purpose).

Specific rules for certain transactions

Specific rules would be provided for transactions involving governmental units and not-for-profit organizations, purchasers of principal residences, and financial intermediation services.[36]

Governmental units.—Any Federal, State, or local governmental unit or political subdivision would not be exempt from the tax on any sale, purchase, use, consumption, or enjoyment of a taxable good or service by the unit. In addition, an excise tax of 15 percent would be imposed on the wages of Federal, State, and local government employees; the tax would be collected from the governmental employers.

Not-for-profit organizations.—Dues, contributions, and payments to a qualified not-for-profit organization generally would not be subject to tax. However, payments to a not-for-profit organization would be subject to the tax if the property or service provided in exchange for the payment is not substantially related to the exempt purpose of the organization or is commercially available. The provision of property or personal services by a not-for-profit organization in connection with contributions or dues to the organization would be treated as a taxable transaction in an amount equal to the fair market value of the property or service. Property or personal services acquired by a not-for-profit organization for resale or use in the production of taxable property or services would not be subject to tax. For this purpose, a "qualified not-for-profit organization" generally would be an organization organized and operated exclusively as an organization generally described in present-law sections 501(c)(3), (4), (5), (6), (8) and (10) of the Code, provided that no part of the net earnings of the organization inures to the benefit of any private shareholder or individual. In general, qualified not-for-profit organizations would apply for a qualification certificate from the appropriate State tax administrator.

Principal residences.—A purchaser may elect to pay the tax (plus simple interest computed at the rate imposed by present-law section 6621 of the Code) in equal installments over a 30-year period with respect to property purchased and used as a principal residence. If the property is sold or ceases to be used as a principal residence by the purchaser before the close of the 30-year period, the unpaid balance of the tax would become payable within two years of such sale or cessation.

Financial intermediation.—The tax would be imposed upon explicitly and implicitly charged financial intermediation services. Explicitly charged financial intermediation services would include brokerage fees; explicitly stated banking, loan origination processing, documentation, credit check and other similar fees; safe-deposit fees; insurance fees (to the extent not allocable to the investment account of the underlying insurance policy); trustee's fees; and other financial service fees, including mutual fund manage-

[36] Principal residences and other durable goods and financial intermediation services present special issues under most consumption taxes. These issues will be examined in future pamphlets devoted to these topics.

ment, sales, and exit fees. Providers of these services would be subject to tax on the amount charged for the services. Implicitly charged financial intermediation services generally would be determined based upon the difference between the rate of interest earned on any underlying interest-bearing investment and the interest paid on any underlying interest-bearing debt.

International aspects of the tax

The tax would be imposed on payments for the use, consumption, or enjoyment in the United States of any taxable property or service, whether produced or rendered within or without the United States. The tax normally would be collected from the seller of a taxable good or service; however, in the case of a taxable good or service purchased outside the United States for use, consumption or enjoyment in the United States, the tax would be collected from the purchaser. The tax would be imposed in addition to any import duties imposed by law and the Secretary of the Treasury would be instructed to issue regulations to coordinate the collection and administration of the tax and import duties.

A financial intermediation service would be deemed to be used, consumed, or enjoyed in the United States if the service provider or any related party has a permanent establishment in the United States and the person purchasing the service is a U.S. resident. In the case of transportation services where either the origin or the final destination of the trip is outside the United States, the service amount would be deemed to be 50 percent attributable to the United States origin or destination.

Credits and rebates

The bill would provide credits with respect to sales of used property, property converted to business use, taxes collected on exempt purchases, administrative costs, compliance equipment costs, and over-collected taxes. These credits may result in a tax refund if the taxpayer files two consecutive tax reports with a credit balance. The used property tax credit is designed to alleviate the cascading of tax when taxable goods are acquired by a consumer, sold to a used goods dealer, and then resold by the dealer to another consumer. The business use conversion credit would allow a credit when a consumer devotes a previously-taxed item to exclusive use in the consumer's business. The administrative costs credit would be an amount equal to the greater of $100 or one-half of one percent of the tax remitted by the taxpayer. The administrative costs credit could not exceed 20 percent of the tax remitted, determined before the application of the credit. The compliance equipment costs credit would be an amount equal to 50 percent of the cost of equipment that a vendor must purchase to comply with the requirement (described below) that the amount of tax be stated and separately charged.

The bill would provide a family consumption rebate for each qualified family unit. The amount of the rebate would be 15 percent of the lesser of: (1) the poverty level of the family, or (2) the wage income of the family unit. The qualified family unit would be determined with respect to family members sharing a common residence. The poverty level of the family would be the quotient of (1)

the level determined by the Department of Health and Human Services poverty guidelines for family units of a particular size, divided by (2) 85 percent. The size of the family unit would determined by including each spouse or head of household, child, grandchild, parent and grandparent. Family members would include certain students living away from home and exclude persons over the age of two without a bona fide Social Security number and unlawful residents of the United States. The rebate would be provided by adjusting the Social Security taxes to be withheld from the wages of employees.

Administration of the tax

The sales tax would be charged separate from the purchase price of each taxable sale. Vendors would be required to provide purchasers with a receipt that sets forth the tax-exclusive price of the taxable item, the amount of tax paid, the tax-inclusive price of the taxable item, the tax rate, the date the item was sold, and the vendor's name and registration number.

Any person liable to collect and remit the tax who is engaged in an active trade or business would register with the appropriate taxing authority. Taxpayers would be required to pay the tax on or before the 25th day following the month in which the tax was collected, and to file a report that sets forth the gross receipts on taxable items for the month, the tax collected in connection with these receipts, and the amount and types of credits claimed. Interest would apply to late payments. Civil or criminal penalties would apply to late filings; failures to register; and failures to collect, remit, or pay the tax.

The tax would be administered, collected, and remitted to the Federal government by an administering State within which taxable items are used, consumed, or enjoyed. A State would be an administering State if it maintains a sales tax that significantly conforms to the Federal tax and enters into a cooperative agreement with the Secretary of the Treasury regarding the State's administration of the tax. Administering States would be allowed to retain one percent of the Federal tax as an administration fee. A conforming State may contract with another conforming State to administer its sales tax. The Secretary of the Treasury would administer the tax in jurisdictions that are not administering States, where the administering State has failed on a regular and sustained basis timely to remit the tax to the United States, where the administering State has been adjudicated to have breached the cooperative agreement, and with respect to certain multistate vendors. Special rules would determine the situs of the use, consumption or enjoyment of a taxable item based on a destination principle. The Secretary of the Treasury would be required to issue guidance with respect to the tax and to establish an Office of Revenue Allocation to arbitrate claims and disputes among administering States.

Appropriations to the Internal Revenue Service ("IRS") would not be authorized after fiscal year 2000. An Excise Tax Bureau would be established to administer and collect excise tax formerly collected by the IRS, and the Social Security Administration would administer and collect payroll taxes.

B. Value-Added Tax

1. In general

A value-added tax ("VAT") generally is a tax imposed and collected on the "value added" at every stage in the production and distribution process of a good or service. Although there are several ways to compute the taxable base for a VAT, the amount of value added generally can be thought of as the difference between the value of sales (outputs) and purchases (inputs) of an enterprise.[37]

The amount of value added may be determined under a VAT in a number of ways. The two most common methods are the credit-invoice method and the subtraction method.[38] The credit-invoice method is the system of choice in nearly all countries that have adopted a VAT,[39] while the subtraction method has been used in the States of Michigan and New Hampshire.[40] A subtraction-method VAT also sometimes is referred to as a business transfer tax.

2. Credit-invoice method VAT

Under the credit-invoice method, a tax is imposed on the seller for all of its sales. The tax is calculated by applying the tax rate to the sales price of the good or service, and the amount of tax generally is disclosed on the sales invoice. A business credit is provided for all VAT paid on all purchases of taxable goods and services (i.e., "inputs") used in the seller's business. The ultimate consumer (i.e.,

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[37] Previous publications by the staff of the Joint Committee on Taxation have discussed some of the broad tax policy and economic issues to be considered in deciding whether a VAT should be enacted and have described the mechanics of various VAT systems. Numerous other publications also address these issues. See, e.g., Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax*; Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States* (JCS–6–91), May 30, 1991 (Part Three: "Discussion of Value-Added Taxes"), pp. 269–341; Joint Committee on Taxation, *Description of Tax Bills ... S. 442* (Value Added Tax) ... (JCS–11–89), May 11, 1989 (Part III.C., "Analysis of Specific Issues"), pp. 9–31; Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth*, Vol. 3, "Value-Added Tax", (1984); Congressional Budget Office, *Effects of Adopting A Value-Added Tax*, February 1992; Government Accounting Office, *Value Added Tax: Administrative Costs Vary with Complexity and Number of Businesses*, GAO/GGD–93–78, May 1993; Alan Schenk, *Value Added Tax: A Model Statute and Commentary, American Bar Association Section on Taxation*, (1989); Martin A. Sullivan, *Flat Taxes and Consumption Taxes*, American Institute of Certified Public Accountants, December 1995; Lorence L. Bravenec, *Design Issues in a Credit Invoice Method Value-Added Tax for the United States*, American Institute of Certified Public Accountants, (1990); Tax Executives Institute, Value-Added Taxes: A Comparative Analysis, (1992); Congressional Research Service, *Value-Added Tax: Tax Bases and Revenue Yields* (CRS Report 92-176E), November 23, 1992 (and publications cited therein); Charles E. McLure, Jr., *The Value-Added Tax: Key to Deficit Reduction?*, American Enterprise Institute for Public Policy Research, Washington, D.C. (1987); and Alan A. Tait, *Value Added Tax, International Practice and Problems*, International Monetary Fund, Washington, D.C. (1988).

[38] An addition method may also be used to compute value added. An addition method measures value added as the sum of wages, interest expense, and cash-flow profits of an entity (i.e., the returns to labor and financial capital of a business). The addition method is disfavored by some VAT commentators generally because of the difficulty in measuring cash-flow profits, but may have utility in certain instances (e.g., for measuring the value added of a not-for-profit organization).

[39] It is reported that Japan imposes a version of an "accounts-based" subtraction method VAT. The Japanese VAT also has elements of the credit-invoice method. See Tax Executives Institute, *Value-Added Taxes: A Comparative Analysis* (1992), p. 80.

[40] The subtraction method also has been proposed in several recent U.S. legislative proposals. See, e.g., the business tax components of the flat taxes proposed in H.R. 2060 and S. 1050 as introduced by Mr. Armey and Senator Specter on July 19, 1995 (described below); the "Business Transfer Tax" of S. 2160 (103rd Cong.) proposed by Senators Boren and Danforth on May 26, 1994; and the business tax component of the "USA Tax" proposed in S. 722 as introduced by Senators Domenici and Nunn on April 25, 1995 (described below). In addition, Mr. Gibbons, although he has not introduced legislation to date, has supported the adoption of a VAT in his testimony before the Bipartisan Commission on Entitlements and Tax Reform on October 6, 1994, the Committee on Ways and Means in 1995, and in various writings.

a non-business purchaser), however, does not receive a credit with respect to his or her purchases. The VAT credit for inputs prevents the imposition of multiple layers of tax with respect to the total final purchase price (i.e., "cascading" of the VAT). As a result, the net tax paid at a particular stage of production or distribution is based on the value added by that taxpayer at that stage of production or distribution. In theory, the total amount of tax paid with respect to a good or service from all levels of production and distribution should equal the sales price of the good or service to the ultimate consumer multiplied by the VAT rate.

In order to receive an input credit with respect to any purchase, a business purchaser generally is required to possess an invoice from a seller that contains the name of the purchaser and indicates the amount of tax collected by the seller on the sale of the input to the purchaser. At the end of a reporting period, a taxpayer may calculate its tax liability by subtracting the cumulative amount of tax stated on its purchase invoices from the cumulative amount of tax stated on its sales invoices.

Example 1. Simple credit-invoice method VAT.—Assume a landowner sells felled trees to a paper mill for $1,000. The landowner had not been subject to tax with respect to anything used in the production of the trees. The paper mill processes the trees into rolls of paper and sells the rolls to a distributor for $1,300. The distributor cuts the rolls into sheets, packages the sheets, and sells the packages to a retail stationery store for $1,500. The retail stationery store sells the entire lot of packages to nonbusiness consumers for $2,000. The jurisdiction in question levies a broad-based VAT at a rate of 10 percent. The tax would be determined as follows:

Production stage	Sales		VAT on sales		VAT on purchases		Net VAT
Landowner	$1,000 x .1	=	$100	–	(0)	=	$100
Paper mill	1,300 x .1	=	130	–	(100)	=	30
Distributor	1,500 x .1	=	150	–	(130)	=	20
Retail store	2,000 x .1	=	200	–	(150)	=	50
Total			$580	–	(380)	=	$200

Thus, a total of $200 of VAT is assessed and collected in various amounts from the four stages of production. If, instead of a VAT, the jurisdiction in question levied a retail sales tax at a rate of 10 percent, the total amount of tax also would be $200 ($2,000 sales price times 10 percent), all collected by the stationery store at the retail level.

3. Subtraction-method VAT

Under the subtraction method, value added is measured as the difference between an enterprise's taxable sales and its purchases of taxable goods and services from other enterprises. At the end of

the reporting period, a rate of tax is applied to this difference in order to determine the tax liability. The subtraction method is similar to the credit-invoice method in that both methods measure value added by comparing outputs (sales) to inputs (purchases) that have borne the tax. The subtraction method differs from the credit-invoice method principally in that the tax rate is applied to a net amount of value added (sales less purchases) rather than to gross sales with credits for tax on gross purchases (as under the credit-invoice method). The determination of the tax liability of an enterprise under the credit-invoice method relies upon the enterprise's sales records and purchase invoices, while the subtraction method may rely upon records that the taxpayer maintains for income tax or financial accounting purposes.

Example 2. Simple subtraction method VAT.—Assume the same facts as in Example 1 above. The subtraction method VAT would operate as follows:

Production stage	Sales	–	Purchases	=	Value added	× rate	=	VAT
Landowner	$1,000	–	(0)	=	$1,000	× .1	=	$100
Paper mill	1,300	–	(1,000)	=	300	× .1	=	30
Distributor	1,500	–	(1,300)	=	200	× .1	=	20
Retail store	2,000	–	(1,500)	=	500	× .1	=	50
Totals					$2,000	× .1	=	$200

Comparing Examples 1 and 2, the credit-invoice and subtraction methods yield the same amounts of tax at the same levels of production.

4. Exclusions under a VAT

Most VATs provide exclusions for various goods and services, or classes of taxpayers, for economic, social, or political reasons. Certain goods and services are excluded from the VAT due to difficulties in measuring either the amount of the value added or the element of consumption (as opposed to the investment element) with respect to the good or service. In addition, as described in detail below, most VATs adopted to date provide special treatment for imported and exported goods and services.[41]

Goods, services, or classes of taxpayers may be excluded from a VAT either by providing a "zero rating" or through an exemption. There may be significant differences between these two alternatives, particularly under the credit-invoice method. If a sale is zero-rated, the sale is considered a taxable transaction, but the rate of tax is zero percent. Sellers of zero-rated goods or services do not collect or remit any VAT on their sales of those items, but are required to register as taxpayers. Sellers of zero-rated items are al-

[41] See the following discussion for the general treatment of imported and exported goods and services under consumption-based taxes.

lowed to claim credits (and perhaps a refund to the extent the taxpayer does not have sufficient taxable sales) for the VAT they paid with respect to purchased goods and services.

