

**BACKGROUND MATERIALS ON BUSINESS TAX ISSUES
PREPARED FOR THE HOUSE COMMITTEE ON
WAYS AND MEANS TAX POLICY DISCUSSION SERIES**

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INTRODUCTION

This document,¹ prepared by the staff of the Joint Committee on Taxation, contains background materials relating to various business tax issues. This document contains: (1) an overview of the U.S. Federal tax system (including the taxation of cross-border transactions); (2) an overview of the tax systems of selected foreign countries; (3) a discussion of issues with respect to corporate tax integration, the taxation of cross-border transactions, and consumption taxation; and (4) background and data relating to international trade and investment. These materials were prepared at the request of the House Committee on Ways and Means in connection with a series of discussions on tax policy issues scheduled by the Committee during April and May, 2002.

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I. OVERVIEW OF THE UNITED STATES FEDERAL TAX SYSTEM AND THE TAXATION OF CROSS-BORDER TRANSACTIONS

A. Summary of Components of the U.S. Federal Tax System

1. Individual Income Tax

In general

A United States citizen or resident generally is subject to the U.S. individual income tax on his or her worldwide taxable income. Taxable income equals the taxpayer's gross income less certain exclusions, exemptions, and deductions. Graduated tax rates are then applied to taxable income to determine his or her individual income tax liability. A taxpayer may reduce his or her income tax liability by any applicable tax credits.

Adjusted gross income

Under the Internal Revenue Code of 1986 (the "Code"), gross income means "income from whatever source derived" except for certain items specifically exempt or excluded by statute. Sources of income include compensation for services, interest, dividends, capital gains, rents, royalties, alimony and separate maintenance payments, annuities, income from life insurance and endowment contracts (other than certain death benefits), pensions, gross profits from a trade or business, income in respect of a decedent, and income from S corporations, partnerships, trusts or estates. Statutory exclusions from gross income include death benefits payable under a life insurance contract, interest on certain State and local bonds, employer-provided health insurance, employer-provided pension contributions, and certain other employer-provided fringe benefits.

An individual's adjusted gross income is determined by subtracting certain "above-the-line" deductions from gross income. These deductions include trade or business expenses, capital losses, contributions to a tax-qualified retirement plan by a self-employed individual, contributions to individual retirement arrangements ("IRAs"), certain moving expenses, and alimony payments.

Taxable income

To determine taxable income, an individual reduces adjusted gross income by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2002, the amount deductible for each personal exemption is \$3,000. This amount is indexed annually for inflation. The deduction for personal exemptions is reduced or eliminated for taxpayers with incomes over certain thresholds, which are indexed annually for inflation. The applicable thresholds for 2002 are \$137,300 for single individuals, \$206,000 for married individuals filing a joint return, \$171,650 for heads of households, and \$103,000 for married individuals filing separate returns.

The basic standard deduction varies depending upon a taxpayer's filing status. For 2002, the amount of the standard deduction is \$4,700 for single individuals; \$6,900 for heads of

households; \$7,850 for married individuals filing jointly; and \$3,925 for married individuals filing separately. Additional standard deductions are allowed with respect to any individual who is elderly or blind. The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation.

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions. The deductions that may be itemized include State and local income, real property and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 7.5 percent of adjusted gross income), casualty and theft losses (in excess of 10 percent of adjusted gross income and in excess of \$100 per loss), and certain miscellaneous expenses (in excess of 2 percent of adjusted gross income). The total amount of itemized deductions allowed is reduced for taxpayers with incomes over a certain threshold amount, which is indexed annually for inflation. The threshold amount for 2002 is \$137,300 (\$68,650 for married individuals filing separate returns).

Tax liability

To determine tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. Separate rate schedules apply based on an individual's filing status. For 2002, the individual income tax rate schedules are as follows:

Table 1.—Federal Individual Income Tax Rates for 2002

If taxable income is	Then income tax equals
<i>Single individuals</i>	
\$0-\$6,000	10 percent of taxable income.
\$6,000-\$27,950	\$600 plus 15% of the amount over \$6,000.
\$27,950-\$67,700.....	\$3,892.50, plus 27% of the amount over \$27,950.
\$67,700-\$141,250.....	\$14,625, plus 30% of the amount over \$67,700.
\$141,250-\$307,050.....	\$36,690, plus 35% of the amount over \$141,250.
Over \$307,050.....	\$94,720 plus 38.6% of the amount over \$307,050.
<i>Heads of households</i>	
\$0-10,000	10 percent of taxable income.
\$10,000-\$37,450	\$1,000 plus 15% of the amount over \$10,000.
\$37,450-\$96,700.....	\$5,117.50, plus 27% of the amount over \$37,450.
\$96,700-\$156,600.....	\$21,215, plus 30% of the amount over \$96,700.
\$156,600-\$307,050.....	\$39,085, plus 35% of the amount over \$156,600.
Over \$307,050.....	\$91,742.50 plus 38.6% of the amount over \$307,050.

Married individuals filing joint returns and surviving spouses

\$0-\$12,000	10 percent of taxable income.
\$12,000-\$46,700.....	\$1,200 plus 15% of the amount over \$12,000.
\$46,700-\$112,850.....	\$6,405, plus 27% of the amount over \$46,700.
\$112,850-\$171,950.....	\$24,265.50, plus 30% of the amount over \$112,850.
\$171,950-\$307,050.....	\$41,995.50, plus 35% of the amount over \$171,950.
Over \$307,050.....	\$89,280.50, plus 38.6% of the amount over \$307,050.

Married individuals filing separate returns

\$0-\$6,000	10 percent of taxable income.
\$6,000-\$23,350	\$600 plus 15% of the amount over \$6,000.
\$23,350-\$56,425.....	\$3,202.50, plus 27% of the amount over \$23,350.
\$56,425-\$85,975.....	\$12,132.75, plus 30% of the amount over \$56,425.
\$85,975-\$153,250.....	\$20,997.75, plus 35% of the amount over \$85,975.
Over \$153,250.....	\$44,640.25 plus 38.6% of the amount over \$153,250.

An individual may reduce his or her tax liability by any available tax credits. Tax credits are allowed for certain business expenditures, certain foreign income taxes paid or accrued, certain child care expenditures, certain expenditures relating to higher education, taxpayers who have qualifying children, and for certain elderly or disabled individuals. In addition, a refundable earned income credit is available to low-income workers who satisfy certain requirements. The amount of the earned income credit varies depending upon whether the taxpayer has one, more than one, or no qualifying children, and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income threshold. For 2002, the maximum earned income credit is \$4,140 for taxpayers with more than one qualifying child, \$2,506 for taxpayers with one qualifying child, and \$376 for taxpayers with no qualifying children.

Capital gains and losses

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange by an individual of most capital assets held more than one year, any net capital gain that results from the sale is taxed at a rate of 20 percent (10 percent for taxpayers in the 15 percent rate bracket). Special treatment applicable to depreciable real estate is summarized below. Any net short-term capital gain is taxed at the taxpayer's ordinary income rate. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Net short-term capital gain is the excess of the net short-term capital gain over the net long-term capital loss. Gain or loss is treated as long-term if the asset is held for more than one year, and short-term if held for a period of one year or less.

Capital losses generally are deductible in full against capital gains. In addition, individuals may deduct capital losses against up to \$3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, and (5) certain publications of the Federal Government, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies.

In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is treated as ordinary income and not as capital gain to the extent of all previous depreciation allowances.

Gain from the disposition of depreciable real property generally is not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method. The amount of gain that is not in excess of the depreciation allowances that would have been available under the straight-line method is capital gain, but it is taxed at a rate of 25 percent. To summarize, gain from the disposition of depreciable real property held more than one year may be taxed at 25 percent to the extent of depreciation allowances not in excess of straight-line depreciation, at the taxpayer's ordinary income rates to the extent of depreciation allowances above the amount determined under the straight-line method, and as long-term capital gain at a rate of 20 percent (10 percent for taxpayers in the 15 percent bracket) to the extent of any gain in excess of depreciation.

Alternative minimum tax

An individual is subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular income tax owed. The tax is imposed at rates of 26 and 28 percent on alternative minimum taxable income in excess of an exemption amount (for years 2001-2004, \$49,000 for joint returns, \$35,750 for single individuals, and \$24,500 for married individuals filing separately). After 2001, the nonrefundable credits that are allowed to offset an individual's regular tax liability are not allowed to offset his or her minimum tax liability. If an individual pays the alternative minimum tax, a portion of the amount of the tax paid may be allowed as a credit against the regular tax of the individual in future years.

Alternative minimum taxable income is the taxpayer's taxable income increased by the taxpayer's tax preferences and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. Among the preferences and adjustments applicable to the individual alternative minimum tax are accelerated depreciation on certain property used in a trade or business, circulation expenditures, research and experimental expenditures, certain expenses and allowances related to oil and gas and mining exploration and development, certain tax-exempt interest income, and a percentage of the amount of gain excluded with respect to the sale or disposition of certain small business stock. In addition, personal exemptions, the standard deduction, and certain itemized deductions are not allowed to reduce alternative minimum taxable income.

2. Corporate Income Tax

Taxable income

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their worldwide taxable income.

The taxable income of a corporation generally is comprised of gross income, less allowable exclusions, exemptions, and deductions. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Allowable deductions include ordinary and necessary business expenditures, such as salaries, wages, contributions to profit-sharing and pension plans and other employee benefit programs, repairs, bad debts, taxes (other than Federal income taxes), contributions to charitable organizations (subject to an income limitation), advertising, interest expense, certain losses, selling expenses, and other expenses. Expenditures that benefit future accounting periods (such as the purchase of plant and equipment) generally are capitalized and recovered over time through depreciation, amortization or depletion allowances. A net operating loss incurred in one taxable year may be carried back two years and carried forward 20 years and allowed as a deduction in another taxable year. Deductions are also allowed for certain amounts despite the lack of an underlying expenditure. For example, a deduction is allowed for all or a portion of the amount of dividends received by a corporation from another corporation.

The Code also specifies certain expenditures that may not be deducted, such as dividends paid to shareholders, expenses associated with earning tax-exempt income such as exempt State and local obligations, certain entertainment expenditures, certain executive compensation in excess of \$1,000,000 per year, a portion of the interest on certain high-yield debt obligations that resemble equity, and fines, penalties, bribes, kickbacks and illegal payments.

Tax liability

A corporation's regular income tax liability is determined by applying the following tax rate schedule to its taxable income.

Table 2.—Federal Corporate Income Tax Rates

<u>If taxable income is:</u>	<u>Then the income tax rate is:</u>
\$0-\$50,000	15 percent of taxable income
\$50,001-\$75,000	25 percent of taxable income
\$75,001-\$10,000,000	34 percent of taxable income
Over \$10,000,000.....	35 percent of taxable income

The first two graduated rates described above are phased out for corporations with taxable income between \$100,000 and \$335,000. As a result, a corporation with taxable income between \$335,000 and \$10,000,000 effectively is subject to a flat tax rate of 34 percent. Also, the application of the 34-percent rate is gradually phased out for corporations with taxable income between \$15,000,000 and \$18,333,333; a corporation with taxable income of \$18,333,333 or more effectively is subject to a flat rate of 35 percent.

The maximum rate of tax on the net capital gains of a corporation is 35 percent. A corporation may not deduct the amount of capital losses in excess of capital gains for any taxable year. Disallowed capital losses may be carried back three years and carried forward five years.

Like individuals, corporations may reduce their tax liability by any applicable tax credits. Tax credits applicable to businesses include credits for producing fuels from nonconventional sources, investment tax credits (applicable to investment in certain reforestation, renewable energy property, and the rehabilitation of certain real property), the alcohol fuels credit (applicable to production of certain alcohol fuels), the research credit (applicable to the incremental investment in certain research and experimental activities), the low-income housing credit (applicable to the investment in certain low-income housing projects), the enhanced oil recovery credit (applicable to the recovery of certain difficult-to-extract oil reserves), the empowerment zone employment credit (applicable to wages paid to certain residents of empowerment zones), the renewable energy production credit, the employer-provided child care credit and the disabled access credit (applicable to expenditures by certain small businesses to make the business accessible to disabled individuals). The credits generally are determined based on a percentage of the cost associated with the underlying activity and generally are subject to certain limitations.

Affiliated group

Domestic corporations that are affiliated through 80 percent or more corporate ownership may elect to file a consolidated return in lieu of filing separate returns. Corporations filing a consolidated return generally are treated as a single corporation; thus, the losses (and credits) of a corporation can offset the income (and thus reduce the otherwise applicable tax) of other affiliated corporations. Also, corporations that file a consolidated return may engage in many types of transactions with their affiliates without immediate recognition of gain or loss.

Alternative minimum tax

A corporation is subject to an alternative minimum tax payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax liability. The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of a \$40,000 exemption amount. Credits that are allowed to offset a corporation's regular tax liability generally are not allowed to offset minimum tax liability. If a corporation pays the alternative minimum tax, the amount of the tax paid is allowed as a credit against the regular tax in future years. A corporation with average annual gross receipts of less than \$7.5 million for the prior three years is exempt from the corporate alternative minimum tax.

Alternative minimum taxable income is the corporation's taxable income increased by the corporation's tax preferences and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. Among the preferences and adjustments applicable to the corporate alternative minimum tax are accelerated depreciation on certain property, certain expenses and allowances related to oil and gas and mining exploration and development, certain amortization expenses related to pollution control facilities, and certain tax-exempt interest income. In addition, corporate alternative minimum taxable income is increased by 75 percent of the amount by which the corporation's "adjusted current earnings" exceeds its alternative minimum taxable income (determined without regard to this adjustment). Adjusted current earnings generally are determined with reference to the rules that apply in determining a corporation's earnings and profits.

Treatment of corporate distributions

The taxation of a corporation generally is separate and distinct from the taxation of its shareholders. A distribution by a corporation to its shareholders generally is taxable as a dividend to the shareholder to the extent of the corporation's current or accumulated earnings and profits. Thus, the amount of a corporate dividend generally is taxed twice: once when the income is earned by the corporation and again when the dividend is distributed to the shareholder. Conversely, amounts paid as interest to the debtholders of a corporation generally are subject to only one level of tax (at the recipient level) since the corporation generally is allowed a deduction for the amount of interest expense paid or accrued.

Amounts received by a shareholder in complete liquidation of a corporation generally are treated as full payment in exchange for the shareholder's stock. A liquidating corporation recognizes gain or loss on the distributed property as if such property were sold to the distributee for its fair market value. However, if a corporation liquidates a subsidiary corporation of which it has 80 percent or more control, no gain or loss generally is recognized by either the parent corporation or the subsidiary corporation.

Accumulated earnings and personal holding company taxes

Taxes at a rate equal to the top marginal rate applicable to individuals may be imposed upon the accumulated earnings or personal holding company income of a corporation. The accumulated earnings tax may be imposed if a corporation retains earnings in excess of

reasonable business needs. Similarly, a personal holding company tax may be imposed upon the excessive passive income of a closely held corporation. The accumulated earnings tax and the personal holding company tax are designed to ensure that both a corporate tax and a shareholder tax are effectively imposed on corporate earnings.

S Corporations

A qualified small business corporation may elect, under subchapter S of the Code, not to be subject to the corporate income tax. If an S corporation election is made, the income of the corporation will flow through to the shareholders and be taxable directly to the shareholders.

3. Estate and Gift Taxes

The United States imposes a gift tax on any transfer of property by gift made by a U.S. citizen or resident, whether made directly or indirectly and whether made in trust or otherwise. Nonresident noncitizens are subject to the gift tax with respect to transfers of tangible real or personal property where the property is located in the United States at the time of the gift. The gift tax is imposed on the donor and is based on the fair market value of the property transferred. Deductions are allowed for certain gifts to spouses and to charities. Annual gifts up to a per-donor, per-donee exclusion amount (\$11,000 for 2002) generally are not subject to tax.

An estate tax is imposed on the “taxable estate” of any person who was a citizen or resident of the United States at the time of death, and on certain property belonging to a nonresident of the United States that is located in the United States at the time of death. The estate tax is imposed on the estate of the decedent and generally is based on the fair market value of the property passing at death. The taxable estate generally equals the worldwide “gross estate” less certain allowable deductions, including a marital deduction for certain bequests to a surviving spouse and a deduction for certain bequests to charities.

Since 1976, the gift tax and the estate tax have been unified, so that a single graduated rate schedule applies to an individual's cumulative taxable gifts and bequests. Under this rate schedule, the unified estate and gift tax rates begin at 18 percent on the first \$10,000 in cumulative taxable transfers and reach 50 percent on cumulative taxable transfers over \$2.5 million. This maximum rate phases down to 45 percent by 2007. A “unified credit” effectively exempts a total of \$1,000,000 in cumulative taxable transfers from the estate and gift tax. The amount of this effective exemption will gradually increase (for estate tax purposes) to \$3.5 million by 2009. Effective for 2010 only, the estate tax is repealed. After 2010, the estate and gift taxes are scheduled to revert to pre-2001 law (55 percent maximum rate and \$1 million unified credit).

A separate transfer tax is imposed on generation-skipping transfers, in addition to any estate or gift tax that is imposed on such transfers. This tax generally applies to transfers to a beneficiary more than one generation below that of the transferor (whether made directly or through a trust or similar arrangement). The generation-skipping transfer tax is imposed at the maximum estate tax rate on generation-skipping transfers in excess of an exemption amount that is roughly correlated with the unified credit effective exemption amount. Like the estate tax, the generation-skipping transfer tax is repealed for 2010 only.

4. Employment Taxes

Social security benefits are financed primarily by payroll taxes on covered wages. As part of the Federal Insurance Contributions Act (FICA), an employer must pay a social security tax based on the amount of wages paid to an employee during the year. The tax is comprised of two parts: (1) the old age, survivors, and disability insurance (OASDI) tax equal to 6.2 percent of covered wages (up to \$84,900 of wages in 2002); and (2) the Medicare hospital insurance (HI) tax in an amount equal to 1.45 percent of wages (HI payroll tax is not subject to a wage cap). In addition to the tax on employers, each employee must pay a social security tax equal to the amount of tax owed by the employer. This amount generally must be withheld by the employer and remitted to the Federal Government. Self-employed individuals are subject to a tax that parallels the employer and employee portions of the social security tax.

In addition to the social security tax, employers are subject to a Federal unemployment insurance payroll tax equal to 6.2 percent of the total wages of each employee (up to \$7,000). Employers are allowed a credit for a percentage of State unemployment taxes. Federal unemployment insurance payroll taxes are used to fund programs maintained by the States for the benefit of unemployed workers.

5. Major Excise Taxes

The Federal tax system imposes excise taxes on selected goods and services, but does not contain a broad-based consumption tax such as a value-added tax or national sales tax. Excise taxes are taxes imposed on a per unit or ad valorem (i.e., percentage of price) basis on the production, importation, or sale of a specific good or service. Among the goods and services subject to U.S. excise taxes are motor fuels, alcoholic beverages, tobacco products, firearms, air and ship transportation, certain environmentally hazardous activities and products, coal, telephone communications, certain wagers, vehicles lacking in fuel efficiency, and luxury automobiles.

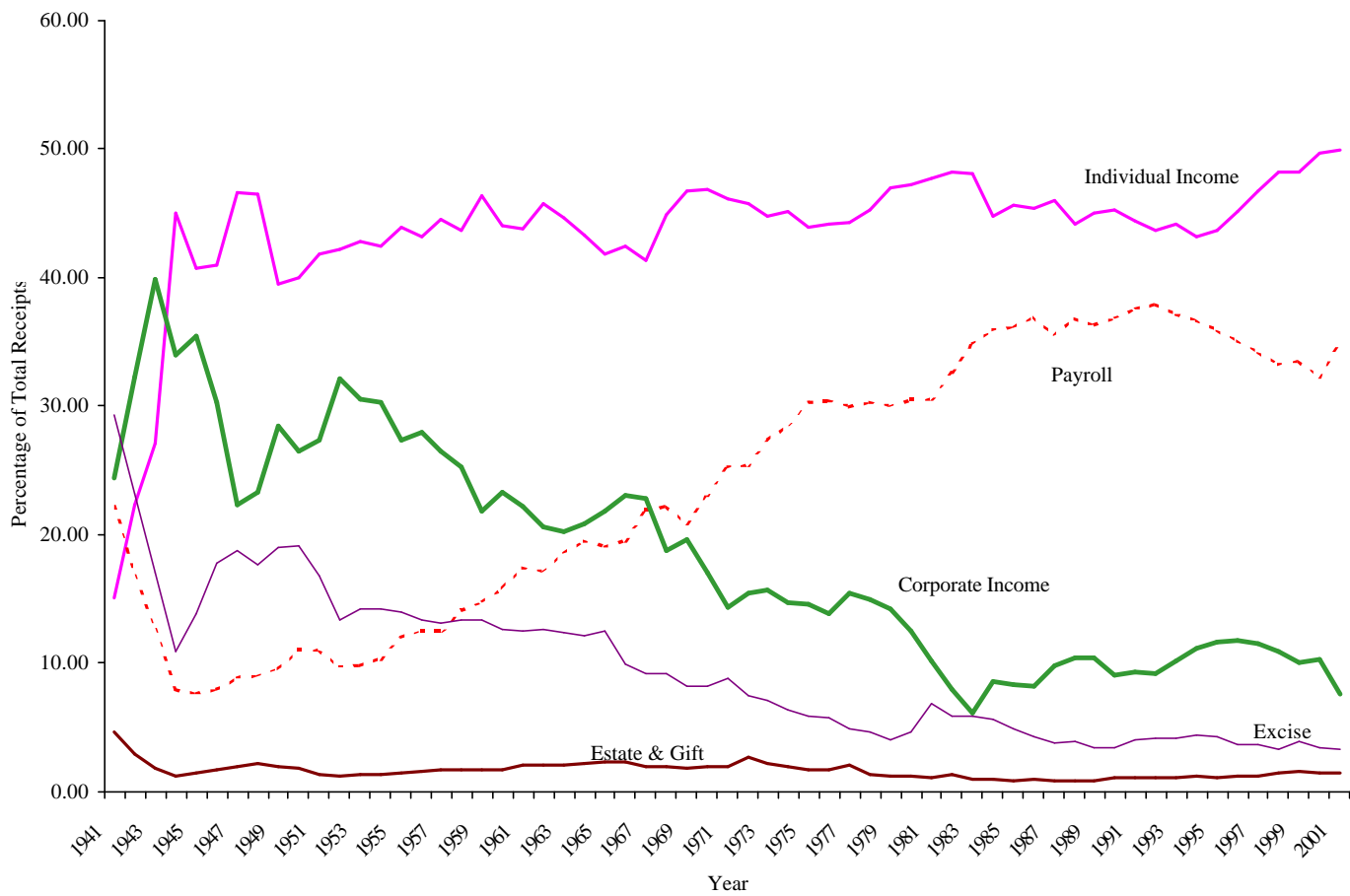
Revenues from certain Federal excise taxes are dedicated to Trust Funds (e.g., the Highway Trust Fund) for designated expenditure programs, and revenues from other excise taxes (e.g., alcoholic beverages) go to the General Fund for general purpose expenditures.