Similarly, a seller of goods or services that is exempt is not required to collect any VAT on its sales. However, because such sellers are not considered taxpayers under the VAT system, they may not claim any refunds of the VAT that they may have paid on their purchases. In addition, under the credit-invoice method, purchasers of exempt goods or services generally are not allowed a credit for any VAT borne with respect to such goods or services prior to the exempt sale. Consequently, a VAT exemption, as opposed to a zero rating, in a credit-invoice system breaks the chain between inputs and outputs along the various stages of production and distribution and may result in a cascading of the tax (i.e., total tax collected from all stages of production would be greater than the retail sales price of the good times the VAT rate). For this reason, most VAT commentators, while recognizing that exemptions may be useful in easing the administrative and recordkeeping burdens of certain targeted taxpayers or transactions (such as small businesses or casual sales), prefer zero rating as the means of providing VAT relief under the credit-invoice method.

There is little practical experience available to assess how exclusions would operate under a subtraction-method VAT. It is, however, theoretically possible to design exclusions under a subtraction method that replicate the effects of either zero rating or exemptions under a credit-invoice VAT. Moreover, exemptions under the subtraction method may relieve the tax on the value added by the exempted activity, but do not result in the cascading that occurs with exemptions under the credit-invoice method.

5. Border adjustments

VATs generally are imposed based upon either an "origin principle" or a "destination principle." A VAT based on the origin principle imposes tax on goods or services produced in the jurisdiction that imposes the tax. Under the origin principle, exports are subject to tax while imports are not. Conversely, a VAT based on the destination principle imposes tax on goods or services consumed in the jurisdiction that imposes the tax. Under the destination principle, imports are subject to tax and the tax on exports is rebated. These import charges and export rebates are commonly referred to as "border adjustments" and are a part of nearly all VAT systems currently in place.[42]

Under the border adjustments, exported goods would not be subject to the credit-invoice VAT through zero-rating the sale of exported goods (i.e., by applying a VAT rate of zero to exports, thus allowing the exporter to claim refundable credits for VAT paid with respect to the purchased inputs). On the other hand, importers would be subject to tax on the full value of imported goods (because inputs with respect to such products previously had not been subject to the U.S. VAT). Similar treatment would be provided for im-

[42] A more detailed discussion of border adjustments under consumption taxes is provided in Part V of this pamphlet.

ported and exported services.[43] Under a subtraction-method VAT, border adjustments could be provided by not including export sales as taxable transactions and by treating the importation of an item as a taxable sale.

Border adjustments are fully consistent with GATT, as long as they do not discriminate against imports or provide over-rebates on exports. Relief from "indirect" taxes on exports does not constitute an illegal export subsidy, while relief from "direct" taxes (such as income taxes) is illegal. "Indirect" taxes are defined to include value-added taxes, and credit-invoice VATs have been accepted as border-adjustable under GATT. Although a subtraction-method VAT has the same base as a credit-invoice VAT, it is not clear whether a subtraction-method VAT is an indirect tax and whether border adjustments under the subtraction-method are GATT-legal.[44] Further, because there are no pure subtraction-method VATs currently in existence, there have been no GATT challenges or test cases with respect to the legality of subtraction-method border adjustments.

C. Consumption-Based "Flat" Tax

1. In general

A "flat tax" generally is any tax system with only one marginal tax rate.[45] For example, one could construct a flat tax out of the current individual income tax by eliminating all but one marginal rate bracket and repealing provisions that impose higher marginal rates by reducing deductions or exclusions (e.g., the personal exemption phaseout and the limitation on itemized deductions). While such a tax would be a flat tax on the basis of its single rate bracket, it would still contain dozens of tax expenditure provisions, including the home mortgage interest deduction, the charitable contribution deduction, the deduction for State and local income taxes, the earned income tax credit, and the dependent care credit.

Many of the flat tax proposals that have been developed do more than simply apply one rate to the current individual income tax base. In addition, they redefine the base of the tax. As discussed above, there are two main approaches: a consumption base and an income base. The gross income of a taxpayer in any year can be thought of as the sum of the taxpayer's consumption and gross saving. The difference between these two approaches is in the treatment of saving. An income-based tax includes the return to saving in the tax base; a consumption-based tax does not.

2. Description of H.R. 2060 and S. 1050

There have been several consumption-based flat taxes introduced in recent Congresses.[46] On March 2, 1995, Senator Specter intro-

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[43] Further discussion of the treatment of imported and exported services is provided in Part V.D. of this pamhlet.

[44] See George N. Carlson and Richard A. Gordon, "VAT or Business Transfer Tax: A Tax on Consumers or on Business?" *Tax Notes*, October 17, 1988, p. 329. A more detailed discussion of border adjustments and GATT is provided in Part V of this pamphlet.

[45] A bracket with a marginal rate of zero also could be provided by allowing a standard deduction and personal exemptions. As long as only one bracket has a marginal tax rate greater than zero, the tax would commonly be referred to as a "flat tax."

[46] The bills describe flat taxes because the taxes would be imposed at a single rate on taxable income. These flat taxes generally may be described as consumption-based because in determin-

duced S. 488. On January 4, 1995, Mr. Crane introduced H.R. 214, "The Tithe Tax." In the 103rd Congress, on January 26, 1993, Senator Helms introduced S. 188, "The Tithe Tax;" and on June 16, 1994, Mr. Armey introduced H.R. 4585, "The Freedom and Fairness Restoration Act of 1994." House Majority Leader Armey modified his flat tax proposal and introduced H.R. 2060 on July 19, 1995. Senator Shelby introduced a companion bill, S. 1050, in the Senate on the same date. The subsequent discussion provides a description of H.R. 2060 and S. 1050.

Overview

H.R. 2060 and S. 1050 are based on a flat tax developed by Professors Robert Hall and Alvin Rabushka of Stanford University.[47] In general, the tax described in the bills is a consumption-based flat tax that is imposed at single rate upon individuals and businesses. An individual is taxed on the amount by which the individual's wages and distributions from qualified plans exceed the individual's standard deduction. The business activities tax is a subtraction-method VAT, with deductions for wages and contributions to retirement plans. The business activities tax proposed by the bills resembles a subtraction-method VAT, as described above. The difference between the bills' business activities tax and a subtraction-method VAT is that the bills would allow businesses to deduct compensation expenses, while VATs generally do not allow compensation deductions. However, under the bills, the receipt of such compensation is subject to tax at the individual level at the same flat rate applicable to businesses. Thus, the combination of the business activities tax and the individual tax is roughly equivalent to a VAT. The combination of the individual and business taxes under H.R. 2060 and S. 1050 is not exactly equivalent to a VAT because of the allowance for standard deductions under the individual-level tax. Alternatively, the bills could be viewed as a VAT that provides individuals with built-in exemptions for a minimum amount of consumption.[48] Following is a more detailed description of the bills.

Taxation of individuals

The bills would impose a tax equal to 20 percent (the tax rate is reduced to 17 percent for taxable years beginning after December 31, 1997) of the excess (if any) of: (1) certain earned income received during the taxable year over (2) the standard deduction for the year. For this purpose, earned income subject to tax would be wages paid in cash for services provided in the United States, distributions from retirement plans, and unemployment compensation.

Under the bills, the "standard deduction" would be the sum of a "basic standard deduction" plus the "additional standard deduc-

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ing taxable income, returns on investment assets would be excluded and businesses would be allowed to expense the cost of capital assets.

[47] See Robert E. Hall and Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax* (New York: McGraw-Hill), 1983.

[48] As described by Robert E. Hall and Alvin Rabushka in "The Flat Tax: A Simple Progressive Consumption Tax," a paper prepared for a Hoover Institution conference of May 11, 1995, the exemption amounts of their proposed flat tax are intended to provide relief for lower income individuals under their consumption-based tax.

tion." As under present law, the amount of the basic standard deduction would be determined based on the individual's filing status as provided in Table 4 below. (For the sake of comparison, the amounts of standard deductions allowable under present law also are provided in the table.)

Table 4.—Comparisons of "Standard Deductions" Under H.R. 2060, S. 1050, and Present Law

Filing status [1]	H.R. 2060 and S. 1050 basic standard deduction	Present-law standard deduction [2]
Joint return	$21,400	$6,550
Surviving spouse	21,400	6,550
Head of household	14,000	5,750
Married filing separately	10,700	3,275
Single	10,700	3,900

[1] The determination of an individual's filing status under the bills is the same as under present law.

[2] The amounts shown for the standard deductions apply for calendar year 1995. These amounts are indexed annually for inflation.

In addition, individuals who are blind or age 65 or older may increase their standard deductions under present law. These additional deduction amounts are not provided under the bills.

Under the bills, the "additional standard deduction" would be an amount equal to $5,000 multiplied by the number of dependents of the taxpayer. (Under present law, a $2,500 exemption amount is allowed for calendar year 1995 for the taxpayer, his or her spouse, and each dependent of the taxpayer. The exemption amounts are indexed annually for inflation.) Similar to present law, the basic standard deduction and the additional standard deduction amounts under the bills would be indexed for inflation.

Taxable income of an individual would include the otherwise taxable income of his or her dependent children under the age of 14.

Taxation of business activities

In general.—The bills would impose a tax equal to 20 percent (the tax rate is reduced to 17 percent for taxable years beginning after December 31, 1997) of the business taxable income of a person engaged in a business activity. The tax would be imposed on the person engaged in a business activity, whether such person is an individual, partnership, corporation, or otherwise. For this purpose, "business taxable income" would mean gross active income reduced by specified deductions. "Gross active income" would mean gross receipts from (1) the sale or exchange of property or services in the United States by any person in connection with a business activity and (2) the export of property or services from the United States in connection with a business activity.

The bills would allow deductions for (1) the cost of business inputs for the business activity, (2) wages paid in cash to employees for the performance of services in the United States, and (3) contributions to qualified retirement plans or arrangements. For this purpose, "the cost of business inputs" would mean (1) the amount paid for property sold or used in connection with a business activ-

ity, (2) the amount paid for services (other than for services of employees, including fringe benefits), and (3) any excise tax, sales tax, customs duty or other separately stated levy imposed by a Federal, State, or local government on the purchase of property or services used in connection with a business activity (other than the flat tax).

If a taxpayer's aggregate deductions for any taxable year exceed its gross active income for the year, the amount of deductions allowed for the succeeding taxable year would be increased by the sum of (1) the excess, plus (2) the product of the excess and the three-month Treasury rate for the last month of the taxable year.

International transactions.—The bills would impose the business tax based on the origin principle.[49] That is, proceeds from the sale or exchange of property or services produced in the United States would be subject to tax, even if such property or service are exported outside the United States. There would be no separate tax on imported goods or services. Deductions would be allowed with respect to inputs for business activity conducted within the United States, whether such inputs are acquired from U.S. or foreign sources.[50]

Special rules.—The bills would provide special rules for financial intermediation service activities and noncash compensation provided by employers not engaged in a business activity. The taxable income from the business activity of providing financial intermediation services would be the value of such services.

Governmental entities and other tax-exempt organizations would not be subject to the business activities tax. However, these entities would be subject to a tax equal to 20 percent (the tax rate is reduced to 17 percent for taxable years beginning after December 31, 1997), on the amount of remuneration for services performed by an employee other than (1) wages, (2) remuneration for services performed outside the United States, or (3) retirement contributions to qualified plans or arrangements (i.e., fringe benefits would be subject to the tax).

Treatment of qualified retirement plans

The bills would make several changes to the present-law treatment of qualified retirement plans. Specifically, the bills would expand the availability of qualified retirement plans by repealing nondiscrimination rules, contribution limits, and excise taxes on premature distributions, and by removing restrictions relating to self-employed individuals and tax-exempt organizations and governments. The bills also would provide rules regarding the transfer of excess pension assets.

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[49] Because the flat taxes of H.R. 2060 and S. 1050 allow businesses deductions for wages, some commentators have suggested that the taxes would be classified as a "direct" tax and thus could not be designed as a destination-principle tax that is in compliance with GATT rules. See, e.g., Reuven S. Avi-Yonah, "The International Implications of Tax Reform", *Tax Notes*, November, 13, 1995, p. 916. A more detailed discussion of border adjustments and GATT is provided in Part V of this pamphlet.

[50] These rules are consistent with the flat tax as originally designed by Professors Hall and Rabushka. See Robert E. Hall and Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax* (New York: McGraw-Hill), 1983, pp. 51-2.

D. Cash Flow Tax

1. In general

A cash flow tax is a personal consumption tax imposed on the net cash flow of an individual taxpayer. The base of the tax is determined by subtracting a deduction for net increases in savings from the gross income of the taxpayer. Under a pure cash flow tax, withdrawals from savings and net borrowings would be treated as gross income. Thus, a cash flow tax differs from a consumption tax such as a retail sales tax in that the cash flow tax can be levied and collected from individual taxpayers rather than businesses. This personalization of the tax can measure the consumption of an individual taxpayer and allows the application of a progressive rate structure.

2. Description of the "USA Tax Act of 1995" (S.722)

Overview

On April 25, 1995, Senators Sam Nunn and Pete Domenici introduced a form of a cash flow tax in S. 722, (the "USA Tax Act of 1995"). In general, S. 722 would replace the current individual income tax with a "savings-exempt income tax"—a broader-based individual income tax with an unlimited deduction for net new saving. The tax would be imposed using a three-tier graduated rate schedule. In addition, S. 722 would replace the current corporate income tax with a subtraction-method VAT imposed on all businesses at a rate of 11 percent. Thus, in general, the bill would apply two different consumption-based taxes—a cash flow tax on individuals and a VAT on businesses. The bill also would provide individuals with a refundable credit against the individual tax for employee payroll taxes paid by them, and businesses with a credit against the business tax for employer payroll taxes paid by them. Following is a more detailed description of the bill.

Treatment of individuals under the "savings exempt income tax"

The individual tax, or "savings exempt income tax," would be a broad-based income tax with an unlimited deduction for new savings. In other words, it is a modified version of a personal consumption tax with one principal distinction. As discussed in more detail below, borrowing would not be included in income, but rather would only reduce (but not below zero) the net saving deduction. Thus, unlike a personal consumption tax, a net borrower would not pay tax on an amount greater than his income in a given year, even though the net borrowing reflects additional consumption. This additional consumption generally would be taxed as the loan is repaid.