6. Summary Data

The individual income tax is the Federal Government's largest single revenue source, accounting for 49.9 percent of total Federal receipts in fiscal year 2001. Payroll and self-employment taxes comprised 34.9 percent of total Federal receipts in fiscal year 2001, followed in importance by the corporate income tax which comprised 7.6 percent of total receipts, the various excise taxes which comprised 3.3 percent of receipts, and the estate and gift taxes which comprised 1.4 percent of receipts. Over the past 60 years, the composition of Federal tax revenues has changed, with the individual income taxes increasing in relative importance and the corporate income tax and excise taxes declining in relative importance. Figure 1 plots the changing composition of Federal tax revenues by measuring each component's contribution as a percentage of total revenues from 1940 through 2001. Table 3 presents the same trends with receipts from each tax measured as a percentage of gross domestic product.

Figure 1

Federal Tax Receipts as a Percentage of Total Federal Receipts, 1940-2001



Source: Office of Management and Budget, JCT staff calculations, see Appendix Table 1.

Table 3 – Federal Receipts By Source, as a Percentage of GDP, 1940-2001

Fiscal Year	Total Receipts as % GDP	Individual Income Tax as % GDP	Payroll Taxes as % GDP	Corporate Income Tax as % GDP	Excise Taxes as % GDP	Estate & Gift Taxes % GDP
2001	19.62	9.80	6.84	1.49	0.65	0.28
2000	20.78	10.31	6.70	2.13	0.71	0.30
1999	20.03	9.64	6.71	2.02	0.77	0.30
1998	19.87	9.56	6.60	2.18	0.67	0.28
1997	19.29	9.01	6.59	2.23	0.70	0.24
1996	18.88	8.53	6.62	2.23	0.70	0.22
1995	18.46	8.06	6.61	2.14	0.78	0.20
1994	18.12	7.82	6.65	2.02	0.80	0.22
1993	17.60	7.77	6.53	1.79	0.73	0.19
1992	17.55	7.65	6.65	1.61	0.73	0.18
1991	17.77	7.89	6.68	1.65	0.71	0.19
1990	17.99	8.14	6.63	1.63	0.62	0.20
1989	18.34	8.25	6.65	1.91	0.64	0.16
1988	18.13	8.00	6.67	1.88	0.70	0.15
1987	18.39	8.45	6.53	1.81	0.70	0.16
1986	17.48	7.93	6.45	1.43	0.75	0.16
1985	17.75	8.09	6.41	1.48	0.87	0.16
1984	17.36	7.77	6.23	1.48	0.97	0.16
1983	17.46	8.40	6.07	1.08	1.03	0.18
1982	19.13	9.22	6.24	1.52	1.12	0.25
1981	19.57	9.34	5.97	2.00	1.33	0.22
1980	18.93	8.93	5.78	2.36	0.89	0.23
1979	18.50	8.70	5.55	2.62	0.75	0.22
1978	18.01	8.16	5.45	2.70	0.83	0.24
1977	18.04	8.00	5.40	2.78	0.89	0.37
1976	17.16	7.58	5.23	2.38	0.98	0.30
1975	17.89	7.85	5.42	2.60	1.06	0.30
1974	18.25	8.25	5.21	2.68	1.17	0.35
1973	17.64	7.89	4.82	2.76	1.24	0.38
1972	17.55	8.02	4.45	2.72	1.31	0.46
1971	17.31	7.97	4.38	2.48	1.54	0.35
1970	19.03	8.92	4.38	3.24	1.55	0.36
1969	19.69	9.19	4.11	3.86	1.60	0.37
1968	17.62	7.91	3.91	3.30	1.62	0.35
1967	18.29	7.56	4.01	4.18	1.69	0.37
1966	17.35	7.35	3.39	3.99	1.73	0.41
1965	16.98	7.09	3.23	3.70	2.12	0.39
1964	17.56	7.59	3.42	3.66	2.14	0.37
1963	17.77	7.94	3.30	3.60	2.20	0.36
1962	17.53	8.02	3.00	3.61	2.20	0.35
1961	17.75	7.77	3.09	3.94	2.23	0.36
1960	17.82	7.85	2.83	4.14	2.25	0.31
1959	16.10	7.46	2.38	3.52	2.15	0.27
1958	17.27	7.53	2.44	4.35	2.31	0.30
1957	17.75	7.90	2.22	4.70	2.34	0.30
1956	17.44	7.53	2.18	4.88	2.32	0.27
1955	16.56	7.27	1.99	4.52	2.31	0.23
1954	18.44	7.82	1.91	5.58	2.63	0.25
1953	18.64	7.99	1.83	5.69	2.65	0.24
1952	18.97	8.01	1.85	6.09	2.54	0.23

Fiscal Year	Total Receipts as % GDP	Individual Income Tax as % GDP	Payroll Taxes as % GDP	Corporate Income Tax as % GDP	Excise Taxes as % GDP	Estate & Gift Taxes % GDP
1951	16.08	6.73	1.77	4.39	2.69	0.22
1950	14.43	5.76	1.59	3.82	2.76	0.26
1949	14.52	5.73	1.39	4.12	2.76	0.29
1948	16.21	7.53	1.46	3.77	2.87	0.35
1947	16.42	7.64	1.46	3.67	3.07	0.33
1946	17.65	7.23	1.40	5.34	3.14	0.30
1945	20.41	8.30	1.56	7.22	2.83	0.29
1944	20.93	9.43	1.66	7.10	2.28	0.24
1943	13.33	3.61	1.69	5.31	2.27	0.24
1942	10.15	2.26	1.70	3.27	2.36	0.29
1941	7.64	1.15	1.70	1.86	2.24	0.35
1940	6.77	0.92	1.85	1.24	2.04	0.37

Source: Joint Committee on Taxation; Office of Management and Budget, Historical Tables, Budget of the United States Government, Fiscal Year 2003.

B. Summary of Income Tax Provisions Relating to Cross-Border Transactions

Summary

U.S. citizens, residents, and corporations (collectively, "U.S. persons") are subject to U.S. income tax on all income, whether derived in the United States or abroad. Foreign persons are subject to U.S. tax only on income that has a sufficient connection to the United States.

Within this basic framework, a variety of rules affect the U.S. taxation of cross-border 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 deductions between related persons in order to ensure the clear reflection of the income of each person and to prevent the avoidance of tax. 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 certain income from foreign operations of certain U.S.-owned foreign corporations.

A cross-border 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 the respective country. However, an income tax treaty between the two countries may operate to coordinate the two tax regimes and mitigate the double taxation of the transaction.

U.S. taxation of U.S. persons with foreign income

In general

The United States taxes U.S. persons on all income, whether derived in the United States or elsewhere. However, 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.

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 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.

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 such 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 relating to such foreign operations. Thus, the income from the U.S. person's foreign operations is subject to current U.S. tax, although a foreign tax credit may reduce or eliminate the U.S. tax on such income.

Foreign operations conducted through a foreign corporation

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 the 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 only 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. A 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 certain U.S. shareholders of foreign corporations with respect to certain categories of income earned by the foreign corporation. The main anti-deferral regimes set forth in the Code (in order of enactment) are the foreign personal holding company rules (secs. 551-558), the controlled foreign corporation rules of subpart F (secs. 951-964), and the passive foreign investment company rules (secs. 1291-1298).

Foreign personal holding companies

The Revenue Act of 1937 established an anti-deferral regime for foreign personal holding companies ("FPHCs"). A FPHC generally is defined as any foreign corporation if five or fewer U.S. individual citizens or residents own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), and at least 60 percent of the corporation's gross income consists of certain types of passive income (such as dividends, interest, certain royalties and certain rents). If a foreign corporation is a FPHC, 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.

Controlled foreign corporations

The Revenue Act of 1962 established an anti-deferral regime for controlled foreign corporations under subpart F of the Code. A controlled foreign corporation generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only). Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation on their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders. Subpart F income typically is passive income or income that is readily 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)). Foreign base company income, in turn, includes 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. For example, foreign personal holding company income includes, among other items, dividends, interest, rents and royalties (subject to certain exceptions). In effect, the United States treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution out of the corporation's subpart F income. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's earnings invested in U.S. property. The U.S. tax on such amounts may be reduced through foreign tax credits.

Passive foreign investment companies

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies. A passive foreign investment company generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income. Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a passive foreign investment company, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment companies that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral. A third set of rules applies to passive foreign investment company stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."

Detailed rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes.

For example, the passive foreign investment company rules generally do not apply to U.S. shareholders that are subject to the subpart F rules.

Foreign tax credit

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-source income by the foreign income taxes they pay on that income. The foreign tax credit, however, does not operate to offset U.S. income tax on U.S.-source income.

A credit against U.S. tax on foreign-source income is allowed for foreign taxes directly paid or accrued by a U.S. person (the “direct” foreign tax credit). 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).

The foreign tax credit provisions 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. 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.

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. Under this limitation, the credit for foreign taxes on income in a particular category may not exceed the same proportion of the taxpayer's U.S. tax liability which the taxpayer's foreign-source taxable income in that category bears to the taxpayer's worldwide taxable income for the taxable year. Detailed rules are provided for the allocation of expenses against foreign-source income. Special rules apply to require the recharacterization of foreign-source income for a year subsequent to a foreign loss year as U.S.-source income.

Transfer pricing

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 an 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 establishing artificial transfer prices for transactions between group members.

Under section 482, the Secretary of the Treasury is authorized to redetermine the income of an entity subject to U.S. taxation when it appears that an improper shifting of income between that entity and a commonly controlled entity has occurred. This authority is not limited to reallocations of income between different countries; it permits reallocations in any common control situation, including reallocations between two U.S. entities. However, it has significant application to multinational enterprises.

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 to clearly 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 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 a 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.

Extraterritorial income exclusion

The United States has in the past provided export-related benefits under its tax law -- specifically the domestic international sales corporation ("DISC") and foreign sales corporation ("FSC") regimes. The FSC regime was enacted in 1984 in response to concerns that the DISC regime constituted an export subsidy in violation of the General Agreement on Tariffs and Trade ("GATT"). In response to European Union complaints, a World Trade Organization ("WTO") Appellate Body held in 2000 that the FSC regime constituted a prohibited export subsidy under the relevant WTO agreements. Later that year, the United States repealed the FSC regime and enacted an exclusion for certain "extraterritorial income" ("ETI"), which was generally defined to include not only export income but also certain types of non-export income. In 2001, a WTO panel held that the ETI regime also constituted a prohibited export subsidy, and in 2002 the Appellate Body affirmed this holding.

U.S. taxation of foreign persons with U.S. income

The United States taxes nonresident noncitizen individuals and foreign corporations (collectively, “foreign persons”) only on income that has a sufficient nexus to the United States.

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. This “effectively connected” income generally is taxed in the same manner and at the same rates as the income of a U.S. person. 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.

In addition, foreign persons generally are subject to U.S. tax at a flat 30-percent rate on certain gross income (interest, dividends, rents, royalties, and other similar types of income) derived from U.S. sources. Certain types of interest (for example, interest from certain bank deposits and from certain portfolio obligations) are not subject to the tax. The tax generally is collected by means of withholding by the person making the payment to the foreign person. The tax may be reduced or eliminated pursuant to an applicable tax treaty.

Income tax treaties

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. For example, treaties often reduce or eliminate withholding taxes imposed by a treaty country on certain types of income (e.g., dividends, interest and royalties) paid to residents of the other treaty country. Treaties also contain provisions governing the creditability of taxes. 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.

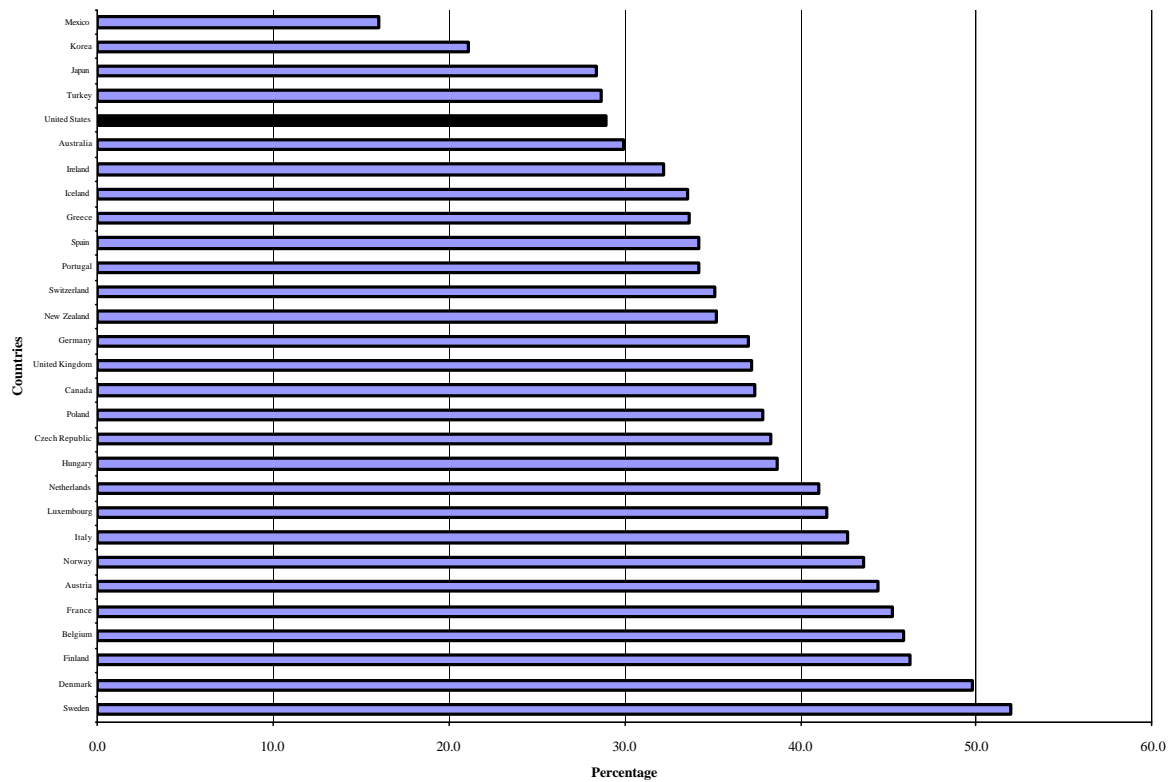
II. OVERVIEW OF THE TAX SYSTEMS OF CERTAIN FOREIGN COUNTRIES

A. The U.S. Tax System Compared to Those of Other Countries

The public sector in the United States comprises a smaller proportion of the economy than does the public sector in most other developed countries. As a consequence, tax revenue as a proportion of gross domestic product (“GDP”) is smaller in the United States than in many other countries. Figure 2 shows total tax revenue, at all levels of government, as a percentage of GDP for the OECD member countries in 1999.

Figure 2

Total Tax Revenue as a Percentage of GDP in OECD Member Countries, 1999

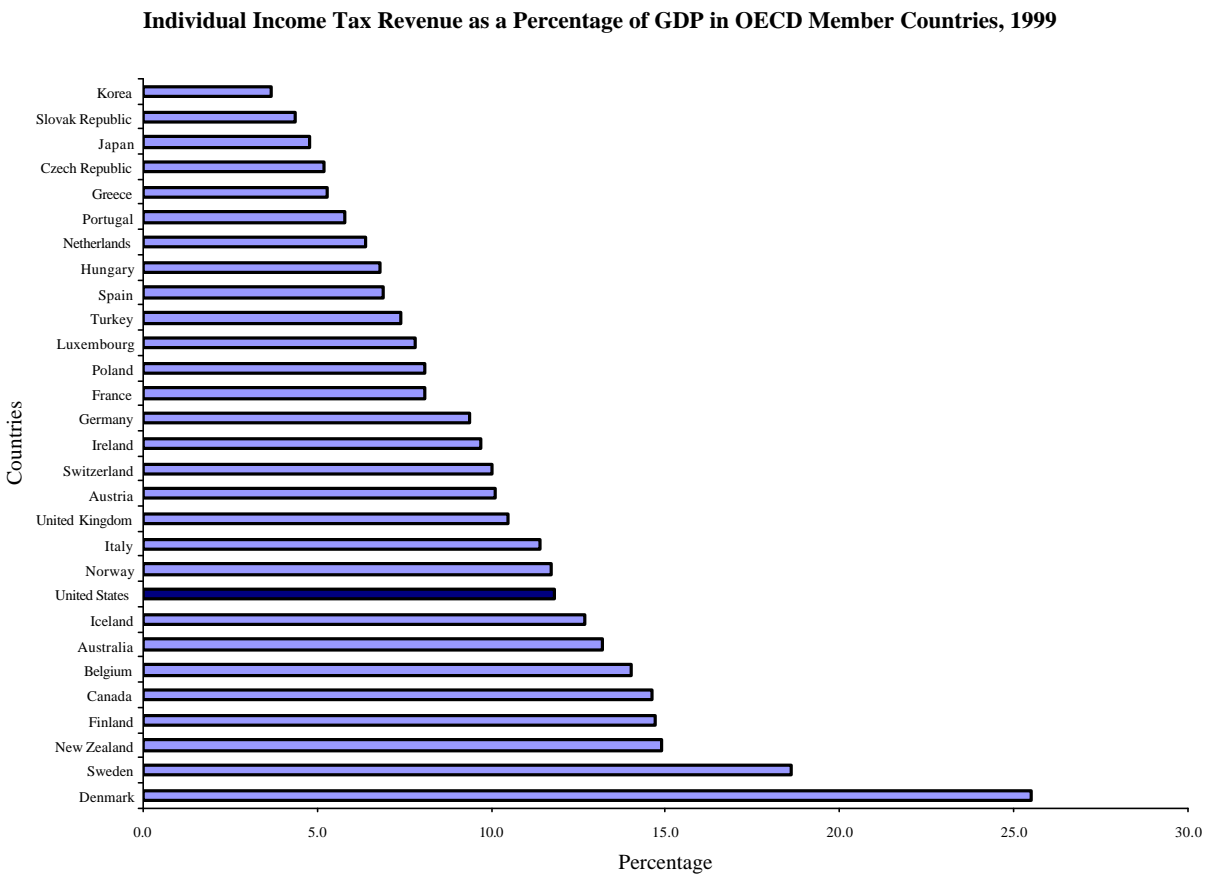


Source: OECD, Revenue Statistics 1965-2000.

Note: Data include all taxes imposed at both national and subnational levels.

While all OECD countries impose an individual income tax, a corporate income tax, payroll taxes, and general sales taxes (or value-added taxes) and selective excise taxes, the relative reliance on these different tax bases varies across countries. Among OECD countries, the United States relies more heavily on the individual income tax and less heavily on general sales taxes or other general consumption taxes. Figure 3, Figure 4, Figure 5, and Figure 6 report individual income tax revenue, corporate income tax revenue, payroll tax revenue, and general consumption tax revenue (general sales taxes or value-added taxes), respectively, as a percentage of GDP in OECD member countries in 1999. All of these figures include taxes imposed at both national and subnational levels.