The individual tax would have a three-tier graduated tax rate structure. As under present law, separate rate schedules would apply based on an individual's filing status. The rate structure would be phased in from 1996 to 1999. After 1999, the individual income tax rate schedules would be as follows:

Table 5.—Individual Income Tax Rates Under S. 722[1]

If taxable income is	Then income tax equals
	Single individuals
$0–$3,200	8 percent of taxable income.
$3,200–$14,400	$320 plus 19% of the amount over $3,200.
Over $14,400	$2,560 plus 40% of the amount over $14,400.
	Heads of households
$0–$4,750	8 percent of taxable income.
$4,750–$21,100	$380, plus 19% of the amount over $4,750.
Over $21,100	$3,486.50, plus 40% of the amount over $21,100.
	Married individuals filing joint returns
$0–$5,400	8 percent of taxable income.
$5,400–$24,000	$432, plus 19% of the amount over $5,400.
Over $24,000	$3,966, plus 40% of the amount over $24,000.
	Married individuals filing separate returns
$0–$2,700	8 percent of taxable income.
$2,700–$12,000	$216, plus 19% of the amount over $2,700.
Over $12,000	$1,983, plus 40% of the amount over $12,000.

[1] The rate schedules are expressed in 1996 dollars and would be indexed for inflation beginning in 1997.

Gross income would be defined broadly to include salaries and wages, pensions, most fringe benefits, annuities, life insurance proceeds, alimony and child support payments, dividends, distributions from partnerships and proprietorships, rents, royalties, interest (other than tax-exempt interest), includible social security benefits, and proceeds from the sale of assets. Exclusions from gross income would be limited to tax-exempt bond interest,[51] gifts and bequests, certain government transfer and similar payments, certain health care payments and reimbursements, certain military pay and veteran's benefits, and a portion of social security payments (generally as under present law).

An individual would be allowed a deduction for any increase in his or her "net savings" during the year. "Net savings" would be the taxpayer's additions to qualified savings assets during the year over taxable withdrawals from qualified savings assets during the year. An annual decrease in net savings would constitute taxable income. Borrowing would not be treated as a withdrawal from saving, but generally would reduce (but not below zero) the amount of "net savings" that could be deducted in a taxable year.[52] In addi-

[51] This exemption may be worth less than under present law, because the "tax" on taxable interest may be deferred under the savings deduction.

[52] Certain types of debt would not reduce deductible "net savings" in a taxable year, including mortgage debt on a principal residence, debt (of $25,000 or less) to purchase consumer durables, credit card and similar debts, and $10,000 of other debts.

tion, "net savings" would be reduced by interest income on tax-exempt bonds.

Qualified savings assets would include stocks, bonds, securities, certificates of deposits, interests in proprietorships and partnerships, mutual fund shares, life insurance policies, annuities, retirement accounts, and bank, money market, brokerage and other similar money accounts. Qualified savings assets would not include investments in land, collectibles, or cash on hand.

Under the bill, in addition to certain itemized deductions (discussed below) each taxpayer would be entitled to two types of standard deductions: (1) a family living allowance, and (2) a personal and dependency deduction. The family living allowance and the personal and dependency deductions under the bill are comparable to the standard deductions and personal exemptions of present law, respectively.

The bill would continue to allow deductions for qualified home mortgage interest[53] and charitable contributions. In contrast to current law, these itemized deductions would be allowed in addition to the standard deduction, rather than in lieu of the standard deduction. Other deductions allowable under present law generally would be eliminated, such as itemized deductions for state and local taxes and medical expenses. The bill would allow a new deduction for certain qualified educational expenses. This deduction generally would be limited to $2,000 per eligible student per year, and to $8,000 in total per year.

The bill would allow certain credits against the amount of tax due. First, a foreign tax credit would be allowed in a manner similar to present law. Second, a credit generally would be allowed for the employee share of payroll taxes paid by the taxpayer. Third, for low-income individuals, an earned income credit similar to present law would be allowed.

The bill would provide certain transition rules (e.g., recovery of pre-transition basis) for purposes of the individual tax. A discussion of these rules is beyond the scope of this pamphlet.[54]

U.S. citizens and U.S. resident alien individuals would be subject to the individual tax.[55] Nonresident alien individuals would be subject to a 30-percent tax on the following U.S. sources of income: interest; original issue discount; dividends; rents; salaries; wages; premiums; annuities; compensation; remunerations; emoluments; other fixed or determinable annual periodic gains, profits or income; gains from the disposal of timber, coal or iron ore with a retained economic interest; 85 percent of social security benefits; and net capital gains for the taxable year (if the individual was present in the United States for a period of 183 or more days during the year). Nonresident alien individuals would not be subject to tax on income from a business entity (other than interest, dividends, or compensation); income protected under tax treaties or certain other international agreements; annuities from qualified plans substantially covering U.S. citizens or residents relating to personal serv-

[53] The home mortgage deduction generally would be the same as under present law, except that no deduction would be allowed for "home equity indebtedness." See Code section 163(h)(3).

[54] Transition issues under tax restructuring proposals will be the subject of a future hearing pamphlet.

[55] A nonresident alien individual who relinquished his or her U.S. citizenship in order to avoid the tax generally would be taxed as a citizen for 10 years.

ices performed by the nonresident alien outside the United States or on a temporary basis in the United States; portfolio or deposit interest; dividends to the extent the paying business entity has 80 percent or more of its gross receipts from sources outside the United States; gambling winnings (except as provided by regulations); compensation paid by a foreign employer to a person temporarily present in the United States as a nonimmigrant; interest on series E or H savings bonds acquired by residents of the Ryuku Islands or the Trust Territory of the Pacific Islands; and amounts earned or paid to bona fide residents of Puerto Rico, Guam, American Samoa, or the Commonwealth of the Northern Mariana Islands. Special rules would provide for the treatment of income of a married couple, one of whom is a nonresident alien.

Business tax

In general.—The bill would impose a subtraction-method VAT on any business that sells or leases property or sells services in the United States. The tax would equal 11 percent of the "gross profits" of the business for the taxable year. "Gross profits" generally is the amount by which the taxpayer's taxable receipts exceed the taxpayer's business purchases for the taxable year. If the taxpayer's business purchases exceed its taxable receipts for the taxable year, the taxpayer generally would be entitled to a loss carryover to future taxable years. Employer payroll taxes paid by the business may be credited against the business tax.

"Taxable receipts" generally would mean all receipts from the sale or lease of property and the performance of services in the United States. The amount treated as taxable receipts from the exchange of property or services is the fair market value of the property or services received, plus any cash received. Taxable receipts do not include: (1) any excise tax, sales tax, customs duty, or other separately stated levy imposed by the Federal, a State, or a local government on property or services, or (2) financial receipts, such as interest, dividends, or proceeds from the sale of stock or other ownership interests.

"Business purchases" generally would mean any amount paid or incurred to purchase property, the use of property, or services for use in a business activity in the United States other than: (1) compensation paid to employees; (2) payments for use of money or capital, such as dividends or interest, (3) life insurance premiums; (4) amounts paid for the acquisition of savings assets or financial instruments; and (5) amounts paid for property purchased or services performed outside the United States (unless treated as an import). The cost of a business purchase does not include any taxes other than any excise tax, sales tax, customs duty, or other separately stated levy imposed by the Federal, a State, or a local government with respect to the property or services purchased for use in a business activity. "Business activity" means the sale of property or services, the leasing of property, and the development of property or services for subsequent sale or use in producing property or services for subsequent sale. A business activity would not include casual or occasional sales of property.

International aspects.—The business tax generally is based on the destination principle. Goods and services sold in the United

States are subject to tax; export sales are not subject to tax. Deductions are allowed only for expenditures relating to the conduct of a business activity in the United States. For purposes of the business tax, the term "United States" would not include the U.S. possessions. A separate tax, imposed at a rate of 11 percent, would apply to the customs value of any property entering the United States (other than property that may be entered duty free under Chapters I through VII of chapter 98 of the Tariff Schedules of the United States). Similarly, recipients of imported services would be subject to an 11-percent tax on the cost of such services. Deductions would be allowed for imported property or services used in a business activity in the United States. The amount of such deductions would be based on the amount upon which the separate import taxes are based; deductions would not be allowed for the amount of the import tax.

Services would be treated as imported or exported based upon where the benefit of the service is realized. If a business entity acquires services from a service provider that provides services both inside and outside the United States, the business entity and the service provider would treat the services as provided as indicated on the invoice provided by the service provider. In the absence of an invoice, the business entity would treat the services as provided in the location to which payment is sent and the service provider would treat any payments received as taxable receipts. Special rules and regulations would apply to international transportation services, international communication services, insurance services, and banking and other financial intermediation services.

Accounting methods.—In computing its gross profits, a taxpayer generally would be required to use an accrual method of accounting. For this purpose, an amount would not be treated as incurred earlier than when "economic performance" with respect to the item has occurred (Code sec. 461(h).) Businesses presently using the cash receipts and disbursements method, however, generally could continue to use that method. The Secretary of Treasury also could allow certain new businesses to use the cash method. The taxpayer's method of accounting could be changed only with the permission of the Secretary. Special accounting rules would apply with respect to property produced pursuant to long-term contracts.

Financial intermediation services.—The bill would impose the business tax on the provision of financial intermediation services. Special rules would apply to determine the taxable amount derived from financial intermediation services. In addition, the bill would permit the business user of financial intermediation services to deduct as business purchases any stated fees for such services and any implicit fees allocated and reported to it by the financial intermediary. The bill would provide a method (and reporting mechanism) for allocating the value of financial intermediation services among users of the services.

Government and non-profit entities.— Government entities would not be subject to the business tax with respect to the following activities: (1) public utility services; (2) mass transit services; and (3) any other activity involving an "essential governmental function." Any other government activity of a type "frequently provided by business entities" would be subject to tax. The governments of pos-

sessions of the United States would not be subject to the business tax.

The bill generally would exempt the following types of entities from the business tax: (1) instrumentalities of the United States, (2) organizations described in present-law Code section 501(c)(3),[56] (3) certain qualified benefit plans and trusts, (4) religious and apostolic organizations, (5) cemetery companies, (6) certain title and real property holding companies, (7) cooperative hospital service organizations, and (8) cooperative educational service organizations. These entities would be subject to the business tax only with respect to their business activities that would be subject to the unrelated business income tax ("UBIT") under present law. The taxable amount for a "UBIT activity" would be determined in the same manner as the taxable amount for any other business activity subject to the business tax.

Entities (other than those listed above) that are tax-exempt under present law would be fully subject to the business tax on transfers of property or furnishing of services, even if such activities are substantially related to what historically has been considered to be the exempt purposes of these organizations.

Transition rules.—The bill would provide certain transition rules (e.g., recovery of pre-transition basis) for purposes of the business tax. A discussion of these rules is beyond the scope of this pamphlet.

E. A "Pure" Income Tax

1. In general

Under a "pure" income tax, all income would be subject to tax and deductions would be allowed only for expenses that are incurred in the production of income. Income would be recognized when earned and deductions generally would be matched with the accounting period in which the related income is recognized.

A significant portion of the current U.S. tax system generally is considered to be an "income tax."[57] Code section 61 subjects to tax "income from whatever source derived," except for certain items explicitly exempted or excluded by statute. However, the current Federal "income" tax has features that are consumption-based. For example, present law excludes from income contributions to, and earnings of, qualified retirement plans. These exclusions are features of a consumption-based tax because of their treatment of savings.

The current Federal income tax also allows certain deductions in a manner similar to the way such deductions are allowed under a consumption-based tax. For example, under a VAT or consumption-based flat tax, businesses are allowed to expense the cost of property used in the business (such as machinery, equipment, real property, and inventory) in the year such costs are paid or in-

[56] The bill, however, would not exempt organizations that test for public safety or foster amateur sports competition.

[57] In 1994, 54.34 percent of Federal receipts came from individual and corporate income taxes, 36.69 percent came from payroll taxes, 4.39 percent came from excise taxes, and 4.58 percent came from other sources. Joint Committee on Taxation, *Selected Materials Relating to the Federal Tax System Under Present Law and Various Alternative Tax Systems* (JCS–1–96), March 14, 1996, pp. 5–8.

curred. Expensing is equivalent to excluding from tax the expected return from the property because the cost of such property is equal to the present value of the expected stream of income from the property. Under a "pure" income tax, costs of property that benefit future accounting periods are capitalized and recovered over such periods. Under present law, certain costs are expensed in the period they are incurred even though such costs may benefit future periods and would be capitalized under a "pure" income tax. Examples of such expenditures include up to $17,500 of the cost of tangible personal property of small business, the cost of clean-fuel vehicles and refueling property, intangible drilling costs, research and experimental expenditures, expenditures to increase the circulation of newspapers, magazines and periodicals, certain timber expenditures, certain expenditures of farmers, costs of removing architectural and transportation barriers to the handicapped and elderly, certain mining expenditures, and certain costs incurred by free lance authors, photographers, and artists. In addition, present law allows certain capitalized costs to be recovered more rapidly than would be allowed under a "pure" income tax. For example, present law allows the cost of tangible personal property to be depreciated using accelerated methods over periods that may be shorter than the useful lives of the property. Expensing or accelerated cost recovery is provided under present law for certain expenditures in order to simplify the tax accounting for such costs or to provide a tax benefit or incentive for particular activities or types of taxpayers.

Certain exemptions, exclusions, deductions, special rates, and credits are provided in the current Federal income tax largely to promote social, economic, or intragovernmental policies, rather than to contribute to a more accurate measure of economic income. Examples of such items include itemized deductions for medical expenses, home mortgage interest, charitable contributions,[58] State and local income taxes,[59] and property taxes; percentage depletion in excess of cost for natural resources; the exclusion from income for employer-provided health insurance; the exclusion of interest on State and local bonds; special rules applicable to military personnel; parsonage allowances for clergy; the special rate of tax on long-term capital gains; and most tax credits. Similarly, present law denies tax deductions for certain trade or business expenses for social policy reasons. Examples include the denial of deductions for penalties, fines, bribes, lobbying activities, and compensation in excess of $1 million for certain executives.

Several adjustments could be made to the present-law tax system to arrive at a more "pure" income tax. The base of the income tax could be expanded to be more comprehensive. A comprehensive income base would include income from all sources, whether labor income or returns to saving. Sources of income currently excluded from tax (such as employer-provided health insurance, and interest from State and local bonds) would be included in the base. Items currently given consumption-base treatment in the individual in-

[58] Under one view, deductions for charitable contributions are allowable in order to measure more properly the disposable income of the donor.

[59] Deductions also may be allowed for State and local income tax for income measurement purposes.

come tax would be put on an income base. For example, contributions by an employer on behalf of an employee to a qualified retirement plan would be taxed to the employee when the amount of the contribution is earned. Long-term capital gains would be treated the same as ordinary income. Present-law conventions that result in the deferral of income could be repealed in order to result in a more accurate measure of economic income.

Under a more comprehensive income tax, deductions would be allowed only for expenditures that are incurred for the production of income. Thus, most present-law itemized deductions would be repealed. Deductions would be allowed to the extent necessary accurately to measure annual economic income. Thus, expenditures that benefit future accounting periods would be capitalized and recovered in the appropriate period. In general, the tax base for business income would more closely resemble the present-law corporate alternative minimum tax base.