Figure 3

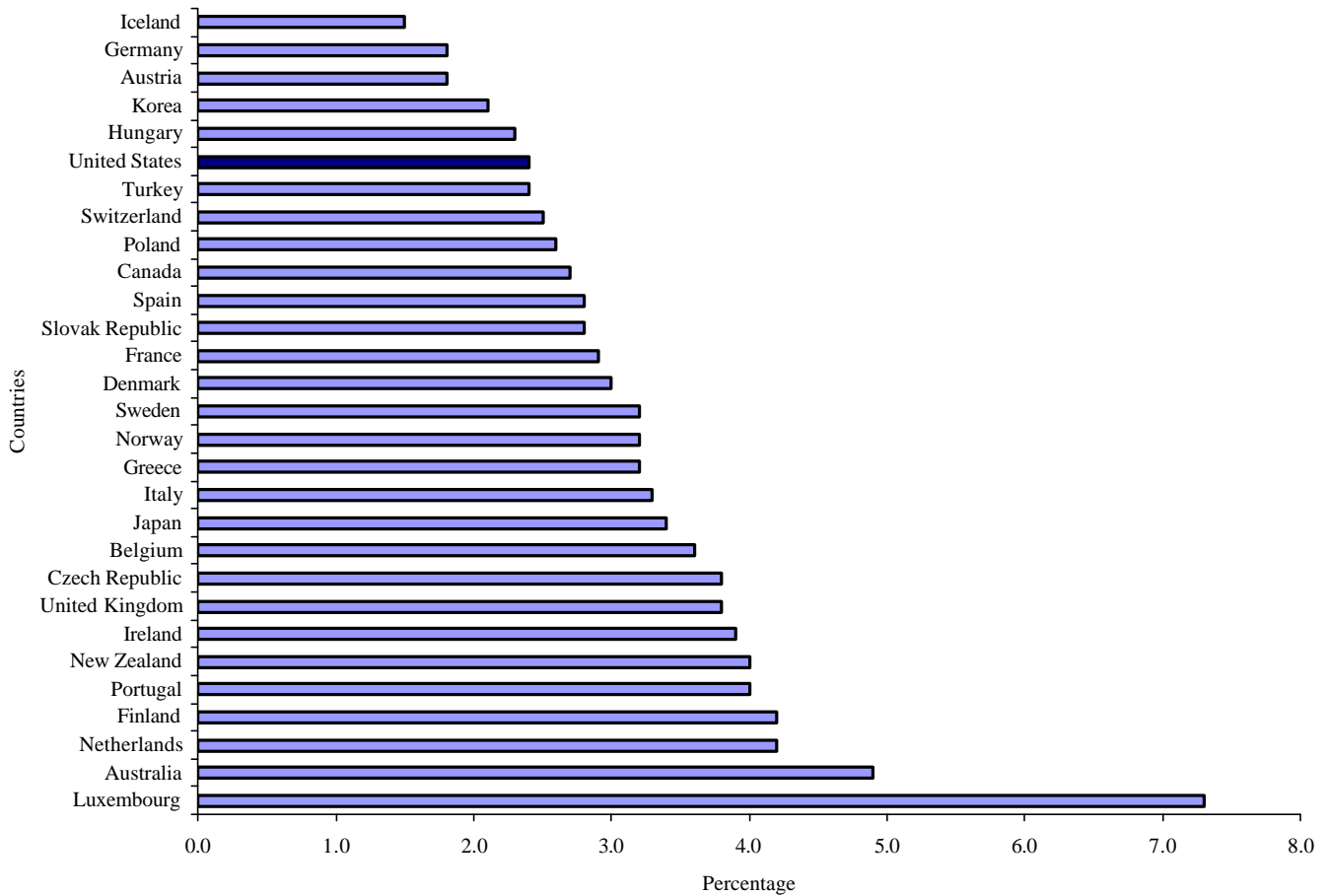


Source: OCED, Revenue Statistics 1965-1999.

Note: Data include all taxes imposed at both national and subnational levels.

Figure 4

Corporate Income Tax Revenue as a Percentage of GDP in OECD Member Countries, 1999

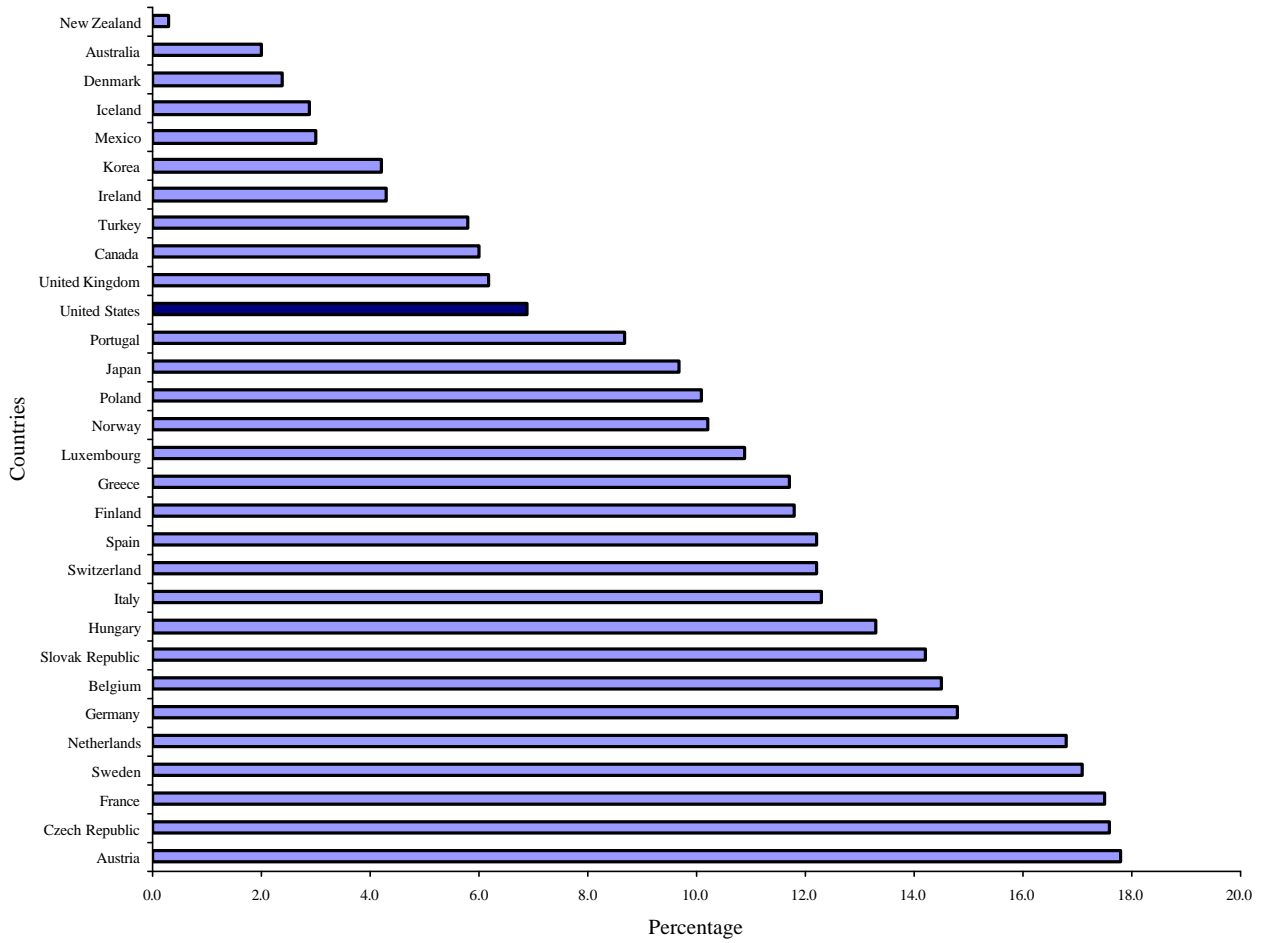


Source: OCED, Revenue Statistics 1965-1999.

Note: Data include all taxes imposed at both national and subnational levels.

Figure 5

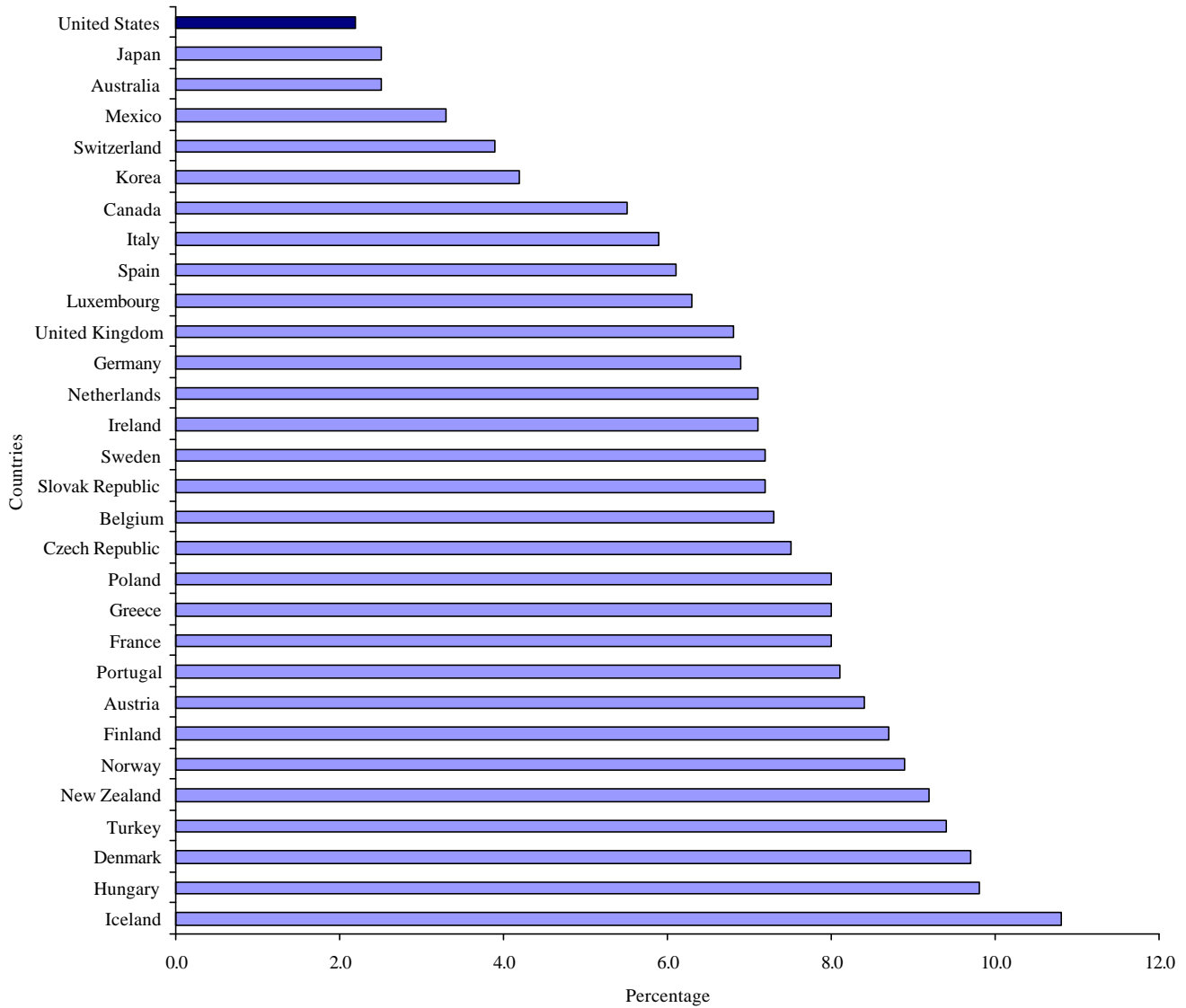
Payroll Tax Revenue as a Percentage of GDP in OECD Member Countries, 1999



Source: Data include all taxes imposed at both national and subnational levels.
Note: OCED, Revenue Statistics 1965-1999.

Figure 6

General Consumption Tax Revenue as a Percentage of GDP in OECD Member Countries, 1999

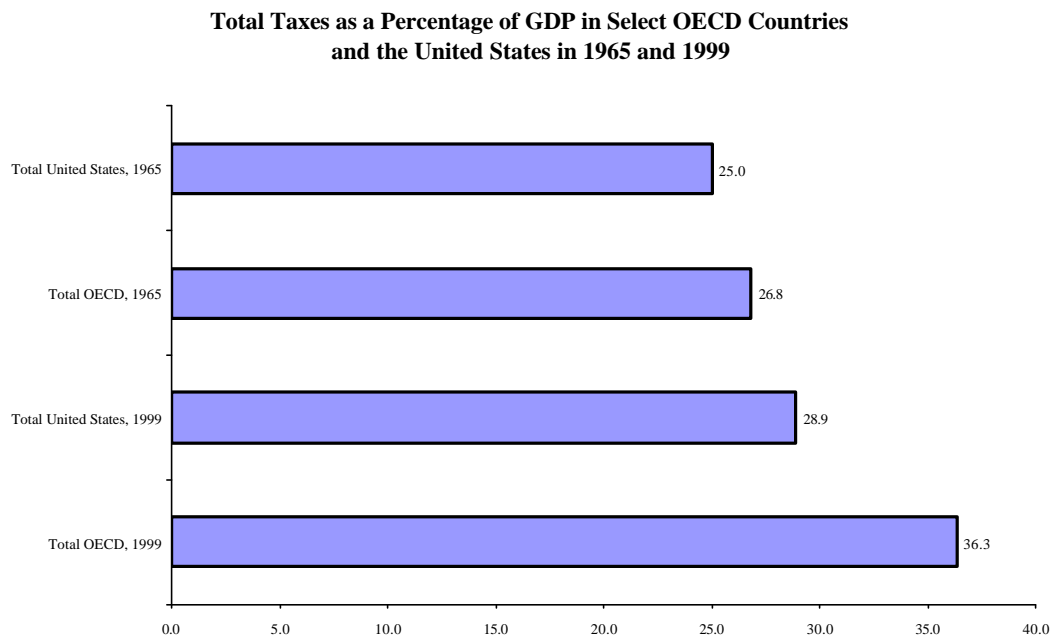


Source: OCED, Revenue Statistics 1965-1999.

Note: Data include all taxes imposed at both national and subnational levels.

While total tax revenue as a proportion of GDP is presently considerably lower in the United States than in most other OECD member countries, this has not always been the case. In the 1960s, for example, tax revenue as a proportion of GDP was roughly equivalent in the United States and in the OECD member countries. Since that time, however, tax revenue relative to GDP has grown significantly in Europe, while it has grown only slightly in the United States. Figure 7 shows total taxes (at all levels of government) as a percentage of GDP in OECD Europe and the United States in 1965 and 1999.²

Figure 7



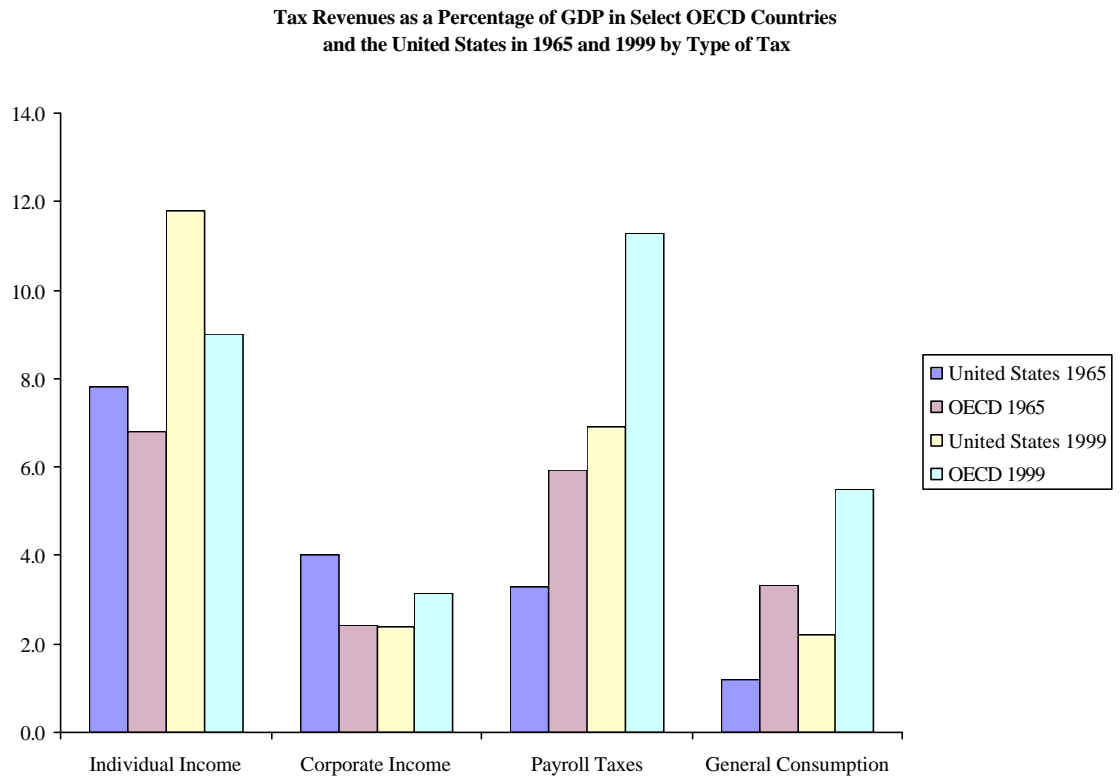
Source: OCED, Revenue Statistics 1965-2000.

Note: Data include all taxes imposed at both national and subnational levels.

² The data for this and the following figure reflect GDP-weighted averages of the percentage of tax revenue relative to GDP for the certain members of the OECD. The use of a GDP-weighted average causes the tax systems of large economies such as Germany and Japan to be weighted more heavily in the average than the tax systems of smaller economies such as Iceland and Luxembourg. In addition, since the number of European members of the OECD has grown over the past 40 years, the figures for both 1965 and 1999 are not based on the current membership of the non-U.S. OECD countries, but on those countries for which comparable data for both 1965 and 1999 are available. The countries in these comparisons are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, Turkey, and the United Kingdom.

The revenues from different types of taxes relative to GDP also have changed over time in the United States and other OECD member countries. For example, the United States has come to rely more heavily on the individual income tax and on payroll taxes as revenue sources than it did in the 1960s. OECD member countries likewise have increased their reliance on individual income taxes and payroll taxes, but general consumption taxes also have become a much more important source of revenue in other OECD countries, unlike in the United States. Another point of difference is that corporate income tax revenues relative to GDP have declined slightly over time in the United States, while they have increased slightly in other OECD countries. Indeed, revenues from all four types of tax shown have increased relative to GDP in other OECD countries, as average tax revenues have grown substantially relative to GDP in other countries. Figure 8 shows revenues from different types of taxes (at all levels of government) as a percentage of GDP in non-U.S. OECD countries and the United States in 1965 and 1999.

Figure 8



Source: OECD, Revenue Statistics 1965-2000.

Note: Data include all taxes imposed at both national and subnational levels.

In addition to differing reliance on the various tax bases, the structure of each tax may vary across countries. The material in the following section briefly describes the tax systems of Australia, Belgium, Canada, China, France, Germany, Ireland, Italy, Japan, Mexico, the Netherlands, Spain, and the United Kingdom. Table 4 shows the extent to which each of these countries relies on the individual income tax, the corporate income tax, payroll taxes, property taxes, and goods and services taxes³ for their government revenue (including all levels of government). This table expresses the revenue from each tax as a percentage of total tax revenues in the particular country, rather than as a percentage of GDP as in the figures above.

Table 4 – Percentage of Total Revenue Derived from Different Taxes in Select Countries, 1998

	Percentage of Total Revenue Comprised From				
	Individual Income Taxes	Corporate Income Taxes	Payroll Taxes	Property Taxes	Goods & Services Taxes
Australia	43.3	15.2	6.6	9.5	25.5
Belgium	30.7	8.5	31.5	3.2	24.9
Canada	37.8	10.0	15.8	10.4	24.7
China	n.a.	n.a.	n.a.	n.a.	n.a.
France	17.4	5.9	38.5	7.3	26.6
Germany	25.0	4.4	40.4	2.4	27.4
Ireland	30.9	10.7	13.8	5.2	38.7
Italy	25.0	7.0	29.5	4.8	27.4
Japan	18.8	13.3	38.4	10.5	18.8
Netherlands	15.2	10.6	39.9	4.9	27.7
Spain	20.8	7.3	35.2	6.0	29.4
United Kingdom	27.5	11.0	17.6	10.7	32.6
United States	40.5	9.0	23.7	10.6	16.2

Source: Organisation for Economic Co-Operation and Development, Revenue Statistics, 1965-1999.

Note: Data include all taxes imposed at both national and subnational levels. Column "Goods and Services Taxes" includes general sales taxes, value added taxes, and specific excise taxes.

³ In Table 4 the category "goods and services taxes" includes specific excise taxes as well as general sales taxes and value added taxes.

B. Summaries of Selected Countries' Tax Systems⁴

Australia

Individual Income Taxation

Australian residents are subject to tax in Australia on their worldwide income. A foreign tax credit is provided. Foreign individuals are generally subject to Australian income tax only on their Australian source income.

Individual income tax rates are progressive and range from 17 percent to 47 percent.

Corporate Income Taxation

Australian resident corporations are subject to tax on their worldwide income. A foreign tax credit is provided. Dividends received by an Australian corporation from a foreign affiliate (10 percent or more ownership) in listed countries (generally comparable-tax countries) are exempt from tax in Australia. Foreign corporations are subject to Australian tax only on their Australian-source income. A corporation is resident in Australia if: (1) it is incorporated under Australian law; or (2) it carries on business in Australia, and either its place of central management and control is Australia, or its voting power is controlled by Australian residents. Under controlled foreign corporation rules, if five or fewer Australian residents own at least 50 percent of a foreign company, then the Australian shareholders are currently taxed on certain tainted income of the company (mainly passive income and income from related-party transactions). Australia also has a foreign investment fund rule that is designed to complement and backstop the controlled foreign corporation regime.