The present-law "income" tax is known as a two-tier income tax in that the income of a "C corporation"[60] is subject to a separate corporate tax as the income is earned and the individual income tax when the income is distributed to the individual shareholders of the corporation (or when the shareholders sell their interests in the corporation). Unlike the two-tier tax treatment of investments in corporate equity, investments in certain "flow-through" entities (e.g., partnerships and S corporations[61]) are subject to tax only at one level (generally, the investor level). Similarly, investment in a security that is issued by any type of entity that is treated as debt for Federal income tax purposes is subject to only one level of tax because interest on debt is deductible by the issuer and includable by the investor. Thus, present law contains certain discontinuities with respect to the tax treatment of different investments and influences the choice of entity through which to conduct business and how to capitalize the business. How these discontinuities would be addressed under a "pure" income tax is unclear.[62] On the one hand, the two-level taxation of business earnings could be preserved. Conversely, the corporate and individual income taxes could be "integrated" to provide one level of taxation.[63]

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[60] A "C corporation" is a corporation described in subchapter C of the Code. Subchapter C provides rules governing the treatment of taxable corporations and their shareholders.

[61] An "S corporation" is a corporation described in subchapter S of the Code. Subchapter S provides an election for a small business corporation to be exempt from the corporate-level tax applicable to C corporations and provides rules governing the treatment of electing corporations and their shareholders. For a more detailed discussion of the treatment of S corporations, see Joint Committee on Taxation, *Present Law and Proposals Relating to Subchapter S Corporations and Home Office Deductions* (JCS-16-95) May 24, 1995.

[62] Charts 1 and 3 included at the end of this Part of the pamphlet assume that the two-tier taxation of corporate earnings would continue under the "pure" income tax depicted therein.

[63] Several of the U.S. trading parties (e.g., Australia, Canada, France, Germany, New Zealand, and the United Kingdom) have integrated their corporate and individual income tax systems to some extent. In addition, the consumption-based taxes described above in this part of the pamphlet provide forms of tax integration by taxing business activity no more than once. For a further discussion of this issue, see Department of the Treasury, *Integration of the Individual and Corporate Tax Systems—Taxing Business Income Once*, January 1992, and American Law Institute, Federal Income Tax Project, *Integration of the Individual and Corporate Income Taxes, Reporter's Study of Corporate Tax Integration*, by Alvin C. Warren, March 31, 1993.

2. Description of the "Ten Percent Tax Plan"

The Treasury Department described a more comprehensive income tax base in its study of tax reform in 1984.[64] Portions of this were enacted as part of the Tax Reform Act of 1986, which broadened the tax base while lowering ordinary income tax rates. More recently, the House Minority Leader (Mr. Gephardt) has proposed an individual income tax (the "Ten Percent Tax Plan") with a more comprehensive base.[65] Under the proposal, interest income on State and local bonds, employer-provided fringe benefits (primarily health insurance), and employer pension contributions would be subject to tax. The foreign earned income exclusion (section 911 of the Code), deductions for IRA and Keogh contributions, and the deduction for self-employed health insurance would be eliminated. The only itemized deduction allowed under the plan would be the mortgage interest deduction. Deductions for investment interest and job-related expenses would be retained. The individual tax rates that would be applied to this expanded income base would be reduced from a range of 15 to 39.6 percent to a range of 10 to 34 percent. The special capital gains rate would be repealed. The proposal would repeal the child care and elderly credit, while retaining the earned income and foreign tax credits.

F. Summary of Treatment of Various Items Under Alternative Tax Systems

The following charts generally describe the treatment of certain common items of income and expense under various alternative tax systems. The charts describe how taxpayers would treat these items on their own tax returns. The treatment of items under "national retail sales tax" is based upon H.R. 3039. The "value-added tax" is based upon the Business Activities Tax of S. 2160, as introduced. The "consumption-based flat tax" is based upon H.R. 2060 and S. 1050, as introduced. The "USA Tax" is based upon S. 722, as introduced. The description of the "pure" income tax is based upon a theoretical model for such a system.

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[64] Department of the Treasury, *Tax Reform for Fairness, Simplicity and Economic Growth, Vol. 1*, 1984.

[65] See press release dated January 17, 1996. The press release also states that the "Ten Percent Tax cuts corporate welfare by more than $50 billion and uses that money to cut taxes for small businesses." Specific details with respect to changes in business taxation are not provided. In addition, the "Ten Percent Tax Plan" has not been introduced as a bill, nor has statutory language for the plan been released.

Chart 1.--Treatment of Income of Individuals Under Various Tax Systems

	National Retail Sales Tax	Value-Added Tax (VAT)	Consumption-based Flat Tax (Armey/Shelby)	USA Tax (Nunn-Domenici)	Present Law Inc. Tax	"Pure" Income Tax
INCOME:						
Wages\Salaries	N/A	N/A	Includible	Includible	Includible	Includible
Retirement Benefits (incl. inside build-up)	N/A	N/A	Includible when Received	Includible when Received	Includible when Received	Includible when Earned
Social Security Benefits	N/A	N/A	Not Includible	Partially Includible	Partially Includible	Includible
Unemployment Compensation	N/A	N/A	Includible	Includible	Includible	Includible
Employer-paid Health Care	N/A	N/A	Not Includible	Includible	Not Includible	Includible
Dividends	N/A	N/A	Not Includible	Includible	Includible	Includible
Interest	N/A	N/A	Not Includible	Includible	Includible	Includible
Municipal Interest	N/A	N/A	Not Includible	Not Includible	Not Includible	Includible
Capital Gains	N/A	N/A	Not Includible	Includible	Includible	Includible
Business, Farm, Partnership, & Sub S Income	N/A	N/A	Subject to Business Tax	Includible	Includible	Includible
Rental & Royalty Income	N/A	N/A	May be subject to Business Tax	Includible	Includible	Includible
Alimony	N/A	N/A	Not Includible	Includible	Includible	Includible
Child Support	N/A	N/A	Not Includible	Includible	Not Includible	Includible

Chart 2.--Treatment of Deductions of Individuals Under Various Tax Systems

	National Retail Sales Tax	Value-Added Tax (VAT)	Consumption-based Flat Tax	USA Tax (Nunn-Domenici)	Present Law Inc. Tax	"Pure" Income Tax
DEDUCTIONS:						
IRA & Savings Contributions	N/A	N/A	Not Deductible	Unlimited Ded. for Savings	Ded. within limits	Not Deductible
Alimony	N/A	N/A	Not Deductible	Deductible	Deductible	Deductible
Child Support	N/A	N/A	Not Deductible	Deductible	Not Ded.	Deductible
Moving Expense	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
Medical	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
State/Local Taxes	N/A	N/A	Not Deductible	Not Ded.	Deductible	Not Ded.
Real Estate Taxes	N/A	N/A	Not Deductible	Not Ded.	Deductible	Not Ded.
Mortgage Int.	N/A	N/A	Not Deductible	Deductible	Deductible	Not Ded.
Investment Int.	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
Charitable Contributions	N/A	N/A	Not Deductible	Ded. within limits	Ded. within limits	Not Deductible
Casualty Losses	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
Employee Business Exp.	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
Investment Exp.	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
Education Exp.	N/A	N/A	Not Deductible	Deductible w/in limits	Generally not ded.	Not Deductible

Chart 3.--Treatment of Businesses Under Various Tax Systems

	National Retail Sales Tax	Value-Added Tax (VAT)	Consumption-based Flat Tax	USA Tax (Nunn-Domenici)	Present Law Inc. Tax	"Pure" Income Tax
INCOME:						
Gross Receipts from Sales of Goods/Services	Retail Sales Only	Includible	Includible	Includible	Includible	Includible
Interest	Not Incl.	Not Incl.	Not Incl.	Not Incl.	Includible	Includible
Dividends	Not Incl.	Not Incl.	Not Incl.	Not Incl.	Partially Includible	Includible
Capital Gains	Not Incl.	Not Incl.	Not Incl.	Not Incl.	Includible	Includible
Proceeds from Sales of Business Assets	Not Incl.	Includible	Includible	Includible	Includible	Includible
Rental & Royalty Income	Not Incl.	Incl. if trade or business	Incl. if trade or business	Incl. if trade or business	Includible	Includible
DEDUCTIONS:						
Inventory	Not Ded.	Ded. when acquired	Ded. when acquired	Ded. when acquired	Ded. when sold	Ded. when sold
Cost Recovery of Property	Not Ded.	Expensed when acquired	Expensed when acquired	Expensed when acquired	Deprec. over time	Depreciate over time
Payments to Indep. K'ors	Not Ded.	Deductible	Deductible	Deductible	Deductible	Deductible
Salaries/Wages	Not Ded.	Not Ded.	Deductible	Not Ded.	Deductible	Deductible
Retire. Benefits	Not Ded.	Not Ded.	Deductible	Not Ded.	Deductible	Deductible
Employee Health	Not Ded.	Not Ded.	Not Ded.	Not Ded.	Deductible	Deductible
Taxes	Not Ded.	Not Ded.	Not Ded.	Not Ded.	Deductible	Deductible
Interest	Not Ded.	Not Ded.	Not Ded.	Not Ded.	Deductible	Deductible
Charitable Contributions	Not Ded.	Not Ded.	Not Ded.	Not Ded.	Ded. with limits	Deductible
Advertising	Not Ded.	Deductible	Deductible	Deductible	Deductible	Deductible

V. ANALYSIS OF ISSUES RELATED TO TAX RESTRUCTURING PROPOSALS AND THE TAXATION OF INTERNATIONAL TRANSACTIONS

A. Characterizing Systems of Taxation

1. Taxation of real transactions and financial transactions

The consumption-based flat tax, the VAT, and the USA tax of S. 722 on businesses are often described as taxing businesses on their "cash flow." Similarly, the USA tax taxes individuals on their personal consumption measured on a cash-flow basis. It is important to specify what cash flows comprise the tax base. There are two alternatives among cash-flow taxes, sometimes labeled as "R" and "R+F."[66] The R alternative accounts only for cash flows based on real (non-financial) activity. Sales of goods and services are included in the base and purchases of inputs are subtracted from the base. Proceeds from a bank loan or a sale of stock are not included in the base and outflows such as loan repayments and payments of interest and dividends are not subtracted from the base. The R+F alternative accounts for cash flows based on both real activity and financial activity (except for transactions with the equity holders of a business). In addition to sales of goods and services, loan proceeds are included in the base. Purchases of inputs, loan repayments and payments of interest are subtracted from the base. Stock sale proceeds and dividends are ignored.

The consumption-based flat tax, the VAT, and USA business tax generally use an R approach to defining the cash-flow base for businesses, which leads to a distinction between them and a pure income-based business tax.[67] The national retail sales tax also is an R-based tax. Interest expense is deductible under an income-based tax as a cost of producing income, but would not be deductible under an R-based tax. By contrast, under an R+F-based tax, interest would continue to be deductible and principal repayments would become deductible, while loan proceeds would become includible in the base. The USA tax on individuals is an example of a modified R+F-based tax.

Though seemingly different, the treatment of interest under the R and R+F bases is economically equivalent. Because the present value of interest and principal payments on a loan is equal to the amount of the loan, the inclusion of loan proceeds and subsequent deductions for repayments of principal and payments of interest under the R+F base is equivalent, in present value, to excluding debt transactions, as is done under the R base. In the international context, however, the distinction between the R base and the R+F base may be important. While interest expense would not be deductible in the United States under an R base, it generally would still be deductible in countries that retain an income tax or that use an R+F base. Multinational businesses may try to arrange

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[66] This nomenclature was introduced by the Meade Committee in the study published by the Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation*, (London: George Allen and Unwin), 1979. "R" stands for "real," while "F" stands for "financial."

[67] The deductibility of interest is not required in an income-based business tax. The Comprehensive Business Income Tax proposed by the Treasury Department was an income-based tax that would have denied businesses a deduction for interest. Department of the Treasury, *Integration of the Individual and Corporate Tax Systems*, January 1992.

their use of debt such that they incur interest expense where it is deductible.

Under either an R or R+F base, a consumption-based flat tax or a VAT on businesses results in an expected tax collection of zero on the returns to additional units of capital. In a competitive market, the price of each additional capital good would be the expected present value of the output produced over the lifetime of the capital good. The business deducts that price in the year of purchase. If we assume that future returns from the capital good are equal to those expected by the taxpayer at the time of purchase, the returns the business receives from using each additional capital good increase its tax base in the future, but only by as much in present value as the amount expensed at the time of purchase. Similar to the present-law treatment under the individual income tax for deductible IRA contributions, the expensing of the cost of a capital good is equivalent to exempting from tax the expected returns generated by such good. Thus, under a consumption tax base, capital income is untaxed at the margin regardless of whether the income arises from capital invested domestically or abroad. (Of course, a foreign country may continue to impose tax on the marginal investments of U.S. persons in that country.)

A numerical example may help illustrate this point. Assume a business can borrow money at a 7.5-percent interest rate. The business can buy a machine that will produce $10 of revenues per year for five years. At the end of five years the machine will no longer operate and will have no salvage value. Because the present value of $10 per year for five years when the business's cost of funds is 7.5 percent is $40.46, the business would pay no more than $40.46 for the machine. Assume the business pays $40.46 for the machine. Under each of the subtraction-method VAT, the USA business tax, and the consumption-based flat tax, the business may deduct such a purchase in the first year. Assume the tax rate under each tax is 25 percent. Because the purchase of the machine is deductible, the net cost of the machine to the business is $30.34 ($40.46 multiplied by (1 - .25)). Oppositely stated, the expensing of the machine gives rise to a tax reduction on the cost of the machine of $10.12 ($40.46 multiplied by the 25-percent tax rate). The $10 annual revenue is taxed at 25 percent, leaving a net for the business of $7.50 per year and sending $2.50 to the government in annual tax revenues. From the business's perspective, the present value of the $2.50 per year in tax revenues discounted at the business' cost of funds is $10.12.[68] That is, in present value terms, any future tax liability that arises from the investment decision (the purchase of the machine) is exactly offset by the initial expensing of the investment. It is in this sense that economists say that the returns to investment are exempt from tax under a consumption tax.[69]

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[68] Oppositely stated, the present value of the annual, net of tax $7.50 revenue stream is $30.34.