Corporate income is subject to tax at a flat 34 percent rate (scheduled to be reduced to 30 percent this year).

Substantial integration of the individual and corporate income taxes is achieved through an imputation credit mechanism. A dividend paid by an Australian company to a nonresident shareholder is generally subject to a 30 percent withholding tax (that may be reduced by treaty). If the dividend is a "franked" dividend (one on which corporate taxes have already been paid), then no withholding tax applies and no imputation credit is permitted to the nonresident shareholder (dividend exclusion mechanism).

Australia does not currently permit the filing of consolidated returns although informal consolidation is possible. Australia is expected to make consolidated filing available effective July 1, 2002.

⁴ The following materials relate to foreign law and are based on the Joint Committee staff's review of various publicly available secondary sources in mid-2001. The descriptions are intended to serve as general overviews; they may not be fully accurate in all respects, as many details have been omitted and simplifying generalizations made for ease of exposition.

Value-Added Tax

Since July 1, 2000, Australia has imposed a VAT (known as a “goods and services tax,” or “GST”) at a standard rate of 10 percent.

Belgium

Individual Income Taxation

Belgian residents are subject to tax in Belgium on their worldwide income. Foreign-source income of Belgian residents is generally taxed at half the normally applicable Belgian rate, thus permitting significant double taxation of cross-border income, absent treaty relief. Under Belgian treaties, double taxation of Belgian residents is usually relieved via an exemption-with-progression method, under which foreign-source income is exempt from Belgian tax, but other income is taxed at the average rate that would apply to all income if foreign-source income were included. Foreign individuals are generally subject to Belgian income tax only on Belgian-source income.

Individual income tax rates are steeply progressive and range from 0 percent to 55 percent. A 3 percent “crisis contribution” surtax on the income tax liability also applies.

Corporate Income Taxation

Belgian resident companies are subject to tax on their worldwide income. Double taxation is relieved via exemption under most Belgian tax treaties; absent a treaty, Belgian corporate income tax is generally reduced by 75 percent on income earned and taxed abroad. Dividends received by a Belgian company from a foreign affiliate (generally 5 percent or more ownership, or shareholding value of at least a certain minimum amount) are generally 95 percent exempt from Belgian tax. This participation exemption does not apply to dividends from companies subject to substantially more favorable tax regimes than Belgium. Non-Belgian companies are subject to Belgian tax only on Belgian-source income. Residence is generally determined by place of management. Belgium has no controlled foreign corporation rules.

Corporate income is generally subject to a flat 39 percent basic rate, although reduced rates apply to lower income levels under certain circumstances. A 3 percent “crisis contribution” surtax on the income tax liability also applies, effectively raising the general rate to 40.17 percent.

The individual and corporate income taxes are not integrated, but dividends received by individuals are subject to reduced rates.

Belgium does not permit the filing of consolidated returns.

A special favorable tax regime is available for coordination centers, service centers, and distribution centers.

Value-Added Tax

Belgium imposes a VAT at a standard rate of 21 percent.

Canada

Individual Income Taxation

Canadian residents are subject to tax in Canada on their worldwide income. A foreign tax credit is provided, subject to a country-by-country limitation. Foreign individuals are generally subject to Canadian income tax only on their Canadian-source income.

Individual income tax rates are progressive and range from 16 percent to 29 percent. Provincial and territorial taxes also apply.

Corporate Income Taxation

Canadian resident corporations are subject to tax on their worldwide income. A foreign tax credit is provided, subject to a country-by-country limitation. Dividends received by a Canadian corporation from a foreign affiliate (10 percent or more ownership) may be exempt from tax in Canada if received out of the “exempt surplus” of the foreign affiliate. Exempt surplus is generally defined as active business income earned in countries with which Canada has a tax treaty. Foreign corporations are subject to Canadian tax only on their Canadian-source income. A corporation is resident in Canada if it is incorporated under Canadian law or Canada is its place of central management and control. Under controlled foreign corporation rules, if five or fewer (in some instances four or fewer) Canadian residents control a foreign company (known as a “controlled foreign affiliate”), then 10 percent Canadian shareholders are taxable currently on their shares of the controlled foreign affiliate’s tainted (mainly passive) income. Canada also has a foreign investment fund rule that is designed to complement and backstop the controlled foreign corporation regime.

Corporate income is subject to a 38 percent tax rate that is generally reduced to 28 percent for taxable income earned in a province or territory, with a four percent surtax, resulting in an effective tax rate of 29.12 percent. (The 28 percent rate will be reduced to 21 percent over four years beginning in year 2001.) Provincial and territorial taxes also apply.

Substantial integration of the individual and corporate income taxes is achieved through an imputation credit mechanism. A dividend paid by a Canadian company to a nonresident shareholder is generally subject to a 25 percent withholding tax (that may be reduced by treaty).

Canada does not permit the filing of consolidated returns, although informal consolidation is possible.

Value-Added Tax

Canada imposes a VAT (known as a “goods and services tax,” or “GST”) at a standard rate of 7 percent.

China

Individual Income Taxation

Chinese residents are generally subject to tax in China on their worldwide income. Individuals who do not have permanent homes in China and have resided in China for between one and five years are subject to tax in China on Chinese source income and on foreign source income that is paid or remitted to China. A foreign tax credit is provided. Foreign individuals are generally subject to Chinese income tax only on their Chinese source income.

Individual income tax rates are progressive and range from 5 percent to 45 percent. Most investment income is taxed at a flat rate of 20 percent.

Corporate Income Taxation

Corporations are classified into three categories: domestic state-owned enterprises, foreign investment enterprises, and foreign enterprises. A domestic state-owned enterprise is taxed on its worldwide income. A foreign investment enterprise, which includes joint ventures and entities wholly owned by foreign persons, is also taxed on its worldwide income. A foreign enterprise, which includes a foreign corporation, is taxed only on its Chinese source income.

Corporate income is subject to a flat 30 percent tax rate (plus an additional 3 percent local rate). A reduced rate of 15 percent applies to foreign investment enterprises (and some foreign enterprises) with establishments in “special economic zones,” “economic and technological development zones,” or “export processing zones” in China.

A dividend paid from Chinese sources to a nonresident shareholder is generally subject to a 20 percent withholding tax (that may be reduced by treaty).

China generally does not permit the filing of consolidated returns but several exceptions apply.

Value-Added Tax

China imposes a VAT at a standard rate of 17 percent and reduced rates of 6 percent and 13 percent.

France

Individual Income Taxation

French nationals and residents are subject to tax in France on their worldwide income. Foreign taxes are deductible, and are not creditable except by treaty. Foreign individuals are generally subject to French income tax only on French-source income.

Individual income tax rates are steeply progressive and range from 0 percent to 54 percent. Two surtaxes also apply: (1) a flat 8 percent “social tax” on 95 percent of salary, passive income, and capital gains; and (2) a 2 percent surcharge on all passive income and capital gains.

Corporate Income Taxation

France taxes corporations on a territorial basis. Thus, income earned by companies (wherever resident) in the conduct of a trade or business abroad is generally not subject to French corporate income tax. However, under controlled foreign corporation rules, a French resident company may be subject to tax on income earned abroad through a foreign enterprise if such income is subject to an effective tax rate that is less than two thirds of the French rate on similar income, and the French company is unable to prove both that the controlled foreign corporation engages in industrial or commercial activities and that the controlled foreign corporation’s business is carried out mostly in its local market. Corporate residence is determined by place of incorporation.

Corporate income is subject to a flat 33.33 percent basic rate, but two surtaxes raise the effective rate to 36.44 percent.

Partial integration of the individual and corporate income taxes is achieved through an imputation credit mechanism.

France permits the filing of consolidated returns.

Value-Added Tax

France imposes a VAT at a standard rate of 19.6 percent.

Germany

Individual Income Taxation

German domiciliaries are subject to tax in Germany on their worldwide income (citizenship is usually not relevant to German tax law, except under treaties). A foreign tax credit is provided. Foreign individuals are generally subject to German income tax only on German-source income.

Individual income tax rates are progressive and range from 20 percent to 48.5 percent. An additional 5.5 percent “solidarity surcharge” on the income tax liability is imposed to finance the costs of German unification.

Corporate Income Taxation

German resident corporations are taxed on their worldwide income. A foreign tax credit is provided. Dividends received by a German corporation from a foreign affiliate (10 percent or more ownership) are generally 95 percent exempt from German tax. Under controlled foreign corporation rules, a German shareholder of a low-tax controlled foreign corporation is taxed currently when the controlled foreign corporation earns “tainted” (mainly passive) income. A controlled foreign corporation is “low-tax” if it pays tax at a rate of less than 30 percent. A corporation is resident in Germany if it is incorporated under the laws of Germany or its place of management is Germany. Foreign corporations are generally taxed only on German-source income.

Corporate income is subject to a flat 25 percent tax rate. An additional 5.5 percent “solidarity surcharge” on the income tax liability is imposed to finance the costs of German unification. Sub-national income taxes also apply, often at relatively high rates.

Germany formerly provided substantial integration of the individual and corporate income taxes through an imputation credit system, but this system was recently repealed. However, beginning in 2002, partial integration will be achieved via a 50 percent dividends-received deduction for individual shareholders. A similar 50 percent exclusion will apply to gains on the sale of stock.

Germany permits the filing of consolidated returns.

Value-Added Tax

Germany imposes a VAT at a standard rate of 16 percent and a reduced rate of 7 percent.

Ireland

Individual Income Taxation

Irish residents are subject to tax in Ireland on their worldwide income. A foreign tax credit is provided under treaties. Absent treaty relief, foreign taxes are only deductible, not creditable. Foreign individuals are generally subject to Irish income tax only on Irish-source income.

Individual income tax rates are progressive and range from 22 percent to 44 percent.

Corporate Income Taxation

Irish resident corporations are taxed on their worldwide income. A foreign tax credit is provided under treaties. Absent treaty relief, foreign taxes are generally deductible, and not creditable, although companies that derive income from certain computer-related and other activities are eligible for a 90 percent unilateral foreign tax credit. Ireland has no controlled foreign corporation rules. A corporation is resident in Ireland if it is incorporated under the laws of Ireland (unless certain conditions are met) or its place of central management and control is Ireland. Foreign corporations are generally taxed only on Irish-source income.

Corporate “trading income” is generally subject to a flat 20 percent rate, but a reduced rate of 10 percent applies to income from the sale of goods manufactured in Ireland and from certain services performed in Ireland. Under pressure from the European Union, Ireland recently agreed to raise the reduced rate to 12.5 percent beginning in 2002. The reduced 10 percent rate will generally remain available to existing operations through 2010, although the more recently established projects will lose the benefit of the 10 percent rate beginning in 2003.

Until 1999, Ireland had a partial imputation credit system; since mid-1999, Ireland has had an unintegrated corporate income tax system.

Although Ireland does not currently permit the filing of consolidated returns, effective consolidation is available to a limited extent through various “group relief” provisions.

Value-Added Tax

Ireland imposes a VAT at a standard rate of 21 percent and reduced rates of 0 percent, 4.2 percent, and 12.5 percent.

Italy

Individual Income Taxation

Italian residents are subject to tax in Italy on their worldwide income. A foreign tax credit is provided. Foreign individuals are generally subject to Italian income tax only on Italian-source income.

Individual income tax rates are progressive and range from 18.1 percent to 45.1 percent. Regional and municipal income taxes may add roughly one or two percentage points to the national rates.

Corporate Income Taxation

Italian resident corporations are taxed on their worldwide income. A foreign tax credit is provided. Dividends received by an Italian corporation from an EU affiliate (25 percent or more ownership) are generally 95 percent exempt from Italian tax. Dividends received by an Italian corporation from a non-EU affiliate (20 percent or more ownership, 10 percent if subsidiary is a listed company) are generally 60 percent exempt from Italian tax. Historically, Italy has not had controlled foreign corporation rules, but the Italian parliament enacted a controlled foreign corporation regime in November 2000. Under this new regime, the Italian tax authority will develop a “blacklist” of countries employing preferential tax regimes, and income earned by controlled foreign corporations incorporated in blacklisted countries will generally be taxable to controlling Italian shareholders, subject to certain activity-based and other exceptions. Foreign corporations are generally taxed only on Italian-source income.

Corporate income is generally taxed at a rate of 36 percent, but lower rates apply to certain income, pursuant to the “dual income tax” system. Under the dual income tax system, a certain level of return on newly invested capital or reinvested corporate earnings is subject to tax at a preferred rate (generally 19 percent), although this dual income tax preference cannot cause the average rate to fall below 27 percent. Companies in their first 3 years of being publicly traded are generally eligible for a more favorable dual income tax regime (7 percent reduced rate, 20 percent average rate limit). Regional corporate income taxes are imposed at relatively high rates and are computed using an expanded tax base, by denying various common income tax deductions.

The individual and corporate income taxes are integrated, through a full imputation credit mechanism.

Italy does not permit the filing of consolidated returns, but effective consolidation is available to a limited extent through an intra-group tax credit exchange mechanism.

Value-Added Tax

Italy imposes a VAT at a standard rate of 20 percent and reduced rates of 4 percent and 10 percent.

Japan

Individual Income Taxation

Japanese permanent residents are subject to tax in Japan on their worldwide income. Japanese nonpermanent residents (i.e., individuals who do not intend to permanently reside in Japan and have resided in Japan for between one and five years) are subject to tax in Japan on Japanese source income and on foreign source income that is paid or remitted to Japan. A foreign tax credit is provided. Foreign individuals are generally subject to Japanese income tax only on their Japanese source income.

Individual income tax rates are progressive and range from 10 percent to 37 percent. An “individual inhabitant tax” (composed of a municipal and a prefectural tax) also applies. Most dividend and interest income is subject to a 20 percent withholding tax, which is the final tax liability on such income. Capital gains are taxed, and certain types may receive preferential treatment.

Corporate Income Taxation

Japanese resident corporations are subject to tax on their worldwide income. A foreign tax credit is provided. Foreign corporations are subject to Japanese tax only on their Japanese-source income. A corporation is resident in Japan if it is incorporated under Japanese law or has its head office in Japan. Japan has imposed a controlled foreign corporation regime since 1978. It applies to a Japanese domestic corporation that owns five percent or more of a tax-haven subsidiary where Japanese domestic corporations or Japanese residents own 50 percent or more of the subsidiary. A foreign subsidiary is a tax-haven subsidiary if its head office is located in a country with no income tax or if the effective tax rate is 25 percent or less. Japan does not have a foreign investment fund rule.

Corporate income is generally subject to a 30 percent tax rate. Smaller corporations (i.e., corporations with capitalization of roughly \$800,000 or less and taxable income of roughly \$65,000 or less) are subject to tax at a 22 percent rate. Japan also has an inhabitant tax and an enterprise tax, both of which are levied on corporations at the local level.

Corporate and individual income taxes are partially integrated, using both dividend exclusion and imputation credit mechanisms. A dividend paid by a Japanese company to a nonresident shareholder is generally subject to a 20 percent withholding tax (that may be reduced by treaty).

Japan currently does not permit the filing of consolidated returns.

Value-Added Tax

Japan imposes a VAT at a standard rate of 5 percent (4 percent national and 1 percent local).

Mexico

Individual Income Taxation

Mexican residents are subject to tax in Mexico on their worldwide income. A foreign tax credit is provided. Foreign individuals are generally subject to Mexican income tax only on their Mexican source income.

Individual income tax rates are progressive and range from 3 percent to 40 percent. Capital gains are generally taxed, with an exception for gains from the sale of shares on the Mexican Stock Exchange. Certain other types of capital gains may receive preferential treatment.

Corporate Income Taxation

Mexican resident corporations are subject to tax on their worldwide income. A foreign tax credit is provided. Foreign corporations are generally subject to Mexican tax only on their Mexican-source income. A corporation is resident in Mexico if it is incorporated under Mexican law or Mexico is its principal place of management. Mexico has a controlled foreign corporation regime that applies to any Mexican resident with an interest in a foreign entity created or established in a listed tax haven.

Distributed corporate income is subject to a 35 percent tax rate; undistributed income is subject to a 30 percent rate.

Partial integration of the individual and corporate income taxes is achieved through a dividend exclusion mechanism. A dividend paid by a Mexican company to a nonresident shareholder is generally subject to a 5 percent withholding tax (that may be reduced by treaty) that may be grossed up to create an effective tax rate of approximately 7.7 percent.

Mexico permits the filing of consolidated returns.

Value-Added Tax

Mexico imposes a VAT at a standard rate of 15 percent.

Netherlands

Individual Income Taxation

Dutch residents are subject to tax in Netherlands on their worldwide income. A foreign tax credit is provided. Foreign individuals are generally subject to Dutch income tax only on Dutch-source income.

Income is divided into three “boxes”: Box 1 includes income from work and home ownership, which is subject to progressive tax rates ranging from 32.25 percent to 52 percent for individuals under age 65, and from 14.35 percent to 52 percent for individuals aged 65 and over; Box 2 includes income from a “substantial shareholding,” which is subject to a flat 25 percent rate; and Box 3 includes income from savings and investments, which is subject to a flat 30 percent rate. Netherlands formerly also imposed an annual wealth tax (a “net worth tax”) at a 0.7 percent rate beyond a certain threshold amount of wealth, but this tax was abolished at the beginning of 2001.

Corporate Income Taxation

Dutch resident corporations are taxed on their worldwide income. A foreign tax credit is provided. Dividends received by a Dutch corporation from a foreign affiliate (5 percent or more ownership) are generally exempt from Dutch tax. The participation exemption also extends to gains on the sale of shares of the affiliate. Netherlands does not have a controlled foreign corporation regime. It does have anti-avoidance rules that address certain accumulations of passive assets and income offshore, but these rules have a more limited reach than the typical controlled foreign corporation regime. A corporation is resident in Netherlands if it is incorporated under Dutch law or it is effectively managed and controlled from Netherlands. Foreign corporations are generally taxed only on certain categories of Dutch-source income.

Corporate income is generally subject to tax at a 35 percent rate, although a 30 percent rate applies to a relatively small initial threshold amount of income.

Netherlands has an unintegrated corporate income tax system.

Netherlands permits the filing of consolidated returns.

Netherlands is generally viewed as an attractive place in which to establish a holding company, because: (1) it imposes no withholding tax on interest and royalties; (2) it has an extensive tax treaty network; and (3) it provides a favorable participation exemption.

Value-Added Tax

Netherlands imposes a VAT at a standard rate of 19 percent and reduced rates of 0 percent and 6 percent.

Spain

Individual Income Taxation

Spanish residents are subject to income tax in Spain on their worldwide income. A foreign tax credit is provided. Foreign individuals are generally subject to Spanish income tax only on Spanish-source income.

National and sub-national (“autonomous community”) income tax rates are combined to determine an individual’s total tax liability. The maximum combined marginal rate is 48 percent. In addition, Spain levies an annual net worth tax at graduated rates from 0.2 percent to 2.5 percent, subject to modification by the various autonomous communities, within certain limits.

Corporate Income Taxation

Spanish resident corporations are taxed on their worldwide income. Both exemption and credit mechanisms are employed to relieve double taxation in different circumstances. Dividends received by a Spanish corporation from a foreign affiliate (5 percent or more ownership) may be exempt from Spanish tax if various conditions are met. Under controlled foreign corporation rules (first implemented in 1995), Spanish resident companies are taxable currently on passive income of their low-tax foreign subsidiaries. A corporation is resident in Spain if it is incorporated under the laws of Spain or its legal headquarters or effective place of management is in Spain. Foreign corporations are generally taxed only on Spanish-source income.

Corporate income is generally taxed at a rate of 35 percent.

The individual and corporate income taxes are partially integrated through a partial imputation credit mechanism.

Spain permits the filing of consolidated returns.

Value-Added Tax

Spain imposes a VAT at a standard rate of 16 percent and reduced rates of 7 percent and 4 percent.

United Kingdom

Individual Income Taxation

British residents and domiciliaries are subject to tax in the United Kingdom on their worldwide income. A foreign tax credit is provided. Foreign individuals are generally subject to British income tax only on British-source income.

Individual income tax rates are progressive and range from 10 percent to 40 percent.

Corporate Income Taxation

British resident corporations are taxed on their worldwide income. A foreign tax credit is provided. Under controlled foreign corporation rules, British resident companies are taxable currently on the income of low-tax controlled foreign corporations in which they hold at least 25 percent share ownership, unless the controlled foreign corporation carries on certain exempt activities. The controlled foreign corporation rules include an intent-based exception: if the primary purpose of the controlled foreign corporation's activities is not to reduce U.K. tax, and the underlying reason for the corporation's existence is not to divert profits from the United Kingdom, then the controlled foreign corporation rules do not apply. A corporation is resident in the United Kingdom if it is incorporated under U.K. law or its place of central management and control is the United Kingdom. Foreign corporations are generally taxed only on British-source income.

Corporate income is generally taxed at a rate of 30 percent, but lower rates are available to certain small corporations.

The United Kingdom formerly provided significant integration of the individual and corporate income taxes through a partial imputation credit system (the "advance corporation tax," or "ACT"), but this system was eliminated in 1999. Under present law, dividends generally still carry tax credits, but these credits are smaller than those provided under the advance corporation tax, such that they fully offset the individual-level tax on dividends only for individuals in a lower rate bracket. Dividends generally now are taxed in the hands of higher-income individuals.

The United Kingdom does not permit the filing of consolidated returns, but effective consolidation is available through "group relief" provisions.