[69] Another way to think of the economics of this investment decision is that the business and the government have invested in partnership in the machine. The partnership is 75/25. The business puts up $30.34 in cash toward the purchase of the machine and the government puts up $10.12 in tax reduction (the value of expensing the entire $40.46 purchase price). The business and the government then split the revenue stream 75/25 with the business receiving $7.50 per annum and the government $2.50 per annum. Thought of in this way, one can see that the business invests 75 percent of the cost of the machine and receives 75 percent of the pretax

Continued

In this example, there is no tax on the investment in present value terms because the business paid a price for the machine exactly equal to the present value of the machine's output. That is, the return from the machine was just sufficient to enable the business to repay its loan at the 7.5 percent interest rate. Assume that the business had been able to purchase the machine for $32. Clearly, this would be an extremely profitable investment to make, because the business could pay $32 for a machine that could produce a present value of output worth $40.46. The business could borrow the $32 at 7.5 percent, buy the machine, repay the loan with interest, and still have money left over. Any such return is called an "above-normal return" or "above-normal profit" because in a competitive market one would expect competing businesses to bid up the price of the machine to equal $40.46. The returns earned on an investment that are just sufficient to repay the opportunity cost of the business's capital are called "normal returns" or "normal profits." If the business were able to purchase the machine for $32, a VAT or the USA business tax each would permit a deduction for the $32 purchase price. In the example above, the deduction would be worth $8 ($32 multiplied by the 25 percent tax rate). Under each of these taxes, $2.50 would be collected in taxes per year on the $10 annual revenues, as before, for a present value of taxes of $10.12. In this case, there is a net tax liability from the investment in the machine of $2.12 in present value terms ($10.12 in taxes less the $8 value of the expensing deduction). This is a tax liability arising from the above-normal profit (the present value of the machine's output exceeds the machine's cost by $8.46 and $8.46 multiplied by the 25-percent tax rate is $2.12).[70] Any net collections (in present value terms) by the United States of the tax arise from returns in excess of those expected at the time of purchase of an additional capital good or from inframarginal units of capital.[71]

An income tax does not fit into the R and R+F taxonomy that applies to cash-flow taxes. Under an income tax, interest payments are deductible by the lender and includible by the creditor, but the proceeds of loans and repayments of principal are not part of the tax base. Under a pure income tax, U.S. persons (individuals and businesses) would be subject to tax on their foreign income. Moreover, the tax would apply currently, regardless of whether the income is actually distributed to the U.S. person. That is, there would be no deferral of tax. Deferral of tax on foreign source income earned through a foreign corporation under present law has the effect of reducing the effective tax rate on investments made by U.S. persons abroad compared to investments made by U.S. persons in the United States.[72] Under a pure income tax, the effective

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return, while the government earns the same rate of return as does the business on its 25-percent share. That is, the business earns a tax-free return on its net investment of $30.34.

[70] The government shares in any above-normal return at the rate of tax, in this example 25 percent.

[71] Inframarginal units of capital are those for which the business *expects* a return in excess of the return that it could make on the next-best use of the funds. For such units of capital, the present value of the expected returns would exceed the cost of the unit of capital. If the actual returns match the expected returns, there will be a positive present value of tax collected on those returns.

[72] For a more comprehensive discussion of deferral, see Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States* (JCS-6-91), May 30, 1991, pp. 252-254. The use of excess foreign tax credits can also reduce the effective U.S. taxation of foreign-source income. A recent study calculates that in 1990 the average effective U.S. tax rate

tax rate would be the same regardless of the location of the investment, except in the case where the foreign country imposes a higher rate of tax than does the United States.[73] In such a situation, the total effective tax rate (U.S. tax and foreign tax) would be greater for an investment made abroad than a domestic investment.

2. Destination principle taxation and origin principle taxation

Consumption-based taxes can differ depending upon whether they are imposed under a destination principle or an origin principle. The premise of the destination principle is that goods and services should be taxed where they are consumed, that is, at the destination of final consumption. Thus, under a destination-principle consumption tax, imports are taxed, either by taxing them directly or by making their purchase nondeductible to the importer, and exports are exempt from tax. Because investment expenditures are expensed, the tax base of a destination-principle consumption tax is expenditures on the domestic consumption of goods and services. The USA business tax and the national retail sales tax are examples of destination-principle consumption taxes. Credit-invoice VATs imposed in Europe and elsewhere also are destination principle taxes.

The premise of the origin principle is that goods and services should be taxed where they are produced, that is, where they originate. Thus, under an origin-principle consumption tax, domestic production of goods and services, including those for export, is subject to tax. Imported goods and services are exempt from tax. Again, because investment expenditures are expensed, the tax base of an origin-principle consumption tax is domestic consumption plus net exports. The consumption-based flat tax of H.R. 2060 and S. 1050 is an example of an origin-principle consumption tax.

The tax base of a destination-principle consumption tax clearly is different from the tax base of an origin-principle consumption tax. However, over the long run, if the tax rates of the two taxes remain the same, economically the two are equivalent in most cases. To see this, assume that the United States is a net exporter (i.e., exports exceed imports).[74] As explained in Part III.A. above, if the United States is a net exporter of goods and services, the United States must be accumulating foreign assets. Under an origin-principle consumption tax, the net exports would be subject to tax, in addition to domestic consumption. Under a destination-principle consumption tax, net exports would be exempt from tax. Economists argue that over time, trade must balance. That is, the reason individuals invest is to earn income to finance future consumption. At the margin, a dollar of foreign assets should produce one dollar's worth of potential imports in present value. If not, it

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on foreign income of U.S. multinational corporations was two percent. See, Harry Grubert and John Mutti, "Taxing Multinationals in a World with Portfolio Flows and R&D: Is Capital Export Neutrality Obsolete?" *International Tax and Public Finance* (forthcoming). This study did not calculate the total tax burden (U.S. plus foreign) on foreign investments.

[73] This assumes that the United States would not provide a credit in excess of the U.S. tax on comparable income.

[74] This discussion follows Harry Grubert and T. Scott Newlon, "The International Implications of Consumption Tax Proposals," 48 *National Tax Journal* 642 (1995).

would not be a wise investment. If the United States were accumulating foreign assets, the income from these assets at some point would be used to purchase imported goods. The destination-principle consumption tax would tax the future import of goods. The origin-principle consumption tax would exempt from tax the future import of goods, but would have taxed the export sales that gave rise to the foreign assets necessary to finance the imports. In present value terms, the tax on exports prepays the tax forgone on future imports. Thus, taxing the current value of exports under an origin-principle tax is economically equivalent to taxing the present value of future imports.

This equivalence holds for post-enactment acquisition of foreign assets and any subsequent imports acquired with income earned on those foreign assets. However, it does not hold in the case of foreign assets acquired prior to enactment. If one presently held foreign assets and used the income from such assets to purchase imported goods, the goods would be taxable under the destination principle. Those same goods would be exempt from tax under the origin principle and no tax would have been prepaid on the exports used to acquire the foreign assets, as the assets were acquired prior to imposition of the origin-principle tax.

The equivalence also will fail where the investor in foreign assets is able to earn above-normal profits. Assume that a U.S. person sells $1 of goods abroad and invests that dollar in foreign assets. Under the destination principle, the sale of goods abroad is exempt from tax. Under the origin principle, the sale of goods abroad is taxable. The discussion above showed that if the investment returned a present value of $1 spent on imports, the destination principle and origin principle are equivalent. Alternatively, assume that the U.S. person is lucky or smart and the investment returns a present value of $3. Under the destination principle, the $3 (in present value) of imported goods would be subject to tax. The full value of the above-normal profit ($3 less $1) would be taxed in exchange for the initial exemption from tax for the $1 of exported goods. Under the origin principle, none of the $3 of imported goods would be subject to tax. The above-normal profit ($3 less $1) effectively is exempted from tax. Tax is collected only on the $1 of exported goods. This outcome is different from that which arises in the case of above-normal profits on domestic investment. If $1 were invested in the United States and it produced $3 worth (in present value) of domestic consumption, the full value of the domestic consumption would be taxable under either a destination or an origin principle tax.[75]

B. Tax Restructuring and Cross Border Trade

1. In general

A VAT based on the destination principle imposes tax on imports and provides tax rebates on exports. These import fees and export rebates are commonly referred to as border tax adjustments and

[75] See the discussion and example in Part V.A.1. above of how consumption-based taxes tax above-normal returns on domestic investments. Here it could be said that the government shares in above-normal returns earned on foreign investments under a destination-based tax but does not share in above-normal returns earned on foreign investments under an origin-based tax.

are a fixture of most VAT systems currently in place. They are also fully consistent with GATT rules, as long as they do not discriminate against imports or provide over-rebates on exports. Since the tax on imports has the appearance of a protective tariff, and the rebate on exports has the appearance of an export subsidy, it is commonly believed that a VAT (based on the destination principle) would help the U.S. balance of trade. However, economists have long held that there is no direct effect of a VAT on the volume of exports or imports.[76] Accordingly, the imposition of a tax on imports—equal to that imposed on goods produced domestically—and a similar tax rebate on exports is intended to maintain a level playing field between domestic and foreign producers in their competition for business in both domestic and foreign markets.

To help understand why border tax adjustments are viewed as not distorting or subsidizing international trade, consider the following example. Suppose a certain good produced both overseas and domestically, such as wheat, sells at $4 (per bushel). With the enactment of a broad-based U.S. VAT at a rate of 10 percent,[77] the price of wheat in the U.S. would increase by 10 percent to $4.40 (under the assumption that the tax is passed forward to consumers) for wheat produced domestically as well as overseas since both are subject to the tax—the domestically produced wheat being subject to the normal VAT and the wheat produced overseas being subject to the import tax at the same rate as the VAT. Thus, even though imports are subject to tax, U.S. buyers' choice between imported and domestically-produced wheat is not altered in this example.

Similarly, in this example foreign consumers' choice between goods produced in the U.S. and goods produced in their own country is not altered even though U.S.-produced goods are provided VAT rebates when exported. Wheat produced outside of the United States and sold to foreign consumers remains at its world price of $4.00 and wheat produced inside the United States and sold to foreign consumers remains at $4.00 since no U.S. VAT is imposed on the exported wheat.

From the preceding discussion it might seem that a VAT without border tax adjustments (an origin-principle VAT) could disadvantage domestic producers relative to foreign producers in overseas markets. However, border tax adjustments may not be the only mechanism that operates to maintain neutrality. Other self-executing adjustments by the markets, such as reductions in wage rates or in the value of the domestic currency, could wholly offset any potentially detrimental trade effects of origin-based taxation on exported goods.

Continuing the above example, if the world price of wheat is $4.00, the burden of the tax cannot be shifted forward to consumers in the form of higher prices. If the markets are competitive, the seller cannot both reduce price and remain in business. However,

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[76] See, for example, Martin Feldstein and Paul Krugman, "International Trade Effects of Value-Added Taxation," in Assaf Razin and Joel Slemrod (eds.) *Taxation in the Global Economy*, Chicago: University of Chicago Press, 1990 ("A VAT is not, contrary to popular belief, a tariff-cum-export subsidy. In fact, a VAT is no more inherently procompetitive trade policy than a universal sales tax . . . . The point that VATs do not inherently affect international trade flows has been well recognized in the international tax literature." (p. 263)).

[77] The same analysis would apply to the enactment of the national retail sales tax.

the burden of the tax may be reflected through reduced wages for example. This would allow the seller to remain in business with a price of $4.00. In this case, there would be no effect on foreign trade. Alternatively, the domestic currency may depreciate so that although the *nominal* price has increased to $4.40, the price paid for U.S. wheat by foreign consumers in their currency is unchanged from its before-tax level.[78]

2. Comparison of a VAT with the corporate income tax

Overview

It is sometimes argued that a VAT or a retail sales tax might boost the competitiveness of U.S. firms vis-a-vis imports from foreign firms or foreign-owned U.S. firms. In the case of imports from foreign firms, it might be argued that foreign firms enjoy access to U.S. markets but bear no U.S. tax because generally no U.S. income tax is imposed on income from the import of goods. In the case of goods produced by foreign-owned U.S. firms importing near-finished goods from the foreign parent company, only a small amount of total income properly allocable to the sale of that product is subject to U.S. corporate income tax.[79] In either case, the foreign firm may pay little U.S. tax, while its U.S. competitor is fully subject to the corporate income tax. Likewise, it is argued, on sales abroad U.S. goods will be subject to a foreign country's VAT and any profits earned are taxable under the U.S. income tax, while the foreign producer is subject only to the VAT on sales in its home country.[80] Thus, it is argued, the United States pays part of the cost of foreign governments, as well as for our own government, while foreign countries generally only pay for their own governments. However, if the products sold in the United States by both foreign- and U.S.-owned firms were subject to a U.S. VAT instead of a corporate income tax, both classes of firms would incur the same U.S. tax liability and the same foreign tax liability. Therefore, it is argued that the competitiveness of U.S.-owned firms would be enhanced by the imposition of a VAT, if the VAT replaced part or all of the corporate income tax.

The preceding reasoning generally rests on a reliance on the statutory incidence of the corporate income tax and a VAT. If, as is generally conceded, economic incidence differs from statutory incidence, a competitive advantage from the imposition of a VAT would not be expected to occur. The following example illustrates this point.

Example: Assume a company in the United States and a company in Germany each manufactures cars and sells the cars both in the United States and in Germany. This example abstracts from any profit that importers, wholesalers, and retailers may generate in the United States. The following table summarizes the line of reasoning presented above and the effects of a hypothetical U.S. in-

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[78] See Martin Feldstein and Paul Krugman, "International Trade Effects of Value-Added Taxation," p. 270. Exchange rate adjustment is discussed in more detail in Part V.B.3. below.

[79] In addition, difficulties in the administration of related-party transfer pricing rules may further reduce the amount of U.S. tax imposed on foreign-owned U.S. corporations.

[80] This argument ignores whatever corporate income tax burdens may be imposed on foreign firms by their home country.

come tax and a hypothetical German consumption tax on cross-border sales.

United States	Germany
U.S. only taxes profit.	Germany only taxes consumption.
U.S. company makes A-cars.	German company makes D-cars.
The profit-maximizing price of an A-car in the U.S. market is equal to the profit-maximizing price of a D-car in the U.S. market.	The profit-maximizing price of a D-car in the German market is equal to the profit-maximizing price of an A-car in the German market.
If a U.S. person buys an A-car in the United States, the U.S. Treasury receives tax revenue from the tax on the U.S. company's profit from the sale. The German treasury receives no tax revenue from the sale.	If a German person buys an A-car in Germany, the U.S. Treasury receives tax revenue from the tax on the U.S. company's profit from the sale. The German treasury also receives tax revenue from the VAT tax imposed on the price of the A-car.
If a U.S. person buys a D-car in the United States, the U.S. Treasury receives no tax revenue from the German company who earned all of its profit in Germany upon sale of the car to the importer/exporter. The German treasury receives no tax revenue under its VAT as the car was sold for export.	If a German buys a D-car in Germany, the U.S. Treasury receives no tax revenue. The German treasury receives tax revenue from the VAT imposed on the price of the D-car.

Sales pattern #1.—Assume that the U.S. company manufactures 100 A-cars and sells 50 in the United States and 50 in Germany. Assume the German company manufactures 100 D-cars and sells 50 in the United States and 50 in Germany.

Sales pattern #2.—Alternatively, assume that the U.S. company manufactures 100 A-cars and sells 100 in the United States and none in Germany. Assume the German company manufactures 100 D-cars and sells none in the Unites States and 100 in Germany.