Value-Added Tax

The United Kingdom imposes a VAT at a standard rate of 17.5 percent and reduced rates of 5 percent and 0 percent.

C. Selected Countries' Tax Treatment of Cross-Border Transactions

Table 5, below, is based on the summaries of selected countries' tax systems set forth in the previous section. Table 5 summarizes those features of the tax systems that are particularly relevant to the taxation of cross-border transactions. In particular, the table indicates whether resident corporations are subject to worldwide or territorial taxation (or whether they are subject to a system that approximates territorial taxation in many respects, by virtue of a "participation exemption" system).⁵ Table 5 also summarizes how the different countries mitigate the double taxation of foreign-source income, whether the countries use "controlled foreign corporation" anti-deferral regimes, and whether the countries tax corporate income under an "integrated" model (in which corporate income generally is taxed only once) or a "classical" model (in which corporate income generally is taxed at both the corporate and shareholder levels). Finally, Table 5 describes certain other characteristics of the country's tax regime relevant to the taxation of international transactions. More detailed descriptions of the features summarized in this table are provided in the summaries set forth in the previous section.

Table 5 – Comparison of Selected Countries' Rules Governing the Taxation of Cross-Border Transactions

Country	Taxation of resident corporations	Relief of cross-border double taxation	Controlled foreign corporation rules?	Integrated or classical (double-tax) corporate tax system	Special characteristics
Australia	Worldwide (but 100% participation exemption for 10% owners)	Foreign tax credit	Yes, with foreign investment fund rules	Partially integrated; imputation credit	Integration relief extends to nonresidents in some cases
Belgium	Worldwide (but 95% participation exemption for 5% owners)	Exemption under treaties; otherwise 75% reduction of tax liability on foreign-source income	No	Classical, but dividends taxed at reduced rates	Favorable regimes for coordination, service, and distribution centers

⁵ See Section III, "Issues in the Taxation of Cross-Border Transactions" of these materials for a discussion of participation exemption systems and other systems based on territorial tax principles.

Country	Taxation of resident corporations	Relief of cross-border double taxation	Controlled foreign corporation rules?	Integrated or classical (double-tax) corporate tax system	Special characteristics
Canada	Worldwide (but 100% participation exemption for 10% owners)	Foreign tax credit	Yes, with foreign investment fund rules	Substantially integrated; imputation credit	
China	Worldwide	Foreign tax credit	No	Classical	Favorable regimes for certain enterprises and zones
France	Territorial (but worldwide for individuals)	Foreign tax credit if controlled foreign corporation rules generate tax on foreign-source income	Yes	Partially integrated; imputation credit	
Germany	Worldwide (but 95% participation exemption for 10% owners)	Foreign tax credit	Yes	Partially integrated; 50% dividends-received deduction	Imputation credit system recently abandoned
Ireland	Worldwide	Foreign tax credit under treaties; otherwise deduction for foreign taxes or unilateral foreign tax credit for special types of income	No	Classical	Favorable rates for business income derived in Ireland; partial imputation credit system abandoned in 1999

Country	Taxation of resident corporations	Relief of cross-border double taxation	Controlled foreign corporation rules?	Integrated or classical (double-tax) corporate tax system	Special characteristics
Italy	Worldwide (but 95% or 60% participation exemption)	Foreign tax credit	Yes	Integrated; imputation credit	Controlled foreign corporation rules first implemented in late 2000
Japan	Worldwide	Foreign tax credit	Yes	Partially integrated; dividend exclusion and imputation credit	
Mexico	Worldwide	Foreign tax credit	Yes	Partially integrated; dividend exclusion	
Netherlands	Worldwide (but 100% participation exemption for 5% owners)	Foreign tax credit	No, but limited anti-deferral rules for passive income	Classical	Favorable jurisdiction for holding companies receiving passive income
Spain	Worldwide (but effective participation exemption)	Exemption or foreign tax credit, depending on circumstances	Yes	Partially integrated; imputation credit	Controlled foreign corporation rules first implemented in 1995
United Kingdom	Worldwide	Foreign tax credit	Yes	Partially integrated; imputation credit	Integration reduced since 1999 repeal of advance corporation tax system

III. ISSUES IN CORPORATE TAX INTEGRATION

A. Introduction to Corporate Tax Integration

Classical income tax systems

The United States has a classical income tax system. In a classical income tax system, corporate earnings are taxed twice: first to the corporation when it earns the income, and second to the shareholders when they receive the income as a dividend (or when they recognize gain on a sale of their shares). Although double taxation of corporate income is the norm in a classical income tax system, in some cases corporate earnings may be taxed only once or not at all. For example, corporate earnings are taxed only at the *corporate* level when a corporation distributes a dividend to a tax-exempt shareholder; corporate earnings are taxed only at the *investor* level when a corporation distributes its earnings in the form of deductible interest payments; and corporate earnings may be entirely free of U.S. tax when a corporation distributes its earnings in the form of deductible interest payments to a tax-exempt shareholder or foreign person.

Integrated income tax systems

A fully integrated income tax system would eliminate the double tax on corporate earnings and would impose a uniform tax on capital income, whether earned through a corporation or not, thus creating a single level of tax on corporate earnings. Many OECD countries have some form of an integrated income tax system, usually resulting in partial integration and thus not completely eliminating the double tax on corporate earnings.

Integration models within the existing U.S. system

The United States has a number of regimes that achieve some form of integration under certain circumstances, and which some may argue can serve as models for broader integration mechanisms.

Subchapter K

Partnerships and limited liability companies are taxed as pass-through entities, resulting in a single level of tax at the partner or member level, with the principal limitation that the entity not be publicly traded (in which case it would generally be treated as a “publicly traded partnership” and taxed as a C corporation). In 1997, taxpayers were provided significant flexibility in electing to treat various business entities as partnerships under the so-called “check-the-box” regulations.

Subchapter S

S corporations are generally taxed as pass-through entities, resulting in a single level of tax at the shareholder level, with the principal limitations being a limit on the number of shareholders, the allowance of only a single class of stock, and a rule that no foreign persons may hold shares.

Subchapter J

Estates and trusts are taxed like pass-through entities in certain cases, leading to a single level of tax.

Subchapter M

Regulated investment companies (RICs), real estate investment trusts (REITs), real estate mortgage investment conduits (REMICs), and financial asset securitization investment trusts (FASITs) are taxed as pass-through entities, subject to a number of requirements specific to each type of entity.

Subchapter T

Cooperatives are effectively taxed as pass-through entities in certain cases by allowing a dividends-paid deduction.

B. Rationale for a Classical Income Tax System

Benefits of incorporation and separate legal status

Corporations are considered appropriate entities to tax on a separate basis because of their separate legal status and the limited liability provided to their shareholders. This rationale has arguably weakened in light of recent changes to the entity classification regulations, which allow certain limited liability companies to achieve pass-through tax treatment. However, since publicly traded companies generally cannot achieve pass-through taxation under these rules, some argue that taxing such companies on a separate basis reflects the benefit of access to the public equity markets.

Capture windfall gains

Large business enterprises may benefit from economic “rents” (returns due to unique attributes and not competition) that are essentially windfall gains. Taxation of these returns will not create economic distortions.

Increase the progressivity of the federal income tax system

The corporate income tax, in conjunction with the individual income tax, is generally thought to promote progressivity in the tax system. However, the degree to which it does has long been debated, since relatively little is known about the extent to which corporations can effectively pass the burden of the corporate tax on to consumers, employees, and others, instead of allowing that burden to rest with shareholders. Moreover, stock ownership has become much more widespread in the United States over the last several years (through tax-favored retirement plans and otherwise), rendering questionable any assumption that a tax borne by shareholders as a group is a progressivity-enhancing tax on wealthy individuals.

Prevent an increase in other taxes

Revenue loss from eliminating the corporate income tax could require other taxes to be increased, and also may create winners and losers.

C. Problems with a Classical Income Tax System

Disincentive for investment in new corporate capital

A classical corporate income tax discourages investors from investing in corporations because of the additional corporate tax burden (higher effective tax rate on corporate equity than on non-corporate equity).

Incentive for corporate financing by debt or retained earnings

Corporations are encouraged to finance their activities through debt or their own retained earnings to avoid the additional corporate tax burden, because interest on debt is deductible, while dividends paid on equity are not deductible.

Incentive to distribute or retain corporate earnings

A classical corporate income tax provides an incentive to distribute or retain earnings depending on the relative tax rates for corporations and shareholders and the capital gains tax rate.

Incentive to distribute corporate earnings in tax-preferred forms

Corporations are encouraged to distribute earnings in forms eligible for capital gains treatment, for example, redemptions of stock that give rise to capital gains, rather than dividends that are taxed as ordinary income (i.e., at non-preferential rates and without basis recovery).

D. Methods of Implementing an Integrated Income Tax System

Shareholder credit for corporate taxes paid

Under a shareholder credit system, when a shareholder receives a taxable dividend, the shareholder is entitled to a credit for the corporate taxes paid with respect to the dividend. The American Law Institute (“ALI”) recommended this approach in a 1993 study,⁶ which set forth four proposals to implement the system: (1) a withholding tax on dividends, with a credit for the corporate income tax paid with respect to the dividend; (2) shareholders would receive a refundable tax credit for the dividend withholding tax; (3) certain corporate tax preferences could be passed through to shareholders; and (4) a withholding tax on corporate interest payments; this tax would be fully creditable by and refundable to the recipients of the interest payments. The

⁶ 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, Jr.) (1993).

Treasury Department (“Treasury”) did not recommend this approach in a 1992 study,⁷ principally because of its complexity; instead Treasury recommended a dividend exclusion method. Most countries that have integrated systems use some form of the shareholder credit method, although in many cases there is a limitation on the amount of the credit, so that only partial integration is achieved.

Corporate deduction for dividends paid

Under a dividends-paid deduction model, a corporation deducts dividends paid to its shareholders, which would generally equalize the treatment of dividends (equity) and interest (debt). However, as a matter of timing, some differential treatment of debt and equity would likely persist, since interest is deductible as it accrues, while dividends are deductible only when paid. Dividends are taxed only at the shareholder rate, which may create a bias toward distributions, particularly if the corporate rate is higher than the individual rate.

Treasury in 1984 recommended a 50 percent dividends-paid deduction, and the President’s tax proposals in 1985 included a ten percent dividends-paid deduction. However, the 1992 Treasury study abandoned this approach, due to a concern that allowing deductible dividends to be paid to tax-exempt and foreign shareholders might completely eliminate the corporate level tax, and a belief that the approach would prove more expensive than a dividend exclusion or imputation credit method of achieving integration.

Shareholder exclusion of dividends received

Under a dividend exclusion model, a shareholder excludes from gross income dividends received from a corporation. The 1992 Treasury study recommended the dividend exclusion model because of the system’s overall simplicity, and because it could be implemented with relatively little structural change.

From 1954 to 1986, individuals were permitted to exclude a limited amount of dividends from gross income (in the early years this was a credit). The Tax Reform Act of 1986 repealed a provision that permitted individuals to exclude up to \$100 (\$200 for married individuals filing jointly) of dividends from domestic corporations.

Other methods of achieving integration

The shareholder credit, dividends-paid deduction, and dividend exclusion models are generally regarded as the most viable alternatives for integration. However, a few other possible approaches also warrant mention.

⁷ Report of the Department of the Treasury, Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once (January 1992).

Pass-through taxation

One alternative would be to treat the corporation as a pass-through or conduit (in a manner similar to the taxation of partnerships or S corporations). This proposal is sometimes referred to as “full integration.” The system would treat retained earnings and distributed earnings equally, thus relieving the incentive to distribute earnings, as may occur under a distribution-based integration system. The 1992 Treasury study discussed a “shareholder allocation” prototype, which is one variation on a pass-through model, but did not recommend it for two reasons: (i) the method raises policy concerns, such as extending tax preferences to shareholders and exempting from U.S. tax foreign-source income; and (ii) the method also raises administrative and compliance problems, such as amending corporate governing documents to provide for income allocations, maintaining capital accounts, and allocation difficulties for shareholders selling stock during the year.

Comprehensive Business Income Tax (“CBIT”)

Under the CBIT, there would be no corporate-level deduction for dividends or interest paid, but both shareholders and debtholders would exclude dividends and interest received, thereby achieving equality in the tax treatment of debt and equity. The 1992 Treasury study proposed the CBIT as a comprehensive, long-term option for equalizing the tax treatment of debt and equity. Treasury recognized that implementing the system would require significant statutory revision and suggested that full implementation would likely be phased in over a period of about ten years. The system would be applicable to all but the smallest businesses, whether conducted in corporate form or not. Treasury predicted that the system would be self-financing and would permit lowering the corporate tax rate from 34% to 31% (which was the maximum individual tax rate in 1992) on a revenue-neutral basis.

Repeal of corporate income tax

Another option would be to repeal the corporate income tax and impose a modified shareholder-level tax. In the case of publicly traded stock, shareholders would be taxed currently on the change in value of their stock under a “mark-to-market” system. Thus, the realization doctrine would be repealed with respect to publicly traded stock. In the case of non-publicly traded stock, shareholders would be taxed currently on the corporation’s income by treating the corporation as a pass-through entity.

E. Additional Issues to Consider in Adopting an Integrated Income Tax System

Untaxed corporate income

Corporate income distributed to shareholders may not have been subject to corporate income tax (for example, a corporation receiving tax-exempt interest on municipal bonds). This poses a challenge for the distribution-based integration models.

Under the shareholder credit method, a shareholder should not receive credit for taxes that have not been paid at the corporate level. The 1993 ALI study would impose an auxiliary withholding tax on dividends to ensure that shareholders do not receive credits for taxes that have not been paid at the corporate level. The ALI study would also treat payments of the

corporate tax as prepayments of the auxiliary withholding tax. Certain dividends could be free of corporate tax as a result of tax preferences that pass through to shareholders.

Under the dividend exclusion method, a shareholder should not exclude a dividend if the dividend is paid out of income that has not been taxed at the corporate level. The 1992 Treasury study recommended that shareholders treat dividends as taxable or non-taxable based on a statement from the corporation as to the amount of the dividend that had incurred corporate tax. Treasury initially rejected the idea of passing through corporate tax preferences to shareholders, primarily because of the large revenue loss. However, a later Treasury release in December 1992 proposed allowing a limited amount of corporate tax preferences to pass through to shareholders.

Equal tax treatment of equity and debt

The different approaches to integration would reduce or eliminate the differential in income tax treatment of equity and debt to varying degrees. The 1993 ALI study proposed achieving equivalent treatment between equity and debt by imposing a withholding tax on interest payments, which would function in the same manner as the credit for dividends. The dividend exclusion method recommended by the 1992 Treasury study would not achieve equivalent treatment between equity and debt, because corporate earnings distributed as a dividend would be taxed at the corporate-level rate, while corporate earnings distributed as deductible interest would be taxed at the investor-level rate. The CBIT system recommended as a long-term option by the 1992 Treasury study would achieve equivalent treatment between equity and debt, because neither dividends nor interest would be deductible by the corporation, nor would either be included in income by the investor. Equalizing the treatment of debt and equity would remove a significant source of complexity and economic inefficiency, and would also reduce the opportunity for tax shelter activity and other difficulties encountered in the taxation of financial transactions.

Double taxation of retained earnings of a corporation

Corporate retention of earnings may lead to double taxation of the same income upon the sale of stock, because the earnings may have been subject to corporate tax, and the corporation's retention of the earnings will increase the value of the stock without an increase to the shareholder's basis in the stock. Thus, when the shareholder sells the stock, the gain may be partially or entirely attributable to earnings that have been subject to tax at the corporate level. This form of double taxation can be eliminated by a constructive dividend and reinvestment mechanism, which would increase the shareholder's basis in the stock. Alternatively, gains from the sale of stock might be excluded from income altogether. The adoption of one of these mechanisms would address the concern that moving to an integrated system might cause investors to prefer dividend-paying stocks to traditionally non-dividend-paying stocks (e.g., high-technology growth stocks).

Tax-exempt shareholders and creditors

Generally, interest received by a tax-exempt debtholder will bear no tax at all, because the interest is deductible by the corporation, while dividends received by an exempt shareholder

will bear a corporate level tax, because the dividend is not deductible. Ideally, an integration system would reduce or eliminate the differential treatment of these two forms of investment by tax-exempt persons. However, neither the 1993 ALI study nor the 1992 Treasury study recommended that corporate income attributable to tax-exempt investors automatically be free of all tax. The ALI recommended that a new tax be imposed on corporate investment income of tax-exempt organizations against which the shareholder and creditor withholding credits could be used (with any excess refundable). Treasury did not propose a new tax on corporate investment income of tax-exempt organizations (but did note that a tax of six to eight percent would approximate the tax burden on investment income received by tax-exempt shareholders). Thus, under the dividend exclusion method recommended by Treasury, differential treatment of debt and equity would continue for tax-exempt investors. Under the CBIT method, equal treatment of debt and equity would be achieved for tax-exempt investors, since neither interest nor dividends would be deductible at the corporate level.

International income

Generally, direct taxes on corporate income are collected by the source country, while taxes on interest and dividend income are collected (mainly) by the investor's residence country. For this reason, integration of the corporate and individual taxes creates an immediate problem in coordinating source-country and residence-country taxation. The 1992 Treasury study would impose tax at the corporate level, while the 1993 ALI study would impose tax at the shareholder level. In either case, existing U.S. law and treaties would have to be reexamined (and renegotiated). Integration of the domestic corporate and individual income taxes can be viewed as incompatible with the norm of double taxation of international corporate income and, as a result, certain international issues arise in an integrated system.

To what extent should the United States tax U.S. corporate income paid to foreign investors and foreign parent companies?

The ALI recommended that a separate new tax be imposed on U.S. investment income of foreign investors and foreign parent companies (replacing the current nonrefundable withholding tax), against which the new dividend and interest withholding tax set forth in the core ALI proposal would be creditable (with any excess refundable). The tax rate could be reduced by treaty. The effects of this mechanism would be to ensure that the United States levies a source-country tax on corporate income paid to foreign investors, to extend integration credits to foreign investors, and to facilitate the mitigation of international double taxation via a residence-country foreign tax credit or a treaty provision. The 1992 Treasury study did not propose a new tax on U.S. investment income of foreign investors and foreign parent companies, and would not extend the benefits of integration to foreign shareholders except as negotiated by treaty.

How should foreign taxes paid by U.S. companies on foreign income affect the U.S. taxation of U.S. shareholders on the distribution of those earnings?

The ALI recommended treating corporate foreign income benefiting from the foreign tax credit as tax-exempt when distributed as a dividend to achieve a result approximate to passing through the foreign tax credits to the shareholders, but without the complexity. This would be provided as part of a tax treaty. Treasury initially recommended no changes in this regard, and would not permit the pass-through of foreign tax credits to shareholders. In a subsequent release in December 1992, Treasury concluded that it would be desirable to permit pass through of some foreign tax credits.

Nondividend distributions

A further question is whether the benefits of integration should extend to nondividend distributions (e.g., redemptions and liquidations), in order to achieve neutrality with dividends. The ALI proposed that nondividend distributions carry shareholder credits to achieve parity with dividends. The 1992 Treasury study would not change existing law as to nondividend distributions, believing that integration would reduce the incentive to make nondividend distributions in the first place.

Transition Rules

There are two general approaches to transitioning to an integrated income tax system. Integration could be made immediately effective, or it could be phased in over time, which is what both the ALI and Treasury recommended. In transitioning to an integrated income tax system, a decision would need to be made as to whether integration would be limited to new equity (as opposed to pre-enactment equity, which the capital markets would have already discounted to account for double taxation).

F. Economic Effects of Integration

Economic efficiency

The 1992 Treasury study determined that integration, by reducing the distortions created by a classical system, would increase the flow of assets into corporations, reduce the use of debt financing by corporations, and create a more uniform (and lower) cost of capital for corporations.

Tax revenue

Most methods of integration involve a projected revenue loss, the amount of which depends on the method of integration and behavioral responses to integration.

Distributional effects

The distributional effects of integration can be analyzed once behavioral responses and revenue gains/losses are estimated.

G. Alternatives to Integration

Cash-flow corporate taxation

One alternative to taxing an individual on personal income is to tax that individual on consumption (or cash flow), which may generally be defined as income minus savings. This idea could likewise be applied to corporations by replacing the corporate income tax with a corporate cash-flow tax. There are three main possible methods of implementing a cash flow corporate tax. One method would be to expense capital expenditures, exclude interest receipts, and disallow interest deductions. A second method would be to include all business receipts in the tax base and deduct all business expenditures (gains and losses from financial assets would be included in the tax base). Finally, a third method would be to tax net distributions to shareholders (business receipts minus business expenditures would equal net distributions to shareholders).

Corporate deduction for return on equity

Another proposal would allow interest payments to be deductible to the extent of a specified interest rate, and allow dividends likewise to be deductible to the extent they are attributable to new equity, up to the same specified rate used for interest deductibility. This proposal was advanced by the ALI in its 1982 and 1989 studies. The proposal would eliminate double taxation of corporate earnings on income earned on corporate assets up to the specified rate of return, but double taxation of corporate earnings would continue on the return to debt and new equity in excess of the specified rate of return, and on the entire return to old equity. A variant of this idea would permit a corporation to deduct annually the product of a specified rate of interest and the amount of its equity capital (and would not rely on an actual payment of dividends). Equity finance in a corporation would be treated similarly to debt finance (except for the cash flow associated with interest payments).

IV. ISSUES IN THE TAXATION OF CROSS-BORDER TRANSACTIONS

A. Introduction: Worldwide vs. Territorial Tax Systems

Worldwide tax system

In a pure worldwide tax system, resident individuals and entities are taxable on their worldwide income, regardless of where the income is derived. Double taxation of foreign income is mitigated through the allowance of a foreign tax credit. However, the credit is generally limited to ensure that the residence country preserves its right to tax income derived within the residence country. Since corporations are separate entities, foreign-source income earned by a resident through a foreign corporation generally is not subject to tax until repatriated. In the United States, several complex anti-deferral regimes apply as exceptions to this general rule and U.S. shareholders are taxed currently on certain mobile or passive income derived through certain foreign corporations.

Territorial tax system

In a pure territorial tax system, the country taxes only income derived within its borders, irrespective of the residence of the taxpayer. Thus, unlike in a worldwide tax system, foreign-source income earned by a resident is exempt from tax. In a pure territorial system, there is no need for a foreign tax credit, because exemption generally eliminates the possibility of double taxation of foreign income. There also is no need for complicated anti-deferral rules, because foreign-source income is exempt from tax in the first place.

Mixed systems

No country uses a pure worldwide or territorial system. Systems may be accurately characterized as predominantly worldwide or territorial, but all systems share at least some features of both worldwide and territorial approaches. (See accompanying materials for summary descriptions of the tax systems of some major U.S. trading partners.)

B. Rationale for a Worldwide Tax System

Economic efficiency

A pure worldwide tax system arguably promotes economic efficiency, in that it does not distort the decision of whether to locate investment at home or abroad. A resident has no tax incentive either to move activities abroad or to keep them within the residence country, since in either case the income generally will be subject to tax at the residence-country rate. Thus, investment-location decisions are governed by business considerations, instead of by tax law. This efficiency norm is referred to as capital export neutrality. Common deviations from the “pure” form of the worldwide tax system, such as the foreign tax credit limitation, reduce this neutrality.

Equity

A worldwide tax system arguably promotes equity in a number of ways.

Horizontal equity

First, a worldwide tax system arguably furthers the policy that taxpayers earning similar levels of income should be subject to tax at similar overall effective rates. Thus, a resident taxpayer earning income abroad should be subject to tax at the same effective rate as a taxpayer earning the same amount of income domestically. Providing a foreign tax credit mitigates the possibility that the taxpayer earning income abroad will be subject to a higher overall effective rate than the taxpayer earning income domestically; subjecting foreign-source income to residence-country tax mitigates the possibility that the taxpayer earning income abroad will be subject to a lower overall effective rate. Thus, a worldwide system provides a framework for treating similarly situated individuals similarly -- a concept known as horizontal equity.

Vertical equity

Second, a worldwide tax system arguably furthers the policy of a progressive income tax that taxes resident taxpayers earning higher levels of income at progressively higher marginal rates, on the theory that their greater ability to pay renders it fair to require them to shoulder a greater proportionate share of the tax burden. If ability to pay is regarded as important, then income earned abroad should be included in the tax base and subjected to progressive rates. Otherwise, the overall progressivity of the tax system may be eroded, as wealthier taxpayers may shift activities and income abroad. Thus, a worldwide system helps to promote the policy that higher income-earners should bear a larger proportionate share of the tax burden -- a concept known as vertical equity.

Citizenship and residency as values

Taxing citizens and residents on their worldwide income arguably also reflects the notion that citizenship and residency bestow important benefits (e.g., legal and technical business infrastructure, military protection, passport and embassy services) that citizens and residents should be made to pay for, regardless of where they might earn their income. The United States is the only industrialized country in the world that taxes its citizens on their worldwide income, even if they reside outside the country.

Preservation of the U.S. tax base

A worldwide tax system arguably preserves the residence-country tax base more effectively than a pure territorial system. If foreign-source income is entirely exempt from taxation, then resident taxpayers will shift investment and income into tax havens, eroding the residence-country tax base. For this reason, even those countries that employ predominantly territorial systems (e.g., France) typically provide for current taxation of certain types of foreign-source income that may easily be earned in tax havens -- a significant departure from "pure" territorial taxation.

C. Rationale for a Territorial Tax System

Economic efficiency

A territorial system arguably promotes economic efficiency better than a worldwide tax system, because a territorial system treats all investment within a particular source country the same, regardless of the residence of the investor. This efficiency norm is referred to as capital import neutrality. Thus, if a residence country adopts a pure territorial system, residents of that country, when investing abroad in a particular source jurisdiction, will not be disadvantaged relative to other investors by virtue of their country of residence. For example, if a source country provides low effective tax rates on manufacturing income, a taxpayer resident in a country with a territorial tax system will fully enjoy the benefits of the lower source-country rate, while a taxpayer resident in a country with a worldwide tax system generally will not. In a world with diverse tax systems and rates, it is impossible to fully achieve both capital import neutrality and capital export neutrality at the same time. Difficult balancing decisions are unavoidable, and there is no consensus as to which of the two goals should take precedence. The weight of academic opinion generally favors capital export neutrality, while the business community generally leans toward capital import neutrality. (It has also been argued that these concepts are inadequate, and too indeterminate to be of any use in formulating policy in the first place, but this is a minority view in the relevant literature.)

Simplicity in compliance and administration

Some argue that territorial tax systems are less complex from an administrative and compliance standpoint than worldwide tax systems. It is certainly true that many complicated features of a worldwide system are not necessary in a *pure* territorial system. For example, the foreign tax credit and anti-deferral regimes, two of the most complex features of a worldwide tax system, are not necessary in a pure territorial system. However, a pure territorial system may not be viable because the country's tax base would be significantly eroded as residents shifted investments and activities abroad to low-tax jurisdictions. Thus, in order to make a territorial system work as a practical matter, various features of a worldwide system probably must be incorporated, which in turn adds back much of the complexity that a pure territorial system would avoid. For example, some type of anti-deferral regime (e.g., for passive income shifted to low-tax jurisdictions) would probably be necessary to protect the tax base, but once adopted, such a regime would add substantial complexity to the system, both in the complexity of the anti-deferral regime itself and in the collateral consequences of having such a regime, such as the need for a foreign tax credit or other mechanism to mitigate double taxation of the "tainted" income. In addition, since source of income would be the fundamental basis for taxation under a territorial system, the rules for sourcing income and expenses (e.g., interest expense), as well as the transfer pricing rules, would bear considerably more weight than they do under a worldwide system, and thus may become more complex to serve their expanded role.

Source vs. residence as basis for taxation

The concept of residence is the fundamental basis of taxation under a worldwide tax system, whereas a pure territorial system, by relying on source, renders the concept of residence generally irrelevant. Several commentators have argued that, as applied to corporations, the

concept of residence is becoming meaningless as a practical matter, since large multinational corporations are becoming “nationless” in the sense that their shareholders, employees, business activities, and income are increasingly spread throughout the world, rather than concentrated predominantly in any one country. Thus, the de-emphasis of residence is arguably one advantage of a territorial system. Of course, in a territorial system that incorporates some attributes of a worldwide system, the concept of residence would become important again, although probably less so than under a predominantly worldwide system.

D. Methods of Implementing a Territorial Tax System

Exempt all foreign-source income

A pure territorial tax system would simply exempt all foreign-source income from residence-country tax.

Exempt only active foreign-source income

A modified territorial tax system might exempt only active foreign-source income, but currently tax passive (or other highly mobile) foreign-source income.

Exempt only high-taxed foreign-source income

Another approach could be to exempt only foreign-source income that is subject to a certain minimum effective foreign tax rate, and to tax foreign-source income that is subject to foreign tax below that rate.

Exempt only certain kinds of foreign-source income

Another approach would be to exempt limited categories of foreign-source income, such as income from e-commerce transactions.

Exempt only income derived from certain countries

Yet another approach might be to exempt only income earned in a country with which the United States has a tax treaty, or simply to extend more favorable treatment to such income if a broader exemption system were adopted (e.g., by not subjecting the exemption to a high-tax test in the case of income derived in a treaty country, if the high-tax variation described above were adopted). Alternatively, a broad exemption system could be adopted, but income derived in tax havens could be excepted from the system (a “blacklist” approach).

Exemption with progression

A further possibility is to employ an exemption system in which the exempt foreign-source income, while not taxed, is nevertheless considered in determining the taxpayer’s position on a progressive marginal rate schedule, thus affecting the rate that applies to the taxpayer’s local-source income. The rationale for this approach would be to preserve as much progressivity as is possible under a territorial tax system.

“Participation exemption” systems

Many countries (including several in Europe) tax resident multinational enterprises on a predominantly territorial basis by exempting dividends received from certain foreign subsidiaries from residence-country tax. The exemption typically applies only where the parent company’s ownership (“participation”) in the subsidiary exceeds a certain threshold (commonly 5-10%), reflecting an intent not to extend territorial principles to portfolio-type investments. The exemption may be total or partial (e.g., only 95%, or 60%, of qualifying dividends might be exempted), and other restrictions generally apply, in order to limit the exemption to certain categories of income (e.g., active income) and to address concerns about shifting income to tax havens. The exemption also may or may not be extended to gains on the sale of a participation interest. A participation exemption system generally provides a significant degree of territoriality with respect to parent companies that receive mainly dividend income from their foreign subsidiaries; much less territoriality is achieved with respect to parent companies that receive large volumes of other types of income (e.g., royalties) from their foreign subsidiaries, and indeed these latter companies may even be better off under present law than under a participation exemption system.

As a mechanical matter, a participation exemption system also may be implemented through a dividends-received deduction. For example, existing dividends-received deduction rules in the United States could be modified to extend to certain dividends received by U.S. corporations from foreign subsidiaries.

Transition issues

A shift from a predominantly worldwide tax system to a predominantly territorial tax system would raise a number of transition issues. For example, it is not clear how the pre-exemption-system deferred income of controlled foreign corporations would be treated. Options would include exempting such income entirely (“fresh start” approach), taxing it upon repatriation (as under present law), or taxing it immediately as a “toll charge” into the new exemption-based system. Pre-exemption-system losses would raise similar issues.

E. Other Issues Raised by a Territorial System

U.S. employment and “runaway plants”

Some would argue that a shift to a territorial system, by exempting income earned overseas, would encourage U.S. companies to move plants (and thus jobs) abroad. Others would respond that, under the present worldwide system that allows deferral of income earned abroad through a foreign corporate entity, these incentives already exist, particularly in the case of favorable source-country tax regimes for various types of manufacturing income. Nevertheless, some may argue that the adoption of a territorial system would not alleviate, and could very well exacerbate, this problem. On the other hand, the adoption of a territorial system also would arguably make the United States a more attractive place in which to incorporate, which may help to create or preserve various “headquarters” jobs, such as research, financial, and corporate and administrative services. This could arguably help to halt or reverse the recent trend toward

“corporate expatriation” from the United States, via cross-border mergers and corporate inversion transactions.

Tax competition

Some argue that if the United States and other major home countries of multinational enterprises were to adopt territorial tax systems, tax competition would intensify. Without the constraint of some residence-based taxation of foreign-source income, a major barrier to tax competition would be removed, and a “race to the bottom” would arguably ensue. Some would argue that a concerted effort, through the OECD or otherwise, would be necessary to ensure an adequate level of tax revenues to finance necessary government operations throughout the world. Others would find the prospect of increased tax competition appealing, and would reject any effort to curtail this.

Tax treaties

The United States has an extensive network of bilateral tax treaties. These treaties are premised on the fact that the United States has a worldwide tax system. A switch to a territorial system would require existing tax treaties to be renegotiated, creating uncertainty in taxation of business investments for a lengthy period of time.

F. Relationship of Territorial-vs.-Worldwide Debate to Trade Dispute Over FSC/ETI

Background and History of the Trade Dispute Over the FSC and ETI Regimes

Like many other countries, the United States has long provided export-related benefits under its tax law. For most of the last two decades, these benefits were provided under the FSC regime. In 2000, the European Union succeeded in having the FSC regime declared a prohibited export subsidy by the WTO. In response to this WTO ruling, the United States repealed the FSC rules and enacted the ETI regime. The European Union immediately challenged the ETI regime in the WTO, and in January of 2002 a WTO Appellate Body held that the ETI regime also constituted a prohibited export subsidy under the relevant trade agreements.

Prior to the enactment of the FSC regime, the United States provided a different system of export-related tax benefits, which applied to certain export-intensive corporations known as “domestic international sales corporations” (“DISCs”). Under this regime, DISCs were incorporated as domestic corporations, but DISC income was exempt from corporate income tax, and the shareholder-level tax on that income was partially deferred. Shortly after the DISC regime’s enactment in 1971, certain signatories to the General Agreement on Tariffs and Trade (“GATT”) challenged the regime as a prohibited export subsidy. In 1976, a GATT panel sustained these challenges, as well as U.S. challenges to certain export tax incentives provided by France, Belgium, and the Netherlands. These rulings proved controversial and remained unadopted by the relevant signatory countries for a number of years.

In 1981, without conceding that the DISC regime violated the GATT, the United States agreed to adopt the general findings of the GATT panel, subject to a 1981 GATT Council Decision (the “1981 Understanding”), which was understood to qualify those findings. The 1981 Understanding had three main components: (1) GATT signatories are not required to tax export

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

A debate subsequently ensued as to whether the DISC regime violated the GATT, as interpreted in light of the 1981 Understanding. The European Communities (“EC”) argued that the DISC regime constituted an illegal export subsidy because it provided tax benefits for export income earned within the United States. The United States defended the regime on the grounds that, as applied to exports, it merely approximated the effect of a territorial tax system of the kind commonly used by European countries, which in turn was considered acceptable under the 1981 Understanding. A majority of GATT Council members sided with the EC and urged the United States to bring the DISC regime into compliance with the GATT. In addition, the EC took steps toward seeking approval for the imposition of trade sanctions against the United States, and other signatories indicated that they would seek compensation from the United States. In late 1982, the United States made a commitment to the GATT Council to develop legislation that would address these concerns, and in early 1983, the President set forth a proposal to replace the DISC regime with a new system that was thought to be GATT-compliant (without conceding that the DISC regime was not GATT-compliant).

In 1984, the Congress enacted legislation along the general lines proposed by the President, creating the FSC regime. Unlike the DISC regime, the FSC regime provided tax benefits for export-related income earned by foreign corporations that were required to have a foreign presence and to perform export-related activities outside the United States. Transfer pricing principles were also set forth for the measurement of FSC income. In light of these features, which caused the FSC regime to emulate more closely certain aspects of an exemption-method territorial tax system, the FSC regime was thought to fall directly within the terms of the 1981 Understanding.

The FSC regime had been in existence for approximately 14 years when the EU brought a case against it in the WTO in mid-1998. In 1999, a WTO panel agreed with the EU that the FSC regime constituted a prohibited export subsidy under the relevant WTO agreements, and in early 2000 a WTO Appellate Body upheld that finding. The rulings held that the FSC rules constituted a subsidy because under those rules the government refrained from collecting revenue that was “otherwise due”; the rulings held that this subsidy was prohibited because it was export-contingent. The EU also expressed additional objections to the FSC regime that were not addressed by the WTO -- specifically, that the FSC transfer pricing rules were not “arm’s length,” and that the FSC regime encouraged the use of tax havens.

In an effort to comply with these rulings (and to address the additional concerns raised by the EU), in 2000 the United States repealed the FSC regime and enacted the ETI regime. Two days after the President signed the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 into law, the EU brought its case against the ETI regime in the WTO. In August of 2001, a

WTO panel held that the ETI regime constituted a prohibited export subsidy under the relevant WTO agreements,⁸ and a WTO Appellate Body later affirmed the panel's holding.⁹

Relevance of WTO rulings to U.S. choice of overall tax framework

Some argue that, given the current state of international trade law as reflected by the WTO decisions on the FSC and ETI regimes, the United States should shift to a territorial-based system (or, for that matter, to a VAT or other consumption-based system), in order to allow U.S. companies to compete on an equal footing with other companies without running afoul of international trade law. However, others argue that the benefits provided by the FSC and ETI regimes, and potentially provided under a territorial system, represent only one consideration among many in evaluating a fundamental shift in the U.S. tax system. In dollar terms, the activities that have benefited from the FSC and ETI regimes represent a relatively small portion of overall U.S. cross-border economic activity. Thus, some argue that it would not be prudent to make a fundamental change to the U.S. tax system on the basis of this narrower set of concerns, and that various incremental proposals may provide an appropriate response (see H. below).

G. Corporate Inversion Transactions

Recent press reports and public filings with the Securities and Exchange Commission indicate that certain U.S. corporations are reincorporating (or planning to do so) as foreign corporations in low-tax jurisdictions such as Bermuda or the Cayman Islands. These transactions are generally referred to as corporate inversions. Inversions can take many forms, including stock inversions, asset inversions, or a combination of the two.

In one stock inversion that has been described publicly, a U.S. corporation forms a Bermuda corporation, which in turn forms a domestic merger subsidiary. The domestic merger subsidiary merges into the U.S. corporation, with the U.S. corporation surviving (as a subsidiary of the Bermuda corporation). As a result of the merger, the U.S. corporation's shareholders receive shares of the Bermuda corporation and are treated as having exchanged their U.S. corporation shares for the Bermuda corporation shares.

An inversion may be accompanied or followed by further restructuring of the corporate group. For example, the U.S. corporation may transfer foreign subsidiaries directly to the new top-tier foreign corporation. By transferring or growing foreign operations directly under the top-tier foreign parent corporation, the group can remove income from its foreign operations from the U.S. taxing jurisdiction. Thus, for example, the subpart F rules applicable to controlled foreign corporations no longer would apply to foreign subsidiaries of the new foreign parent. As

⁸ United States -- Tax Treatment for "Foreign Sales Corporations" -- Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW, Report of the Panel, August 20, 2001.

⁹ United States -- Tax Treatment for "Foreign Sales Corporations" -- Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW, Report of the Panel, as modified by the Appellate Body, January 14, 2002, adopted January 29, 2002 (the "Appellate Body Decision").

a result, the corporate group can obtain the equivalent of a pure territorial tax system (i.e., an exemption for both passive and active foreign-source income).

The corporate group also may engage in various related party transactions to reduce U.S. tax on U.S.-source income. This may include "earnings stripping" through payment by a U.S. corporation of deductible amounts such as interest, royalties, or reinsurance premiums to related foreign entities (including the foreign parent corporation).¹⁰

Inversion transactions may give rise to U.S. tax consequences, both at the shareholder and corporate level, depending on the type of inversion. For example, in stock inversions, the U.S. shareholders may recognize gain (but not loss) under section 367(a), based on the difference between the fair market value of the foreign corporation shares received and the adjusted basis of the U.S. corporation stock exchanged. Further restructuring of the group may also give rise to tax consequences at the corporate level.

The Treasury Department recently announced that it is conducting a study of the issues arising in connection with corporate inversions and the implications of these transactions for the U.S. tax rules. In addition, certain recently introduced bills would curtail the benefits of certain inversion transactions.¹¹

H. Possible Incremental Reforms

Fundamental reform unnecessary?

Some argue that fundamental reform of the U.S. international tax system is unnecessary, and that the competitiveness, complexity, and other concerns raised by U.S.-based multinational enterprises could be adequately addressed within the framework of the present system through a number of incremental reforms. Indeed, some regard such incremental changes as constituting an appropriate and adequate response to recent developments regarding the FSC and ETI regimes. Various incremental changes have been proposed in recent years, mostly affecting two key areas of the U.S. international tax system: the foreign tax credit and the anti-deferral regimes. The major proposals are described below.

Incremental reform proposals relating to the foreign tax credit

Background

Since the United States taxes its citizens and residents on their worldwide income, and the countries in which such income is earned generally also tax the same income on the basis of source, cross-border income earned by U.S. persons may be subject to double taxation. In order

¹⁰ In the case of debt, section 163(j) addresses the use of earnings stripping for interest paid by a U.S. corporation (with a debt-equity ratio of in excess of 1.5 to 1) to a foreign related party, by capping the amount of deductible interest in a year to no more than 50 percent of an adjusted taxable income amount.

¹¹ See H.R. 3857, H.R. 3884, and S. 2050.

to mitigate this possibility, the United States provides a credit against U.S. tax liability for foreign income taxes paid, subject to a number of limitations. Most incremental reform proposals in this area relate to these limitations.

Allocation of interest expense using “worldwide fungibility” approach

The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer’s foreign-source income, in order to ensure that the credit serves its purpose of mitigating double taxation of cross-border income without offsetting the U.S. tax on U.S.-source income. In light of this limitation, a taxpayer must allocate gross income and expenses between U.S. and foreign sources in order to determine the amount of foreign tax credits allowable. Under present law, interest expense that a U.S.-based multinational enterprise incurs in the United States is allocated to U.S. and foreign sources based on the gross assets located in the United States and abroad. Thus, a U.S.-based multinational with a significant portion of its assets overseas must allocate a significant portion of its interest expense to foreign-source income, which reduces the foreign tax credit allowable (even though the interest expense incurred in the United States is not deductible in computing the actual tax liability under the relevant foreign law). Many companies complain that this approach unduly limits their ability to claim foreign tax credits and leaves them exposed to double taxation of their foreign-source income. The proposal would allocate interest expense using an elective “worldwide fungibility” approach, under which interest expense incurred in the United States would be allocated against foreign-source income only if the debt-to-asset ratio was higher for U.S. than for foreign investments.