Analysis using economic incidence.—Under either assumption about the pattern of import penetration, German tax revenue is unchanged (market forces cause A-cars and D-cars to sell at the same price). The United States's tax revenue will only differ if the profit-maximizing price is different in the German market than in the U.S. market. Moreover, because the German tax is a consumption tax and generally is assumed to be borne by German consumers under either pattern of import penetration, the cost of the German government is borne by German consumers. Likewise, because the United States's tax is a profits tax and generally is assumed to be

borne by the owners of capital,[81] under either pattern of import penetration the cost of the United States government is borne by the U.S. owners of the company that manufactures A-cars.

Analysis using statutory incidence.—The analysis using standard economic incidence assumptions regarding the incidence of a consumption tax and the incidence of a profit tax does not lead to the conclusion that *vis a vis* countries with a VAT, the United States pays part of the cost of other countries' governments while they pay none of the cost of our government. But, if one only considers the statutory incidence of a VAT and a corporate income tax, one can reach a different conclusion. Under both an income tax and a VAT, businesses send checks to the treasuries of the respective governments. Consider sales pattern #1, where the U.S. company sells 50 A-cars in Germany and the German company sells 50 D-cars in the United States, the U.S. company must write two checks: one to the U.S. Treasury for the tax on the worldwide profits from the sale of 100 A-cars and one to the German treasury for the VAT collected on the sale of 50 A-cars in Germany. The German company, on the other hand, must write only one check, to the German treasury for the VAT collected on the sale of 50 D-cars in Germany. By following the checks one would conclude that the U.S. company has paid 100 percent of the cost of the United States government and 50 percent of the cost of the German government.

Discussion

At issue here is the difference between statutory incidence and economic incidence. For example, assume that in the absence of taxation the profit-maximizing price of the cars is $20,000 in both the U.S. market and the German market, and that the unit profit is $10,000. Now assume that the United States imposes a 20-percent profits tax. The U.S. company will earn a net profit of $8,000 and pay $2,000 in tax for each car sold in either the United States or Germany. Further assume Germany imposes a 10-percent VAT. In Germany, A-cars and D-cars will sell for $22,000, with $2,000 payable to the German treasury and $20,000 to the U.S. company or the German company. If it is an A-car sold in Germany, $2,000 also must be sent to the U.S. Treasury, leaving the U.S. company its net $8,000, the same as if sold in the United States. The U.S. government's cost is borne by the U.S. capitalist ($2,000 reduction in net profit) and the German government's cost is borne by the German consumer ($2,000 increase in market price). It may appear to be better to be a capitalist in Germany (higher net profit $10,000 versus $8,000) and a consumer in the United States (lower price $20,000 versus $22,000), but in this example the United States does not pay any part of the cost of the German government.

Some question whether the economic incidence of a corporate income tax falls on the owners of capital. Some believe the corporate

[81] As discussed above in Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS-18-95), June 5, 1995, the burden of consumption taxes such as the VAT is widely assumed to be passed along to consumers. However, this assumption is not beyond reasonable dispute. There is much less agreement about the burden of the corporate income tax. A large body of public finance literature has focused on the "Harberger model," which concludes that the corporate income tax is borne by all capital. However, the Harberger model assumes that savings is not responsive to changes in tax rates and that capital is not mobile across international borders. To the extent that these assumptions are not correct, the burden of the tax may be partially or totally borne by consumers or by labor.

income tax is a cost of production rather than a profits tax. Assume that all or part of the corporate income tax is a cost of production that must be reflected in the market price of a car. This will imply that the U.S. company is a higher cost producer than the German company. Each country's auto market is still competitive, so A-cars must sell at the same price as D-cars in each market, but we might expect the low-cost producer (the German company) to have greater market share in each market and prices to rise in each market.[82] By this production-cost incidence assumption, assume the pre-consumption tax price of an A-car becomes $22,000. This reflects non-tax unit costs of $10,000 per car, unit profit of $10,000 per car, and $2,000 in profits tax per car. Thus, the price of a car in the United States is $22,000. On sales of A-cars in the United States, the U.S. Treasury receives $2,000 per A-car purchased. The German treasury receives no revenue from the sale of an A-car in the United States. On sales of D-cars in the United States, neither the U.S. Treasury nor the German treasury receive any revenue. By the incidence assumption, in this example the revenues paid into the U.S. Treasury are paid by U.S. consumers.

In Germany, assume the price of all cars will be $24,200, the $22,000 sticker price as in the United States plus the 10-percent VAT. On sales of D-cars in Germany, the U.S. Treasury receives nothing, while the German treasury receives $2,200. On sales of A-cars in Germany, the U.S. Treasury receives $2,000 and the German treasury receives $2,200. By the incidence assumptions, these revenues paid to the U.S. and German treasuries are paid by German consumers. Thus, under this incidence assumption, in this example all German revenues are raised by taxing German consumers, while U.S. revenues come both from U.S. and German consumers. That is, Germans help pay for the United States government as well as their own, while U.S. persons are asked only to pay for the United States government. But, as before, if one tracks who writes the checks, one would again conclude that U.S. persons are asked to pay for both the United States and German governments, while Germans are asked only to pay for the German government.

3. Advantage in cross-border trade and exchange rate adjustment

Most economists argue that even if the imposition of a new tax regime were to create a competitive advantage in cross-border trade, under a system of flexible exchange rates, in the long run, an offsetting adjustment in the exchange rate is likely to occur and eliminate any advantage to exports from decreased prices. Assume the United States imposes a 10-percent VAT with border adjustments. That is, exports are exempt from the tax while imports are subject to the tax. Now assume that the United States eliminates the border adjustments. This would imply that exports would now be liable for a 10-percent tax while imports would no longer be taxable. The instantaneous effect would be to make U.S. exports 10 percent more expensive in foreign markets than they were before the tax change and to make U.S. imports of foreign goods 10 per-

[82] While the German company may be the low-cost producer, it still faces increasing costs, so as its market share expands, its unit costs expand.

cent less expensive in the United States than they were before the tax change. All else (quality, convenience, etc.) being equal, foreign consumers naturally would reduce their demand for the now more expensive U.S. goods (U.S. exports). Similarly, all else being equal, U.S. consumers would increase their demand for the now less expensive foreign goods (U.S. imports). The purchase of U.S. exports requires foreign importers to purchase dollars to buy the goods from U.S. manufacturers. The purchase of U.S. imports requires U.S. importers to purchase foreign currencies to pay foreign manufacturers. Therefore, the reduction in demand for U.S. exports would reduce the demand for dollars. The increase in demand for U.S. imports would increase the demand for foreign currencies. The result would be a depreciation of the dollar relative to foreign currencies.

If the dollar depreciated by 10 percent relative to foreign currencies, the elimination of the border adjustments would be perfectly offset. A 10-percent weaker dollar means a French importer can purchase U.S. exports with 10 percent fewer francs than previously. In this example, the elimination of border adjustments would cause the price of the U.S. exports to rise 10 percent denominated in dollars. Accordingly, a 10-percent dollar devaluation would permit the French importer to purchase the good at the same cost, denominated in francs, as prior to the elimination of border adjustments. The after-tax profits of the U.S. manufacturer, measured in dollars, remain unchanged. Similarly, U.S. importers of foreign goods will have to use 10 percent more dollars to buy foreign goods. In this example, the elimination of border adjustments would permit the price of U.S. imports to fall by 10 percent, denominated in dollars. Accordingly, using 10 percent more dollars to purchase the foreign goods would permit return of the market price of imports to that which prevailed prior to the elimination of the border adjustments.

In sum, if a temporary price advantage is created by a tax change, this will alter the demand for the dollars and the demand for the foreign currencies necessary to purchase traded goods and services. The resulting change in exchange rates should eliminate the temporary price advantage. This analysis suggests that differences in tax policy should not affect U.S. export performance. The analysis hinges on the extent to which exchange rates respond to differences in the prices of traded goods in different markets. Attempts at management of exchange rates by central banks or monetary policy designed to address other domestic policy goals (in the United States or abroad) may disrupt the adjustment of exchange rates which otherwise would occur. Recent reviews[83] of the empirical evidence on exchange rate adjustment suggest that while ex-

[83] James R. Hines, Jr., "Fundamental Tax Reform in an International Setting," in Henry Aaron and William Gale, eds., *The Economic Effects of Fundamental Tax Reform*, (Washington, D.C.: The Brookings Institution), forthcoming. The underlying theory of exchange rate adjustment is called "purchasing power parity" or "PPP" by economists. The basic idea of PPP is that the ability to engage in cross-border arbitrage trades of traded goods should eliminate price differences in those goods across countries. For a review of empirical tests of PPP, see Kenneth Rogoff, "The Purchasing Power Parity Puzzle," *Journal of Economic Literature*, vol. XXXIV, June 1996, pp. 647–668. Rogoff summarizes the empirical literature as finding that "deviations appear to damp out at a rate of roughly 15 percent per year" (p. 647) and deviations from PPP have "a half-life of three to five years, seemingly far too long to be explained by nominal rigidities" in the foreign markets (p.648).

change rate adjustment as described above should hold in the long run, significant deviations can persist in the short run. The reviews report that studies find that price deviations have half-lives of approximately four years, that is, adjustments in exchange rates eliminate half of any price deviation within four years of the initial deviation. However, the deviations from the long run result may not always be in one direction. That is, in the short run exchange rates could overreact such that the instantaneous price advantage is reversed.

4. Possible reduction in the trade deficit from increased savings

A significant potential benefit of fundamental tax reform on international trade is the possibility that the replacement of the current tax system with a VAT, consumption-based flat tax, retail sales tax, or pure income tax will increase saving by reducing the penalties on saving imposed by the present-law income tax. As discussed in Part III.A. above, many analysts view the inflow of foreign investment and concomitant current account deficits of the past decade to be a result of low U.S. saving rates. Greater U.S. saving, in this view, would help redress the imbalance of imports over exports by reducing demand for imported goods. If, at the same time, greater U.S. saving reduces the cost of capital to domestic businesses, increased investment will improve productivity and the price competitiveness of U.S. goods and services in foreign markets. The possible effects of consumption taxes on saving were discussed in an earlier publication.[84]

C. Tax Restructuring and International Investment Decisions

1. Location of physical investment

Location of physical investment by U.S. persons.—As explained in Part V. A above, under either the R or R+F base and under either a destination-principle or origin-principle consumption tax base, capital income is untaxed by the United States at the margin whether it is capital invested domestically or abroad. Above-normal profits (inframarginal returns) earned on domestic or foreign investments generally are taxed under a destination-principle consumption tax, but under an origin-principle consumption tax above-normal profits earned on foreign investments are untaxed while above-normal profits earned on domestic investments are taxed. Under a pure income tax, all profits are taxed equally by the United States, regardless of the location of the investment.

An effective rate of tax of zero on incremental foreign investments might suggest that consumption-based taxes would induce investment abroad by U.S. persons. The choice of investment location, all other factors being equal, depends upon the tax imposed on investments abroad versus the tax imposed on investments in the United States and hence the after-tax return offered to the investor by alternative locations. The destination-principle consumption-based taxes and the pure income tax treat the returns to in-

[84] Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS-18-95), June 5, 1995.

vestments the same regardless of their location. Thus, the national retail sales tax and the USA business tax (both destination-principle taxes) and the pure income tax are neutral regarding the location of investment. This is not the case under present law. Many believe that under present law, U.S. businesses have an incentive to invest abroad in low tax foreign jurisdictions because investments are subject to lower effect tax rates when located abroad.[85]

Under the consumption-based flat tax of H.R. 2060 and S. 1050, an origin-principle tax, there may be an incentive to locate abroad assets on which the owner can earn above-normal returns. This incentive for investment abroad may be no greater than incentives under present law.

Since both destination-principle and origin-principle consumption taxes would eliminate taxes on returns from marginal investments, the United States should be a relatively more attractive location for investment by U.S. persons compared to present law. This should reduce foreign investment and increase domestic investment by U.S. businesses. Similarly, the equal treatment of all investments under a pure income tax should reduce foreign investment and increase domestic investment by U.S. businesses. To the extent that present-law foreign tax credits mitigate the tax burden for U.S. businesses investing in high-tax foreign jurisdictions, adoption of a consumption-based tax that does not permit a credit for foreign income taxes paid may encourage U.S. businesses to locate investments in low-tax foreign jurisdictions or in the United States rather than in high-tax foreign jurisdictions. If reduced taxation of the returns to new investment under any of the tax reform plans increases total investment by U.S. businesses, investment abroad would be expected to continue to increase, but less rapidly than domestic investment when compared to present law.

Location of physical investment by foreign persons.—The investment location decisions of foreign persons after a tax reform in the United States would be expected to vary depending upon the foreign person's home country tax rules. If the home country does not tax foreign-source income, adoption of consumption-based taxes effectively would lower taxes on investment by foreign persons in the United States. In this case, increased foreign investment would be expected to result.

If the home country taxes foreign-source income, but provides a credit for foreign income taxes paid that completely offsets the home country's otherwise applicable income tax, adoption of a consumption-based tax would be expected to have no effect on foreign investment. In this case, although the United States ceases to tax the income generated by investments located in the United States, the foreign country continues to tax such income and tax revenue that used to flow to the United States Treasury would now flow to a foreign treasury with no change in the after-tax return to the for-

[85] See Hines, "Fundamental Tax Reform in an International Setting," and Grubert and Newlon, "The International Implications of Consumption Tax Proposals," and the sources cited therein. James R. Hines, Jr., "Tax Policy and the Activities of Multinational Corporations," National Bureau of Economic Research Working Paper #5589, May 1996, surveys quantitative studies of the effect of U.S. tax rules on the financial and real decisions of U.S. multinational corporations. Hines finds that "taxation significantly influences the financing of multinational corporations and their allocation of factors [of production] and products around the world" (p.2).

eign person on his or her investment. The foreign person would see no change in the investment environment in the United States.

If the home country taxes foreign-source income, provides a credit for foreign income taxes paid, but permits deferral of home-country tax on foreign-source income, adoption of a consumption-based tax may only modestly increase foreign investment in the United States. In this case, while the United States ceases to tax the income generated by investments located in the United States, the foreign country's tax system already has substantially reduced the foreign person's tax burden on investment located in the United States. Whether reduction of U.S. taxes leads to a further reduction in the aggregate tax burden on foreign investment would depend on the specific structure of the foreign country's tax system.

The effect of a pure income tax on the decision of foreign persons to undertake physical investments in the United States generally would be determined by the rate of tax imposed and the foreign person's home country tax system. In foreign countries that do not tax foreign-source income, any reduction (increase) in U.S. income tax rates would be expected to encourage (discourage) foreign investment in the United States. In foreign countries that tax foreign-source income, changes in U.S. income tax rates may or may not matter to foreign investment depending upon the foreign persons' abilities to claim credits on U.S. income tax liabilities or to defer taxation of U.S. source income.