Reduction of the number of foreign tax credit limitation categories (or “baskets”)

Present law applies the foreign tax credit limitation separately to different types of foreign-source income, in order to reduce the extent to which excess foreign taxes paid in a high-tax foreign jurisdiction can be “cross-credited” against the residual U.S. tax on low-taxed foreign-source income. For example, if a taxpayer pays foreign tax at an effective rate of 45 percent on certain active income earned in a high-tax jurisdiction, and pays little or no foreign tax on certain passive income earned in a low-tax jurisdiction, the untaxed (or low-taxed) passive income could expand the taxpayer’s ability to claim a credit for the otherwise uncreditable excess foreign taxes paid to the high-tax jurisdiction. This sort of cross-crediting is constrained by rules that require the computation of the foreign tax credit limitation on a category-by-category basis. Thus, in the example above, the rules would place the passive income and the active income into separate limitation categories (or “baskets”), and the low-taxed passive income would not be allowed to increase the foreign tax credit limitation applicable to the credits arising from the high-taxed active income. Present law provides nine separate baskets as a general matter, and effectively many more in situations in which various special rules apply. Many companies complain that the large number of different baskets creates unnecessary complexity and distorts business decisionmaking. The proposal would reduce the number of baskets to three or even two. This proposal would likely reduce complexity and compliance costs, but at a risk of allowing more cross-crediting than may be considered appropriate.

Incremental reform proposals relating to the subpart F anti-deferral rules

Background

Generally, income earned indirectly by a U.S. person through a foreign corporation is subject to U.S. tax only when the income is distributed to the U.S. person. This deferral of U.S. tax is limited by a number of anti-deferral regimes (e.g., “subpart F”) that impose current U.S. tax on certain types of income earned by certain corporations. Drawing the line between “good” income (active business income) and “tainted” income (passive or highly mobile income) has proven contentious and has also engendered considerable complexity.

Exclusion of all active income from the scope of subpart F

Present law places the income from many sales, services, shipping, and certain other activities conducted abroad on the “tainted” side of the line (because such activities are thought to be highly mobile and thus prone to tax-motivated manipulation), thus subjecting the income from such activities to current U.S. tax. Many U.S.-based multinationals complain that these rules penalize the use of common, non-tax-motivated business structures (e.g., centralizing sales and services functions for a number of different foreign markets within a single foreign entity), thus placing U.S.-headquartered businesses at a competitive disadvantage in the normal conduct of their active business activities around the world. They argue that the scope of subpart F should be limited to passive income (e.g., dividends and interest) earned abroad, and that other rules (e.g., the arm’s length transfer pricing rules of section 482) are sufficient to address any abuses involving the manipulation of active income streams. The proposal would eliminate certain subpart F active-income categories (the foreign base company sales, services, shipping, and oil-related income categories). This proposal arguably could exacerbate problems that may arise in taxing income from electronic-commerce transactions.

Permanent “active financing” exception

Passive income (e.g., interest) generally falls on the “tainted” side of the subpart F line, since such income can easily be shifted into low-tax jurisdictions. In the case of banking, financing, insurance, and similar businesses, however, this taint is arguably inappropriate, since these businesses earn this type of income in the active conduct of their core business activities. Subjecting this income to subpart F would arguably cause U.S.-based financial services companies to be treated more harshly than both U.S.-based manufacturing companies and foreign-based financial services companies. Accordingly, since 1997 a temporary exception from subpart F for “active financing income” has been provided. The exception under present law is set to expire after 2006. U.S.-based financial services companies argue that the temporary nature of the exception makes it difficult for them to engage in long-range business planning. The proposal would make the exception permanent.

Expansion of the “de minimis” exception

To avoid subjecting taxpayers to the complex rules of subpart F when a controlled foreign corporation earns incidental amounts of “tainted” income, subpart F provides a “de minimis” exception. Under this exception, a controlled foreign corporation’s income is not treated as tainted as long as the tainted income constitutes less than the lesser of \$1 million or 5%

of the corporation's gross income. For example, a controlled foreign corporation that conducts an active business but also earns a trivial amount of interest on its working capital generally does not need to contend with subpart F, as long as the amount of the interest falls short of the de minimis threshold. U.S.-based multinational enterprises argue that this threshold is set too low to provide them any meaningful relief. For example, a controlled foreign corporation that earns only \$1 million of interest income on its working capital is ineligible for the exception, even though \$1 million may indeed represent an incidental amount in the context of a large foreign subsidiary of a U.S.-based multinational. The proposal would raise the dollar limit (or even eliminate it), and the percentage limit.

V. ISSUES IN CONSUMPTION TAXATION

A. Introduction to Broad-Based Consumption Tax Systems

In general

The term “consumption tax” is a generic description for systems that tax some form of “dissaving” (i.e., purchases and withdrawals from savings or investments) rather than taxing income. By contrast, a corporate income tax is imposed and collected on the taxable income (generally, gross income minus deductions) of a corporation.

There are numerous forms that a broad-based consumption tax can take, including a retail sales tax, business transfer tax (or subtraction method value-added tax), or credit-invoice method value-added tax. A characteristic that is common to all broad-based consumption taxes is the current deduction of all investment, including capital expenditures that would otherwise only be depreciable or amortizable under an income tax. It is widely believed that the economic burden of a consumption tax is borne by the ultimate consumer of taxed goods.

Retail sales tax

A retail sales tax is a tax imposed and collected on the retail sales (i.e., sales to end-use consumers) of taxable goods or services. A retail sales tax is the most conspicuous and transparent form of consumption tax.

Business transfer tax (or subtraction method VAT)

Generally, a value-added tax (“VAT”) is a tax that is imposed and collected on the “value added” at every stage in the production and distribution process of a good or service. The VAT base is generally defined as the amount of value added, which is the difference between the value of sales (outputs) and purchases (inputs) of an enterprise. A broad-based VAT generally achieves the same economic results as a retail sales tax, although a VAT is collected at many stages of production rather than only at the time of final sale to an end-use consumer.

A business transfer tax (or subtraction-method VAT) is a form of a VAT in which a statutory tax rate is applied to newly added value, as measured by the difference between an enterprise’s taxable sales and its purchases of taxable goods and services from other enterprises.

Credit-invoice method VAT

The most common type of VAT is the credit-invoice method VAT, under which the statutory tax rate is applied to gross sales (rather than only to newly added value), and credits for previously paid taxes on gross purchases are allowed.

B. Arguments For a Broad-Based Consumption Tax

Effect on private savings

By reducing the disincentives to save that can result from an income tax, a broad-based consumption tax would benefit U.S. international trade through increased saving and reduced cost of capital to domestic businesses. Lower cost of capital can improve the productivity and price competitiveness of U.S. goods and services in foreign markets, reduce the demand for imported goods (relative to U.S. goods), and help redress the persistent imbalance of imports and exports.

Effect on international competitiveness

Proponents of a broad-based consumption tax maintain that, if U.S. sales by both foreign- and U.S.-owned firms were subject to the same broad-based consumption tax instead of a corporate income tax, the competitiveness of U.S. firms would be enhanced relative to imports from foreign firms or foreign-owned U.S. firms because all U.S. sales would bear the same U.S. tax liability without regard to the location of the firm. In addition, some argue that a border adjustable VAT that would exempt exports from such a tax would better enable U.S. manufactured goods to compete in foreign markets.

Simplification

Switching from a system of worldwide income taxation with foreign tax credits to a broad-based consumption tax could simplify tax compliance and international tax planning because the consumption tax base typically is territorial rather than worldwide.

Suitability for electronic commerce

A broad-based consumption tax generally may be more suitable than an income tax for the taxation of electronic commerce, although difficult issues are presented by the consumption taxation of cross-border services provided through electronic commerce. A consumption tax could reduce the potential for double-taxation or non-taxation of cross-border electronic commerce transactions that involve other countries with a consumption tax.

C. Arguments Against a Broad-Based Consumption Tax

Incidence of tax

Many argue that the purportedly positive effects of a broad-based consumption tax on the competitiveness of U.S. firms generally reflect only the *statutory* incidence (i.e., the legal burden) of a corporate income tax relative to a consumption tax. Thus, any competitive advantage that is derived from replacing a corporate income tax with a broad-based consumption

tax would be diminished if (as is generally conceded) the *economic* incidence (i.e., the financial burden) of a broad-based consumption tax differs from its statutory incidence.¹²

Balance of trade

Although it is commonly believed that a broad-based consumption tax may improve the U.S. international trading position, economists have determined that broad-based consumption taxes do not directly affect the overall volume of exports or imports.

In addition, even if the imposition of a broad-based consumption tax creates a short-term competitive advantage in cross-border trade, most economists believe that offsetting adjustments in exchange rates are likely to restore the pre-existing equilibrium to international markets in the long run and eliminate any immediate price advantage that a consumption tax might provide in the short run.

Administrative concerns

Because a consumption tax presents unique compliance issues, the necessary enforcement regime under a consumption tax is much different from the enforcement regime under an income tax. The taxation of imported property and services under a broad-based consumption tax raises additional administrative concerns.

Taxation of services

Cross-border services present difficulties under a broad-based consumption tax because services may be performed in whole or in part in one jurisdiction but may be used or provide benefits in another jurisdiction.

Taxation of financial services

Financial services can raise special implementation and administration issues under a broad-based consumption tax. The taxation of financial services under a VAT has proven to be particularly problematic because of the difficulty in determining the value-added component of financial services, and because the financial inputs purchased by financial services (i.e., deposits) are often obtained from clients who are outside of the VAT system. Taxing financial services under a retail sales tax raises similar concerns.

¹² As discussed 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 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.

D. Methods of Implementing a Broad-Based Consumption Tax on Businesses

National retail sales tax

A retail sales tax is a tax imposed on the retail sales price of taxable goods and services. A retail sales tax is collected only by entities that sell directly to end-use consumers of the taxed goods or services, while purchases by other businesses are exempt.

The primary distinction between a retail sales tax and a business transfer tax or credit-invoice method VAT involves the statutory incidence of tax (i.e., who actually collects and remits the tax). A retail sales tax has approximately the same economic burden as a credit-invoice method VAT and, as an economic matter, the tax base for a retail sales tax generally is identical to that used for a business transfer tax or subtraction method VAT.

A retail sales tax may vary from other broad-based consumption taxes in terms of administrability, compliance burden, and ease of implementation. A retail sales tax may be attractive because the transition and overall compliance costs of the tax could be small compared to those of other broad-based consumption taxes, although ongoing enforcement of a retail sales tax (especially at high tax rates) may be relatively greater because of the lack of cross-validation. Unlike a business transfer tax or credit-invoice method VAT, a retail sales tax compresses the tax collection responsibilities into a single stage in the production and distribution chain, potentially resulting in greater noncompliance when businesses at just one stage (i.e., retail businesses) in the entire production and distribution process fail to remit the taxes owed. Taxable retail sales that are erroneously treated as nontaxable sales to business has been a particular source of noncompliance for State and local governments with retail sales taxes, especially with regard to small business owners who make purchases for both business and personal use. It is widely believed that a high retail sales tax rate would exacerbate these compliance problems.

Most States and many local governments impose general retail sales taxes within their jurisdictions. Even though retail sales tax bases vary among States, the experience of State and local governments with a retail sales tax may facilitate the implementation of a national retail sales tax, although most advocates of a national retail sales tax envision a tax base that is significantly broader than the sales tax imposed by any State.

Business transfer tax (or subtraction method VAT)

A business transfer tax provides for a rate of tax that is applied to the difference between an enterprise's taxable sales and its purchases of taxable goods and services from other enterprises. The statutory tax rate is applied to a net amount of value added (taxable sales less purchases of taxable goods and services) rather than to gross sales with credits for taxes previously paid on gross purchases (as under the credit-invoice method VAT, discussed below). In other words, the business transfer tax is based upon deductions, while the credit-invoice VAT method is a credit-based system.

A business transfer tax generally imposes lower compliance costs on a business than a credit-invoice method VAT because it requires records that usually are already maintained by the business. However, the business transfer tax also potentially entails lower levels of compliance.

Compared to a credit-invoice method VAT, a business transfer tax is less similar in appearance to a retail sales tax (assuming that the tax is not separately stated at the retail level) and more similar to a corporate income tax, with the major difference between a business transfer tax and a corporate income tax being the current deduction of what otherwise would constitute depreciable or amortizable capital expenditures under a corporate income tax.

Credit-invoice method VAT

The credit-invoice method VAT is utilized in nearly all industrialized countries with a VAT. A credit-invoice method VAT provides a tax credit to purchasers (except ultimate end-use consumers) for all VAT previously paid by the seller on all purchases of taxable goods and services used in the seller's business.

A fundamental VAT principle is that the cumulative amount of tax paid with respect to a good or service at all levels of production and distribution should equal the sales price of the good or service to the ultimate consumer multiplied by the statutory VAT rate. By providing a business credit for inputs, the credit-invoice method VAT generally fulfills this principle and prevents the imposition of multiple layers (or “cascading”) of tax with respect to the total final purchase price, so that the net tax paid at a particular stage of production or distribution is based only on the value added by that taxpayer at that stage of production or distribution.

Adopting a credit-invoice method VAT would impose new compliance costs on businesses, which would likely intensify with multiple tax rates and statutory exemptions. However, the record keeping requirements would improve compliance through cross-validation of taxes paid by sellers with credits claimed by buyers, similar to information return matching performed by the IRS under present law. A credit-invoice method VAT is regarded as more suitable than a business transfer tax for accommodating targeted tax relief, but this suitability also leaves the credit-invoice method VAT more susceptible to complexity and economic inefficiency.

E. Additional Considerations in Implementing a Broad-Based Consumption Tax

Exclusions from the consumption tax base

Many broad-based consumption tax regimes provide special treatment for imported and exported goods and services and provide exclusions for various goods and services, certain classes of taxpayers (for economic, social, or political reasons), and goods and services that are difficult to measure either in terms of the amount of the value added or the element of consumption (such as financial services).

Exclusions from the consumption tax base may be implemented through “zero rating” or statutory exemption, with potentially significant different consequences. A zero-rated sale is considered to be taxable, but the statutory rate of tax is zero percent. Accordingly, sellers of zero-rated goods or services need not collect or remit any tax on their sales of such items, but nevertheless may claim credits for the tax they paid with respect to purchased goods and services. By contrast, an exempt sale is not considered to be taxable. Although the seller of exempt goods or services also is not required to collect or remit any tax on such sales, the seller

may not claim any refunds of, or (in the case of a credit-invoice method VAT) credits for, the tax that may have been paid on related purchases.

In a credit-invoice method VAT, a statutory exemption 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., the total tax collected from all stages of production is greater than the retail sales price multiplied by the VAT rate). By contrast, statutory exemptions may be implemented under a business transfer tax without the occurrence of cascading.

Destination-principle taxation and origin-principle taxation

Broad-based consumption taxes can differ depending on whether they are imposed under a destination principle or an origin principle.

Destination principle

Under the destination principle, imports are taxed (either by taxing them directly or by making their purchase nondeductible to the importer), and exports are exempt from tax through border tax adjustments (i.e., rebates on previously paid taxes), on the premise that goods and services should be taxed where they are consumed. Thus, the tax base consists of expenditures on domestic consumption of goods and services. A national retail sales tax is an example of a destination-principle consumption tax. The credit-invoice method VATs imposed in Europe and elsewhere generally are also destination-principle taxes.

Origin principle

Under the origin principle, domestic production of goods and services is taxed (including those for export), and imported goods and services are exempt from tax, on the premise that goods and services should be taxed where they are produced. Thus, the tax base consists of domestic consumption plus net exports.

Comparison of destination-principle consumption taxes with origin-principle consumption taxes

In the short term, destination-principle consumption taxes are thought to be economically superior to origin-principle consumption taxes because of greater neutrality with regard to international trade (i.e., less distortion of consumer’s choices between domestic and imported goods in both domestic and overseas markets).

Although the tax base of a destination-principle consumption tax clearly differs from that of an origin-principle consumption tax (particularly with regard to transition issues and the treatment of above-normal returns on investment), the two variations generally are thought to be economically equivalent in the long run (assuming equivalent tax rates) because other self-executing market adjustments, 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.

Taxation of sales of goods and services and financing transactions

There are two primary alternative business consumption tax bases. One consumption tax base consists of sales of goods and services. The tax base of most business transfer taxes, credit-invoice method VATs, and retail sales taxes is limited to the cash flow from such transactions. This feature distinguishes typical consumption taxes from a pure income-based business tax. Alternatively, the consumption tax base may consist of both sales of goods and services and financing transactions (except for transactions with the equity holders of a business).

Although the treatment of interest is economically equivalent under either variation of the consumption tax base, the distinction between a consumption tax that is based only upon sales of goods and services and a consumption tax that is based upon both sales of goods and services and financing transactions may be important in the international context, because interest expense is not deductible under the tax base that only includes sales of goods and services but is deductible under the tax base that includes both sales of goods and services and financing transactions. This difference may affect borrowing transactions by multinational firms.

Because the entire cost of capital expenditures and inventory purchases is currently deductible at the time of purchase (rather than over the life of the asset or using an inventory method of accounting) under a consumption tax, capital income is untaxed at the margin without regard to whether the tax base includes only sales of goods and services or includes both sales of goods and services and financing transactions, and without regard to whether the income arises from capital invested domestically or abroad (although a foreign country may continue to impose tax on the marginal investments of U.S. persons in that country).

Taxation of financial services

Financial services raise special implementation and administration issues under a consumption tax. These issues include: how to measure the value of financial services; allocating the value of financial services among various clients; distinguishing financial institutions from other businesses; the treatment of imports and exports; and transition issues. These issues dictate the extent to which financial services should be included in the tax base of a consumption tax.

It is often argued that certain types of financial services should not be subject to consumption tax because taxing such services would be equivalent to taxing savings. Another reason for excluding financial services from the base of a consumption tax is that the charge for financial services typically is blended with other elements of the transaction and, thus, the value of most financial services is not easily determined. The difficulties in ascertaining the value of financial services has led most countries that impose a consumption tax to totally or partially exempt financial services.

Others argue that economic efficiency and equity dictate the inclusion of financial services in the tax base of any broad-based consumption tax at the same statutory tax rate that generally applies to other goods and services. Additionally, exempting financial services from the tax base raises additional issues and may be disadvantageous to nonexempt businesses that purchase financial services. Under the consumption tax systems of many countries, exempting

financial services means that financial institutions are not considered taxpayers. Consequently, financial transactions with nonexempt business customers generally result in cascading of tax.

F. Tax Restructuring and International Investment Decisions

Major destination-principle consumption tax features affecting international business

Three main features of a destination-principle consumption tax are particularly important in connection with cross-border transactions: the exclusion of exports from the tax base; the taxation of imports; and the exemption of foreign subsidiaries and branches of U.S. businesses from U.S. tax.

Location of investment and economic efficiency

The highest and best use of investment funds may not always coincide with locating investment in the United States, and adopting a broad-based consumption tax to encourage investment in the United States at the expense of investment elsewhere may not necessarily promote global economic efficiency. However, increased investment in the United States should increase the future income of United States residents and citizens.

Because anti-deferral rules would be eliminated under a broad-based consumption tax, the timing of income repatriation by foreign subsidiaries of U.S. businesses would no longer be relevant because repatriation would not be a taxable event. For U.S. businesses operating abroad and foreign businesses operating in the United States, transfer pricing would no longer be an issue under a consumption tax with border tax adjustments.

Consequently, under a destination-principle consumption tax, the net tax burden of locating in a particular jurisdiction would primarily depend on the tax rate in that jurisdiction relative to other jurisdictions.

Location of investment in tangible assets

Location of investment in tangible assets by U.S. persons

Broad-based consumption tax systems in foreign countries may encourage investment in such countries by U.S. persons because the choice of investment location (all other factors being equal) depends upon the after-tax return offered to the investor by alternative locations, and capital income is untaxed at the margin under a business consumption tax. A destination-principle consumption tax is neutral regarding the location of investment. Therefore, U.S. persons may have an incentive to invest abroad in low-tax foreign jurisdictions because investments are subject to lower effective tax rates when located abroad.

A consumption tax would eliminate taxes on returns from investments at the margin. Therefore, adopting a consumption tax would likely make the United States a relatively more attractive location for investment by U.S. persons, which should reduce foreign investment and increase domestic investment by U.S. businesses. Adoption of a consumption tax (which would not provide 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 on new investment under a broad-based consumption tax increases total investment by U.S. businesses, investment abroad would be expected to continue to increase, but less rapidly than domestic investment.

Location of investment in tangible assets by foreign persons

If the home country does not tax foreign-source income, increased foreign investment in the United States would be expected to result, because adoption of a broad-based consumption tax effectively would lower taxes on new investment by foreign persons in the United States. 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 broad-based consumption tax would be expected to have no effect on foreign investment in the United States. If the home country taxes foreign-source income and provides a credit for foreign income taxes paid that permits only deferral of home-country tax on foreign-source income, adoption of a broad-based consumption tax may only modestly increase foreign investment in the United States.

Location of investment in intangible assets and research and development

By permitting the current deduction of expenditures on capital goods at the time of purchase, a broad-based consumption tax may shift business investment toward tangible assets and away from investment in intangible assets or research and development because a consumption tax provides no preferential tax treatment of expenditures to create intangibles and expenditures for research and development.