Location of investment and economic efficiency.—The preceding discussion suggests that certain tax reforms might increase investment in the United States at the expense of investment in other countries. Taxes, both in the United States and abroad, generally distort investment decisions. In a world with no taxes, investment would be located according to its highest and best use. Eliminating certain distortions in the U.S. tax system does not imply that investment will be made according to its highest and best pre-tax use if other distortions continue to exist in the economy. The highest and best use of investment monies may not always coincide with locating investment in the United States. Encouraging investment in the United States at the expense of investment elsewhere may not promote global economic efficiency. On the other hand, increased investment in the United States should increase the future income of United States residents and citizens.[86]

2. Location of intangible assets and R&D

Under present law, expenditures to create intangible assets and expenditures on research and development generally are favored compared to expenditures on capital goods. Expenditures on capital goods are recovered through depreciation, while expenditures to create intangibles and on research and development generally are expensed. By permitting the expensing of expenditures on capital goods as well as expenditures to create intangibles and expenditures for research and development, the VAT, the USA business tax, a national retail sales tax, and the flat tax of H.R. 2060 and S. 1050 each may relatively shift business investment toward phys-

[86] For a detailed discussion of issues related to cross border investment and economic efficiency, see Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States*, pp. 232-248.

ical goods and away from investment in intangible assets or research and development.[87] Similarly, if a pure income tax required the capitalization of certain expenses related to the development of intangible assets and expenses on research and development, a pure income tax may relatively shift business investment toward physical goods and away from investment in intangible assets or research and development.

Present law also provides incentives for certain U.S. persons to exploit U.S.-created intangible assets abroad and to undertake research and development activity abroad. U.S. persons with excess foreign tax credits may exploit U.S.-created intangible assets abroad and pay the earnings back to the United States as royalty payments. Royalty payments frequently are a deductible expense under foreign income taxes and, by being classified as foreign-source income under present law, the taxpayer's excess foreign tax credits can offset U.S. tax liability on the royalty income. Had the taxpayer exploited the intangible asset in the United States and generated export sales, the returns to the intangible asset generally would have been fully taxable as domestic (U.S.) income. Under a national retail sales tax, the location of expenses does not matter. The U.S. person would be indifferent from a tax perspective between locating intangible assets in the United States or abroad. Similarly, under a destination-principle consumption-based tax, if payments of royalties are treated as payments for exports and, hence, exempt, the U.S. person would be indifferent from a tax perspective between locating the intangible asset abroad and receiving royalties or locating the intangible asset in the United States and receiving payments for exporting goods. Likewise, under an origin-principle consumption-based tax, if payments of royalties are treated as payments for exports and, hence, taxable, the U.S. person would be indifferent from a tax perspective between locating the intangible asset abroad and receiving royalties or locating the intangible asset in the United States and receiving payments for exporting goods. By eliminating the relative U.S. tax preference for royalty payments by certain U.S. persons under present law, these tax reform proposals generally would be expected to induce increased location of intangible assets in the United States relative to abroad.

Under present law, as explained in Part II above, U.S. persons have to allocate a portion of research and development expenses against foreign income. For many taxpayers with excess foreign tax credits this results in an allocation of costs against revenues on which there will be no U.S. tax liability (because of available foreign tax credits). Were the taxpayer able to claim the U.S.-source research and development expenses entirely against U.S.-source income, his tax liability would be reduced. The taxpayer effectively is denied a deduction for a portion of his research and development expenses, thereby increasing the cost of undertaking research and development in the United States. Hence, present law may discour-

[87] For a discussion of tax reform and the treatment of intangible assets and expenditures on research and development, see Joint Committee on Taxation, *Impact on Small Business of Replacing the Federal Income Tax* (JCS–3–96), April 23, 1996.

age some research and development activity in the United States.[88] Under either a destination-principle consumption tax or an origin-principle consumption tax, expenses incurred in the United States are fully deductible. Adoption of a VAT, the USA tax, a national retail sales tax, or the consumption-based flat tax of H.R. 2060 and S. 1050 may increase research and development activity in the United States by those taxpayers who are affected by the allocation rules under present law.

D. Tax Restructuring, Cross Border Transactions, and Simplicity

The present-law income tax has been criticized by some as being overly complex. Among the specific provisions that have been cited as complex are some of the international provisions discussed in Part II of this pamphlet.[89] The sources of complexities inherent in the present-law international tax provisions are varied. First, rules are needed to determine which persons are subject to the taxing jurisdiction of the United States and which are not. In addition, present law provides that foreign income earned through a foreign corporation is not subject to U.S. income tax until such income is repatriated to the United States. In order to ensure that the availability of this deferral is not abused, present law contains several

[88] A recent empirical study of this issue found that, in practice, research and development activity in the United States did not appear to be discouraged. James R. Hines, Jr., "No Place Like Home: Tax Incentives and the Location of R&D by American Multinationals," in James M. Poterba, ed., *Tax Policy and the Economy*, 8, (Cambridge, MA.: The MIT Press), 1994, pp. 65–104.

[89] In 1992, Joel Slemrod and Marsha Blumenthal conducted a survey by mail of the 1672 firms in the Internal Revenue Services Coordinated Examination Program. They received responses from 365 firms, which represented 27.5 percent of the firms on the mailing list that were still active businesses. The survey asked corporate tax officers about the costs their companies incurred in complying with corporate income taxes.

The survey included open-ended questions regarding the aspects of the current corporate income tax (Federal, State and local) that are most responsible for the cost of compliance. Of the 365 respondents overall, 315 answered the question about the Federal income tax. The most frequent responses were as follows:

Federal income tax	Number of responses
Depreciation	118
Alternative minimum tax	115
Uniform capitalization	85
International	44

Besides the responses mentioning international issues overall, some responses cited specific items involving international taxation: foreign tax credit (37 responses), controlled foreign corporation reporting (21), transfer pricing (16) and allocation rules (12). See Joel Slemrod, and Marsha Blumenthal, "Measuring Taxpayer Burden and Attitudes for Large Corporations," Report to the Coordinated Examination Program of the Internal Revenue Service, August, 1993.

sets of anti-deferral provisions (e.g., the subpart F rules and the PFIC provisions) and requires information reporting with respect to U.S.-owned foreign corporations. Further, present law allows foreign tax credits so that income earned overseas is not subject to multiple levels of income tax. In order to ensure that these credits are properly allowed, present law contains rules for allocating and apportioning income and expenses between foreign and domestic sources and sorting the credits and net income among separate income categories. Each of these provisions involves various degrees of complexity.

Some commentators and lawmakers have proposed alternative tax systems in order to address complexity concerns. However, the proposed alternatives themselves raise complexity issues. For example, as discussed above, some of the proposed replacement tax systems involve consumption-based taxes operating on the destination principle which subjects imports to tax and relieves tax on exports (e.g., a VAT).

The taxation of imported property and services under a destination-principle VAT raises certain administrative concerns. Procedures must be established to ensure that taxpayers report the importation of goods and services as taxable activities and that the Federal tax authorities can trace such activities. These issues are of less concern with respect to taxpayers that are otherwise subject to the VAT with respect to a trade or business conducted in the United States because such taxpayers: (1) should be familiar with the operation of the tax; (2) would generally file periodic VAT returns subject to review; and (3) would be expected to maintain the documentation that discloses the import activity in order to claim a business purchase deduction for the imported good or service. However, taxpayers that import goods or services but are not otherwise subject to the VAT (i.e., non-business consumers) present deeper concerns. Such taxpayers may not be aware of their VAT responsibilities or may attempt to evade the tax. Taxation of imported property may be enforced by levying the VAT at the place of import through the U.S. Customs Service.

On the export side, providers of goods or services have a similar incentive to classify their sales of goods or services as nontaxable exports. As in the case of imports, it may be appropriate to elicit the services of the U.S. Customs Service in the determination of which goods are being exported and by whom.

The cross-border provision of services presents more difficult issues under a destination-principle VAT. Services may be performed in whole or in part in one jurisdiction and used or provide benefits in another. Theoretically, (1) services performed by a person outside the United States but used or providing benefits in the United States would be subject to the U.S. VAT, (2) services performed by a U.S. person but used or providing benefits in a foreign country would not be subject to the U.S. VAT, and (3) the value of services used within and without the United States would be allocated between the two jurisdictions based on the relative values of such services. In the case of services, as demonstrated by the present-law income tax controversies surrounding the section 482 transfer pricing rules, the identification, measurement, and valuation of the

use or the benefits provided is particularly difficult.[90] Alternatively, services could be sourced based on the situs of the service provider. Although such a rule may be easier to administer, it would be inconsistent with the goal of taxing U.S. consumption and may invite tax evasion.

Certain services that are provided both within and without the United States, such as international transportation or communication, could be allocated pursuant to statutory (although somewhat arbitrary) ratios, as under the present-law income tax. Other countries that impose VATs based on the destination principle also have confronted these issues and have responded in various ways.

E. Other Issues

1. Income tax treaties

a. Reasons for entering into bilateral income tax treaties

The principal purposes of an income tax treaty are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of income taxes of the two countries. Present law includes various provisions designed to avoid double taxation; however, notwithstanding the unilateral relief measures under the domestic law of the United States and its treaty partners, double taxation still might arise. For example, double taxation can occur because of differences in source rules between the United States and the other country. In addition, issues sometimes arise in the determination of whether a foreign tax qualifies as a creditable tax for U.S. tax purposes. Also, double taxation may arise in situations where a person is treated as a resident of both the United States and another country.

To prevent double taxation, treaties generally assign the source country primary taxing jurisdiction with respect to an item of income that arises within that country. Double taxation may be avoided through treaty provisions under which income taxed by the source country is deemed to be foreign source income for purposes of allowing the taxpayer to claim the source country tax as a credit against its residence country tax. In the case of certain categories of income such as business profits, double taxation may be avoided through treaty provisions providing that a resident of one treaty country is not taxable on its business profits derived from the other country unless such profits are attributable to a permanent establishment situated in the other country. To resolve double taxation problems arising in individual cases, treaties typically include provisions that allow a taxpayer to seek the assistance of the competent authority of the country of residence or citizenship which, in turn, will attempt to resolve the double taxation issue by mutual agreement with its counterpart from the other country.

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[90] The identification, measurement, and valuation of the use or the benefits provided by cross-border financial intermediation services (e.g., the provision of borrowed funds, guarantees, insurance, etc.) may be especially troubling and will be discussed in greater detail in a future pamphlet dedicated to the treatment of such services under alternative tax systems.

b. Potential treaty ramifications of adoption of a replacement tax system

Overview

The primary issue with respect to the impact of fundamental tax reform on the U.S. tax treaty network is whether a treaty that was negotiated when both of the treaty countries had comparable tax systems would be still applicable and desirable if the United States replaces its current income tax system with a vastly different tax system (e.g., a consumption-based tax system).[91] The impact of a revision of the U.S. income tax system on existing treaties depends largely on the type of tax system that is adopted. If the new system resembles the existing income tax regime, as in the case of a pure income tax, then the existing treaties may remain intact. On the other hand, if the new system is different from the existing income tax regime, but contains certain elements of an income tax system, then it is likely that many U.S. treaty partners would wish to renegotiate the existing treaties with the United States. Finally, if the new system is completely incompatible with any income tax regime, then U.S. treaty partners may prefer to terminate the existing treaties with the United States.

Although many U.S. income tax treaties obligate the competent authority of each country to notify its counterpart from the other country of any significant changes in its internal tax laws, they do not grant the countries the right or the obligation to amend the treaty to take into account such changes. A few recent income tax treaties include a provision that requires the competent authorities to consult whenever the internal law of one of the treaty countries is applied in a manner that may impede the full implementation of the treaty. Thus, if one of the competent authorities becomes aware of such actual or potential application, it is required to inform the other in a timely manner, and consultations, with a view to establishing a basis for the full implementation of the treaty, would begin within six months.[92] A country with this type of treaty provision may have more flexibility in responding to a restructuring of the U.S. tax system within the context of the existing treaty.

Renegotiation of existing tax treaties

The most likely option for most of the U.S. treaty partners may be the renegotiation of their existing tax treaties with the United States. A treaty partner that wishes to renegotiate an existing income tax treaty with the United States may begin the process immediately upon the adoption of a new U.S. tax regime, or it may wait to observe the effect of the new regime prior to notifying the United States of its desire to renegotiate a new treaty.[93] During

[91] The fact that two countries have different taxation systems should not, by itself, prevent the countries from reaching agreement on a tax treaty. For example, the 1995 U.S.-Canada protocol coordinates the U.S. estate tax (imposed at death on the fair market value of the property owned by a decedent) with the Canadian capital gains at death tax (imposed at death on the gains accrued on property owned by the decedent).

[92] See, e.g., Article 29(6) of the 1992 U.S.-Netherlands income tax treaty.

[93] If many U.S. treaty partners simultaneously notified the United States that they wanted to renegotiate existing income tax treaties with the United States, it could take years for the U.S. Treasury Department to renegotiate all the treaties. The Treasury Department might also commence drafting a new model treaty designed to coordinate the new U.S. regime with the income tax regimes of U.S. treaty partners, resulting in further delay in the negotiation process.

the negotiation process, a treaty country may either terminate the existing treaty or leave it in place. A termination of the treaty would subject the residents of either country that engage in cross-border transactions to the internal law of the country in which activities are conducted or assets are located. This could lead to substantial uncertainties for taxpayers. If the goal is to modify certain aspects of an income tax treaty, the countries may leave the existing treaty in place while the two governments renegotiate the terms of a new treaty. Thus, during the interim period, taxpayers may still need to rely on the terms of the existing U.S. income tax treaties, notwithstanding the fact that the two countries no longer have similar tax regimes.

In addition to maintaining U.S. income tax treaty obligations, some of the tax restructuring proposals would provide incentives for foreign countries to enter into other types of agreements with the United States. For example, the USA tax of S. 722 would provide an exemption from the 30-percent U.S. withholding tax for residents of certain foreign countries that is conditioned on the foreign country entering into a tax information and exchange agreement with the United States.

Termination of existing tax treaties

If the United States adopts a new tax system that is vastly different from the system in place when a treaty was entered into, the treaty partner may not view the existing treaty as a viable vehicle for elimination of double taxation and reduction of barriers to cross-border investments and trade. A treaty country could choose to terminate its present income tax treaty with the United States, if the treaty is no longer relevant because of the incompatibility of the two taxing systems.

Another reason that a country might terminate its existing income tax treaty with the United States is to enhance its revenue base. For example, a country may see the change in the U.S. tax system as an opportunity to terminate the treaty and therefore impose its full withholding tax on payments made to U.S. persons with respect to investments in the country. Such a tactic would not be successful in the long run if the U.S. investors were to respond to the higher withholding tax by pulling their investments out of the country. Generally, an investor would compare the after-tax returns of investing in different countries to find the maximum rate of return. If the United States had enacted a consumption-based tax under which investment income is exempt from U.S. tax, then it may be more attractive for a U.S. investor to invest domestically.

Treaties contain specific procedures to be followed in the case of a unilateral termination. However, it is unclear if these procedures would be relevant if the United States adopts a replacement system that is vastly different from the present income tax system. Under such circumstances, for example, the United States may agree to terminate an existing income tax treaty with a particular country, rendering the provisions for unilateral termination irrelevant.

Continuation of existing tax treaties

If the new U.S. tax system, like present law, imposes a substantial level of withholding tax on payments made to foreign investors, a treaty country would have an incentive to continue the existing income tax treaty with the United States in order to obtain a reduced level of withholding tax on U.S. source payments made to the residents of the treaty country. For example, the USA tax of S. 722 generally would impose a 30-percent withholding tax on certain nonbusiness income paid to a nonresident alien, but would permit a reduced rate of withholding under an income tax treaty between the United States and the recipient's country of residence.[94] Such a reduction in the withholding rate would benefit the treasury of the investor's residence country (rather than the investor) if the U.S. withholding tax is creditable against the taxpayer's residence country income tax and such a tax is imposed at a rate that is the same or higher than the U.S. withholding rate.[95]

Some have suggested that if the new U.S. tax system imposes a withholding tax only on income paid to foreign persons but does not apply a similar regime to the same income paid to U.S. persons, then a foreign recipient that is a resident of a treaty country might try to avoid paying the U.S. tax by invoking the nondiscrimination rules of the income tax treaty between the United States and the recipient's country of residence.[96] An important factor to consider in evaluating this type of argument is whether the withholding tax would be considered an appropriate surrogate for the U.S. tax imposed on U.S. citizens and residents.[97]

Continuation of an existing treaty may be desirable to a foreign country in order to retain for its residents the benefit of provisions aimed at eliminating double taxation. In this regard, a treaty definition of who is a resident alien could continue to be relevant if the new U.S. tax system imposed tax on foreign persons resident in the United States. For example, S. 722 generally would apply the USA income tax to U.S. citizens and resident aliens.

A treaty provision assigning primary taxing jurisdiction to the respective countries also could continue to be relevant. For example, the business tax of H.R. 2060 and S. 1050 would be imposed on profits from the sale of goods or performance of services within the United States in connection with a "business activity."[98] A resident of a treaty country might argue that business activities must be conducted through a permanent establishment within the Unit-

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[94] Section 133(b) of S. 722.

[95] For example, assume a foreign person resident in country X is subject to country X tax at a rate of 35 percent on all its income. The United States and country X have an income tax treaty in place which generally reduces the U.S. withholding tax on dividends paid by a U.S. corporation from 30 percent to 15 percent. If the U.S. withholding tax is creditable against the country X income tax, then country X would collect a 20 percent tax on the dividend and the United States would collect a 15 percent tax on the same amount. On the other hand, in the absence of the treaty, country X would collect only a 5 percent tax and the United States would collect a 30 percent tax on the same income. In other words, whether or not a treaty applied to reduce the rate of the U.S. withholding tax, the foreign person would pay an aggregate tax of 35 percent.

[96] See Grubert and Newlon, "The International Implications of Consumption Tax Proposals," 48 *Nat. Tax J.* 642 (1995).

[97] The 30-percent withholding tax imposed on foreign persons under present law is considered to be a surrogate for the net income tax imposed on U.S. persons because it generally is not feasible to determine and collect a tax on net income from foreign persons who have limited contacts with the United States.

[98] Section 11 of H.R. 2060 and S. 1050.

ed States in order for the associated profits to be subject to U.S. tax under the proposal.[99] In addition, H.R. 2060 and S. 1050 generally would require an individual earning any U.S. wages to include such wages in taxable income without regard to whether the recipient is a U.S. citizen or resident. Most U.S. income tax treaties limit the right of a country to tax income from the performance of personal services by a resident of the other country.

In addition, sourcing rules provided by the treaty could be relevant. For example, in the case of S. 722, the statute does not specify the rules used to determine the source of certain nonbusiness income subject to the withholding tax when such income is paid to a nonresident alien. Further, treaty provisions regarding competent authority and other dispute resolution procedures to resolve potential double taxation issues could be of continued benefit to the foreign country's residents. For example, if a treaty resident is subject to the business tax of H.R. 2060 and S. 1050 and the same profits are again taxed by the taxpayer's resident country, the taxpayer may present the case to the competent authority of its resident country in an attempt to avoid double taxation.

A treaty country may also choose to continue an existing income tax treaty with the United States because of the protection and benefits provided under the treaty to U.S. investors to attract or retain such investments. A country may be willing to reduce by treaty its withholding taxes imposed on payments made to a U.S. investor in order to attract additional capital into that country. In the event the United States replaces its present income tax system with a consumption-based tax (which does not tax investment income), foreign withholding taxes on investment income generally would not be creditable against the investor's U.S. tax. Consequently, the foreign withholding tax would represent an out-of-pocket cost to the investor, reducing the investor's return on capital. To the extent a foreign country wishes to continue to attract U.S. investments, the country may wish to preserve the benefits of reduced withholding tax for U.S. investors by continuing its present income tax treaty with the United States. The treaty's reduced withholding rates would be attractive to the foreign country even though the treaty would no longer provide reciprocal benefits to residents of the country who invest in the United States.

Continuing the existing income tax treaty also could ameliorate the instances of double taxation with respect to U.S. investors in the foreign country. For example, a treaty definition of "resident" could avoid classification of a U.S. investor as a resident of both countries. Under the treaty, business profits of a U.S. investor that has minimal contacts with the source country could be exempt from that country's tax.

2. GATT rules and alternative tax systems

Under GATT, rebates for exports and taxation of imports are generally allowed in the case of indirect taxes but not for direct taxes. Sales taxes and credit-invoice VATs are considered indirect taxes, and income taxes are considered direct taxes. Thus, unlike

[99] The same issue exists with respect to the USA business tax imposed by S. 722.

an income tax, a credit-invoice VAT may be imposed on imports and rebated on exports under GATT rules.

Border tax adjustments under a credit-invoice VAT would be consistent with current GATT rules, as long as they do not discriminate against imports or provide rebates on exports in excess of the tax. However, there is considerable uncertainty as to whether border adjustments under a subtraction-method VAT would be legal under GATT. The distinction may be made that a subtraction-method VAT, unlike a credit-invoice VAT, is not imposed on particular transactions but directly on a business, where the tax base is equal to the business's value added. In this technical respect, a subtraction-method VAT may more closely resemble a corporate income tax than a sales tax. If viewed as an indirect tax, it is not clear whether border adjustments under a subtraction-method VAT are GATT-legal.[100] Likewise, because the consumption-based flat tax of H.R. 2060 and S. 1050 allow businesses deductions for wages, some commentators have suggested that the tax would be classified a direct tax and could not be designed as a destination-principle tax and be in compliance with GATT.[101]

Although there are important differences in the administration of a subtraction-method VAT and a credit-invoice method VAT, as discussed in an earlier pamphlet in this series,[102] there is no reason to expect that there will be substantial difference between these two taxes with regard to their incidence or their effects on international trade. For the same reasons, there should be no difference between the two taxes with regard to the proper role of border tax adjustments. In addition, the importance of the United States to the international economy leads some analysts to conclude that, given the economic equivalence of the different types of VATs, if the United States were to chose a subtraction-method VAT, our trading partners would not rule it illegal under existing trade arrangements. In this regard, no challenge has been brought against Japan for its consumption tax, which may be characterized as a modified subtraction-method VAT. On the other hand, the low rate of the Japanese tax may not have made a challenge worthwhile. The possible illegality of border tax adjustments of a subtraction-method VAT under GATT rules looms as a potential practical deterrent to the implementation of a subtraction-method VAT or consumption-based flat tax that is based on the destination principle.

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[100] See George N. Carlson and Richard A. Gordon, "VAT or Business Transfer Tax: A Tax on Consumers or on Business?" *Tax Notes*, October 17, 1988, p. 329.

[101] See Reuven S. Avi-Yanoh, "The International Implications of Tax Reform," *Tax Notes*, November 13, 1995, p. 916.

[102] Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS-18-95), June 5, 1995.

APPENDIX:

Appendix Table A.1.—U.S. International Transactions, 1962–1994

[Dollars in millions]

Years	Exports of goods, services and income	Exports of merchandise adjusted (excluding military)	Exports of services	Income receipts on U.S. assets abroad	Imports of goods, services and income	Imports of merchandise adjusted (excluding military)	Imports of services	Income payments on foreign assets in the U.S.	Unilateral transfers (Net)
1962	$33,340	$20,781	$6,941	$5,618	$25,676	$16,260	$8,092	$1,324	$4,277
1963	35,776	22,272	7,348	6,157	26,970	17,048	8,362	1,560	4,392
1964	40,165	25,501	7,840	6,824	29,102	18,700	8,619	1,783	4,240
1965	42,722	26,461	8,824	7,437	32,708	21,510	9,111	2,088	4,583
1966	46,454	29,310	9,616	7,528	38,468	25,493	10,494	2,481	4,955
1967	49,353	30,666	10,667	8,021	41,476	26,866	11,863	2,747	5,294
1968	54,911	33,626	11,917	9,367	48,671	32,991	12,302	3,378	5,629
1969	60,132	36,414	12,806	10,913	53,998	35,807	13,322	4,869	5,735
1970	68,387	42,469	14,171	11,748	59,901	39,866	14,520	5,515	6,156
1971	72,384	43,319	16,358	12,707	66,414	45,579	15,400	5,435	7,402
1972	81,986	49,381	17,841	14,765	79,237	55,797	16,868	6,572	8,544
1973	113,050	71,410	19,832	21,808	98,997	70,499	18,843	9,655	6,913
1974	148,484	98,306	22,591	27,587	137,274	103,811	21,379	12,084	9,249
1975	157,936	107,088	25,497	25,351	132,745	98,185	21,996	12,564	7,075
1976	172,090	114,745	27,971	29,375	162,109	124,228	24,570	13,311	5,686
1977	184,655	120,816	31,485	32,354	193,764	151,907	27,640	14,217	5,226
1978	220,516	142,075	36,353	42,088	229,870	176,002	32,189	21,680	5,788
1979	287,965	184,439	39,692	63,834	281,657	212,007	36,689	32,961	6,593
1980	344,440	224,250	47,584	72,606	333,774	249,750	41,491	42,532	8,349
1981	380,928	237,044	57,354	86,529	364,196	265,067	45,503	53,626	11,702
1982	361,436	211,157	64,079	86,200	355,804	247,642	51,749	56,412	17,075
1983	351,306	201,799	64,307	85,200	377,573	268,901	54,973	53,700	17,718

Appendix Table A.1.—U.S. International Transactions, 1962–1994—Continued

[Dollars in millions]

Years	Exports of goods, services and income	Exports of merchandise adjusted (excluding military)	Exports of services	Income receipts on U.S. assets abroad	Imports of goods, services and income	Imports of merchandise adjusted (excluding military)	Imports of services	Income payments on foreign assets in the U.S.	Unilateral transfers (Net)
1984	395,850	219,926	71,168	104,756	474,203	332,418	67,748	74,036	20,598
1985	382,747	215,915	73,155	93,677	484,037	338,088	72,862	73,087	22,954
1986	401,843	223,344	86,523	91,976	528,513	368,425	80,992	79,095	24,189
1987	449,514	250,208	98,539	100,767	592,745	409,765	91,678	91,302	23,107
1988	560,426	320,230	111,126	129,070	662,487	447,189	99,491	115,806	25,023
1989	642,025	362,120	127,387	152,517	719,758	477,365	103,535	138,858	26,106
1990	697,426	389,307	147,819	160,300	756,694	498,337	118,783	139,574	33,393
1991	718,194	416,913	164,278	137,003	732,486	490,981	119,614	121,892	6,869
1992	737,394	440,352	178,617	118,425	766,796	536,458	121,991	108,346	32,148
1993	763,826	456,823	187,755	119,248	829,668	589,441	129,979	110,248	34,084
1994	838,820	502,485	198,716	137,619	954,304	668,584	138,829	146,891	35,761

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business,* June 1995, pp. 84–85.

Appendix Table A.2.—U.S. Gross Domestic Product, Gross Saving, Gross Investment, and Net Foreign Investment, 1960–1994

[Dollars in billions]

Year	GDP	Gross saving	Gross investment	Net foreign investment
1960	$526.6	$113.9	$110.2	$3.2
1961	544.8	116.8	113.5	4.3
1962	585.2	127.4	125.0	3.9
1963	617.4	135.4	131.9	5.0
1964	663.0	145.8	143.8	7.5
1965	719.1	161.0	159.6	6.2
1966	787.8	171.7	174.4	3.9
1967	833.6	174.4	175.1	3.5
1968	910.6	185.8	186.0	1.7
1969	982.2	202.9	200.7	1.8
1970	1,035.6	198.2	199.1	4.9
1971	1,125.4	215.3	220.4	1.3
1972	1,237.3	244.9	248.1	−2.9
1973	1,382.6	297.5	299.9	8.7
1974	1,496.9	302.3	306.7	5.1
1975	1,630.6	298.3	309.5	21.4
1976	1,819.0	340.9	359.9	8.9
1977	2,026.9	395.5	413.0	−9.0
1978	2,231.4	477.4	494.9	−10.4
1979	2,557.5	540.9	568.7	2.6
1980	2,784.2	547.4	574.8	12.5
1981	3,115.9	651.1	665.7	7.4
1982	3,242.1	604.7	601.8	−6.1
1983	3,514.5	589.6	626.2	−37.3
1984	3,902.4	751.5	755.7	−91.5
1985	4,180.7	746.7	748.0	−116.9
1986	4,422.2	721.0	743.1	−142.9
1987	4,692.3	780.9	764.2	−156.4
1988	5,049.6	877.2	828.7	−118.1
1989	5,438.7	907.9	919.5	−92.4
1990	5,743.8	904.4	920.5	−78.6
1991	5,916.7	935.3	944.0	7.3
1992	6,244.4	905.4	949.1	−50.5
1993	6,550.2	938.4	993.5	−88.2
1994	6,931.4	1,055.9	1,087.2	−139.6

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Appendix Table A.3.—Increase in U.S. Assets Abroad and Foreign Assets In the U.S., 1962–1994

[Dollars in billions]

Years	Increase in U.S. assets abroad	Increase in foreign assets in U.S.
1962	$4,174	$1,911
1963	7,270	3,217
1964	9,560	3,643
1965	5,716	742
1966	7,321	3,661
1967	9,757	7,379
1968	10,977	9,928
1969	11,585	12,702
1970	9,337	6,359
1971	12,475	22,970
1972	14,497	21,461
1973	22,874	18,388
1974	34,745	34,241
1975	39,703	15,670
1976	51,269	36,518
1977	34,785	51,319
1978	61,130	64,036
1979	66,054	38,752
1980	86,967	58,112
1981	114,147	83,032
1982	122,335	92,418
1983	61,573	83,380
1984	36,313	113,932
1985	39,889	141,183
1986	106,753	226,111
1987	72,617	242,983
1988	100,087	240,265
1989	168,744	218,490
1990	74,011	122,192
1991	57,881	94,241
1992	65,875	153,823
1993	184,589	248,529
1994	125,851	291,365

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business,* June 1995, pp. 84–85.

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