Similarly, by eliminating the relative U.S. tax preference for outbound royalty payments by certain U.S. persons, a broad-based consumption tax generally would be expected to induce increased location of intangible assets in the United States relative to locations abroad.

Because expenses incurred in the United States would be fully deductible (including research and development expenditures), a broad-based consumption tax may increase research and development activity in the United States.

G. Transition Issues

For several reasons, transition is the threshold issue in replacing an income tax with a broad-based consumption tax. Transitioning to a consumption tax likely would require substantial educational resources as both taxpayers and administrators become familiar with statutory rules and fundamental consumption tax principles. Adopting a consumption tax also likely would shift the relative tax burdens of businesses with different profiles or in different sectors of the economy, which raises certain political issues involving the perceived “winners” and “losers” under a broad-based consumption tax. In addition, any transition to a consumption tax would need to address the disposition of certain pre-existing tax attributes maintained by businesses under an income tax, such as scheduled depreciation and amortization deductions that have not yet been claimed, costs that have not yet been deducted under inventory accounting, and carryovers of net operating losses and tax credits. Similarly, adjustments would be needed in converting businesses from accrual-based accounting to cash-based accounting.

At least in the short run, addressing these transition issues could require the investment of significant fiscal resources and diminish the expected efficiency gains that would otherwise result from adopting a broad-based consumption tax.

VI. BACKGROUND AND DATA RELATING TO INTERNATIONAL TRADE AND INVESTMENT

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 financial account¹³ (U.S. investment abroad and foreign investment in the United States).

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 among 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.¹⁴

¹³ Prior to 1999, the U.S. Department of Commerce, Bureau of Economic Analysis reported and described international transactions by reference to the “current account” and the “capital account.” Beginning in June 1999 the Bureau of Economic Analysis adopted a three-group classification to make U.S. data reporting more closely aligned with international guidelines. The three groups are labeled: current account; capital account; and financial account. Under this regrouping, the “financial account” encompasses all transactions that used to fall into the old “capital account,” that is, the financial account measures U.S. investment abroad and foreign investment in the United States. Under the new system, the “current account” is redefined by removing a small part of the old measure of unilateral transfers and including it in the newly defined “capital account.” The newly defined capital account consists of capital transfers and the acquisition and disposal of non-produced, non-financial assets. For example, the newly defined capital account includes such transactions as forgiveness of foreign debt, migrants’ transfers of goods and financial assets when entering or leaving the country, transfers of title to fixed assets, and the acquisition and disposal of non-produced assets such as natural resource rights, patents, copyrights, and leases. In practice, the Bureau of Economic Analysis believes that newly defined “capital account” transactions will be small in comparison to the current account and financial account.

¹⁴ 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

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 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

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,

$$(1) \text{ GNP} = C + I + G + (X-M) + \text{NI}.$$

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,

$$(2) \text{ GNP} = C + S + T.$$

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:

$$(3) I = S + (T - G) + (M - X) - \text{NI}$$

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

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):

$$\begin{aligned}\text{Net Foreign Borrowing} &= \text{Investment} - \text{Saving} \\ &= (\text{Imports} - \text{Exports}) - \text{Net Investment Income}\end{aligned}$$

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.¹⁵ 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.

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

¹⁵ This equation in the text can be seen from equation (3) in footnote 14 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.

invest in these profitable projects.¹⁶ If the economy currently does not have enough domestic savings 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 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

¹⁶ 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.

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.

The balance of payments accounts, presented in Table 6, are analogous to a sources and uses of funds statement of the United States with the rest of the world. As demonstrated above, the current account balance, which consists primarily of the trade balance, should be exactly offset by the capital account and financial account balances, which measure 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 and financial accounts deficit or surplus is recorded as a statistical discrepancy. Problems of measurement, which have been large in some years, cause the accounts to be somewhat mismatched in practice, but basic patterns are unlikely to be significantly distorted by these problems. The subsequent sections examine trends in the current account and financial account in more detail.

**Table 6 – International Transactions of the United States, Selected Years,
1975-2000
(\$ Billions nominal)**

	<u>1975</u>	<u>1985</u>	<u>1995</u>	<u>2000</u>
Current Account Balance	18.1	-118.2	-109.9	-444.7
Exports of Goods and Services	<u>157.9</u>	<u>387.6</u>	1,005.9	1,418.6
Merchandise	107.1	215.9	575.2	772.2
Services	25.5	73.2	219.2	293.5
Receipts from U.S. assets abroad	25.4	98.5	211.5	352.9
Imports of Goods and Services	<u>132.7</u>	<u>483.8</u>	<u>1,081.8</u>	<u>1,809.1</u>
Merchandise	98.2	338.1	749.4	1,224.4
Services	22.0	72.9	141.4	217.0
Payments on foreign-owned U.S. assets	12.6	72.8	191.0	367.7
Unilateral Transfers	7.1	22.0	34.1	54.1
Financial Account Balance	-22.5	101.3	113.3	443.2
Foreign Investment in the United States	<u>17.2</u>	<u>146.1</u>	<u>465.7</u>	<u>1,024.2</u>
Direct Investment	2.6	19.7	57.8	287.7
Private non-direct investment	7.5	127.5	298.0	700.2
Official	7.0	-1.1	109.9	37.6
U.S. Investment Abroad	<u>39.7</u>	<u>44.8</u>	<u>352.4</u>	<u>581.0</u>
Direct Investment	14.2	18.9	98.8	152.4
Private non-direct investment	21.1	19.1	242.9	427.3
Increase in government assets	4.3	6.7	10.7	1.2
Capital Account Transactions, net	n.a.	0.3	0.4	0.7
Statistical Discrepancy	4.4	16.5	3.8	0.7

Source: Douglas B. Weinberg, "U.S. International Transactions, First Quarter 2001," Survey of Current Business, 81, July 2001, pp. 37-81.

n.a. - not applicable

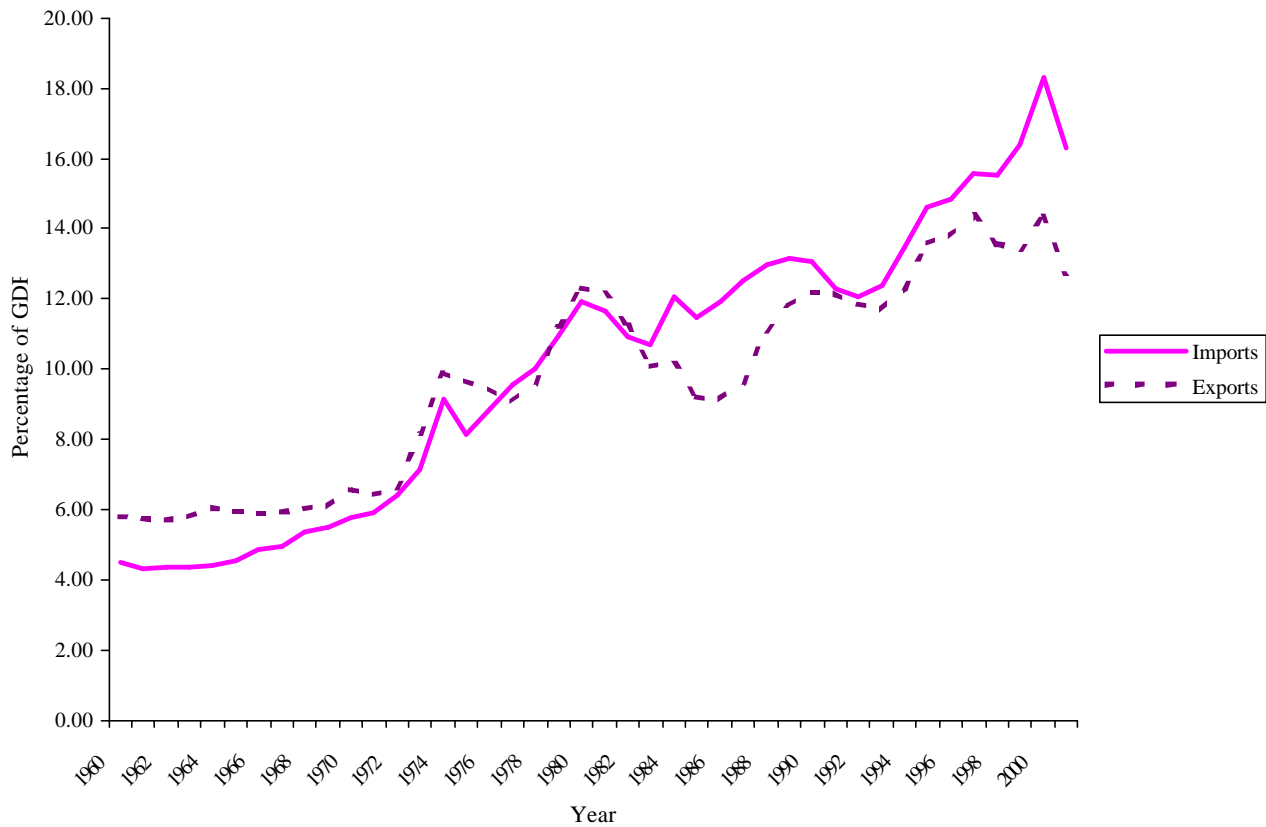
B. Trends in the United States' Balance of Payments

Overview of U.S. balance of payments (current account)

Foreign trade has become increasingly important to the United States economy. Figure 9 presents the value of exports from the United States and imports into the United States as a percentage of GDP for the period 1960-2001.¹⁷ As depicted in Figure 9, exports and imports each have risen from less than six percent of GDP in 1960 to more than 12 percent in 2001. Figure 9 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.

Figure 9

Exports and Imports as a Percentage of United States GDP, 1960-2001



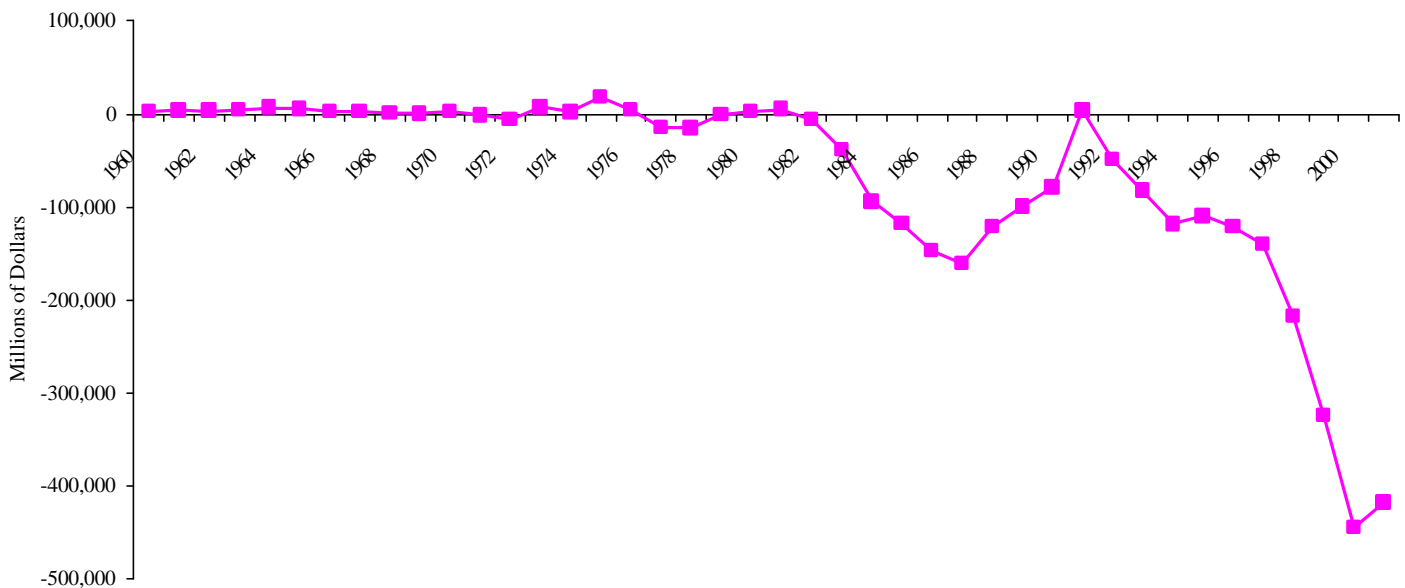
Source: Department of Commerce, Bureau of Economic Analysis.

¹⁷ Data for Figure 9 are from the U.S. Commerce Department, Bureau of Economic Analysis and are reprinted in Appendix Table 2 and Appendix Table 3.

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), generally was positive from 1960 through 1981, but generally has been in deficit by over \$90 billion per year 13 times since 1984. Figure 10 reports the current account balance of the United States for the period 1960 through 2001 in nominal (non-inflation-adjusted) dollars.¹⁸ Figure 11 presents the same data as a percentage of GDP to eliminate the effect of inflation on reported nominal figures. Figure 10 and Figure 11, like Figure 9, show the United States' change in status from net exporter to net importer since the early 1980s. Figure 10 and Figure 11 reflect 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.

Figure 10

United States Current Account Balance, 1960-2001
[millions nominal dollars]

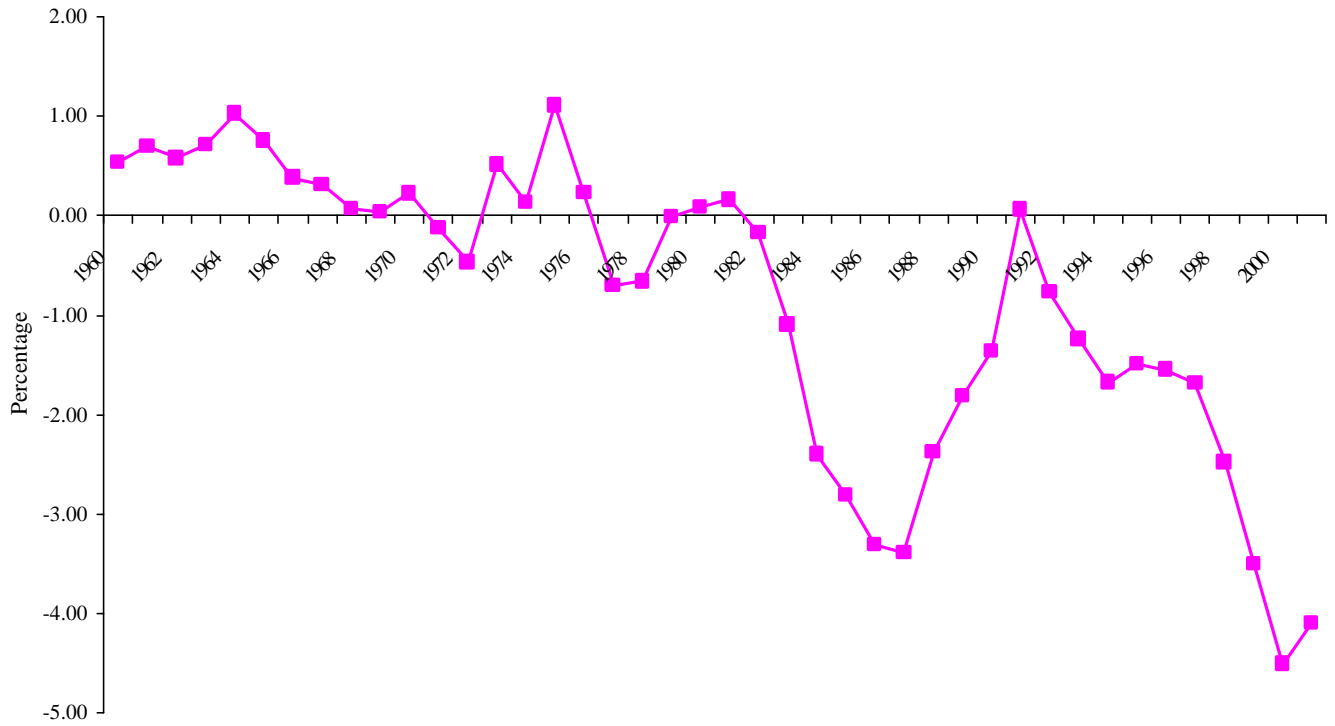


Source: Department of Commerce, Bureau of Economic Analysis.

¹⁸ Data for Figure 10 and Figure 11 are from the U.S. Commerce Department, Bureau of Economic Analysis and are reprinted in Appendix Table 2.

Figure 11

**United States Current Account Balance as a Percentage of GDP, 1960-2001
(percent)**



Source: Department of Commerce, Bureau of Economic Analysis.

Components of the current account

Merchandise trade, trade in services, and income from investments

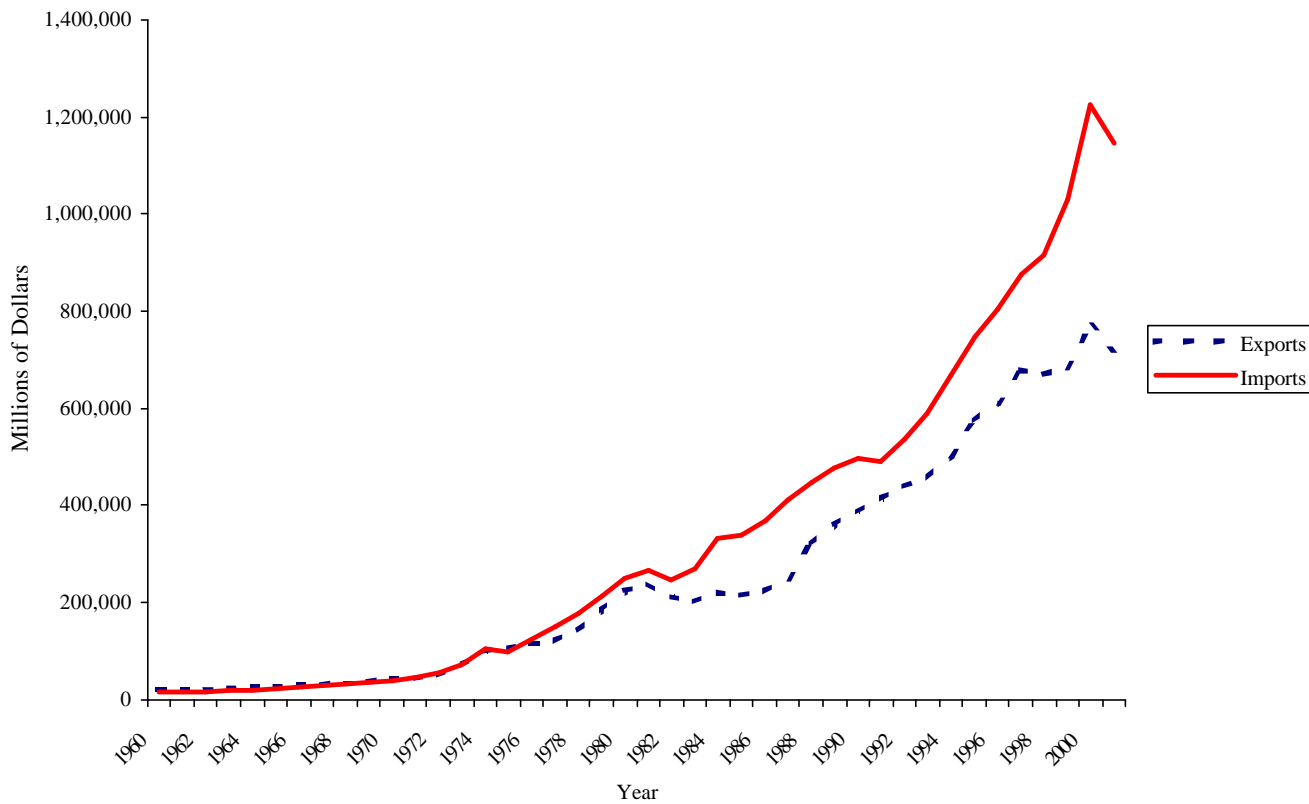
The aggregate data reported in Figure 9, Figure 10, and Figure 11 mask differences in the trade position of various sectors of the economy. As explained above, the current account compares exports of goods and services and payments of income earned by U.S. persons on foreign investments to imports of goods and services and payments of income earned by foreign persons on their investments in the United States. Figure 12 and Figure 13 separately chart the nominal dollar value of exported and imported goods referred to as “merchandise trade” (Figure 12) and merchandise trade as a percentage of GDP (Figure 13). Figure 14 and Figure 15 separately chart exported and imported services in nominal dollars and as a percentage of GDP. Figure 16 and Figure 17 separately chart investment income earned by U.S. and foreign persons in nominal dollars and as a percentage of GDP.¹⁹ The sum of the export curves in, Figure 12, Figure 13, Figure 14, Figure 15, Figure 16, and Figure 17 less the sum of the import curves (plus unilateral remittances) equals the current account balance curves of Figure 10 and Figure 11.

Figure 12, Figure 13, Figure 14, Figure 15, Figure 16, and Figure 17 reveal different trends. As has been widely reported, the merchandise (goods only) trade deficit has been over \$100 billion per year since 1984 and over \$500 billion per year since 1996. On the other hand, the United States has been a net exporter of services since the mid-1970s (Figure 14 and Figure 15). Only since 1998 have payments of income to foreign persons on their U.S. investments exceeded U.S. receipts of income on investments abroad (Figure 16 and Figure 17).

¹⁹ Data for Figure 12, Figure 13, Figure 14, Figure 15, Figure 16, and Figure 17 are from the U.S. Commerce Department, Bureau of Economic Analysis and are reprinted in Appendix Table 2.

Figure 12

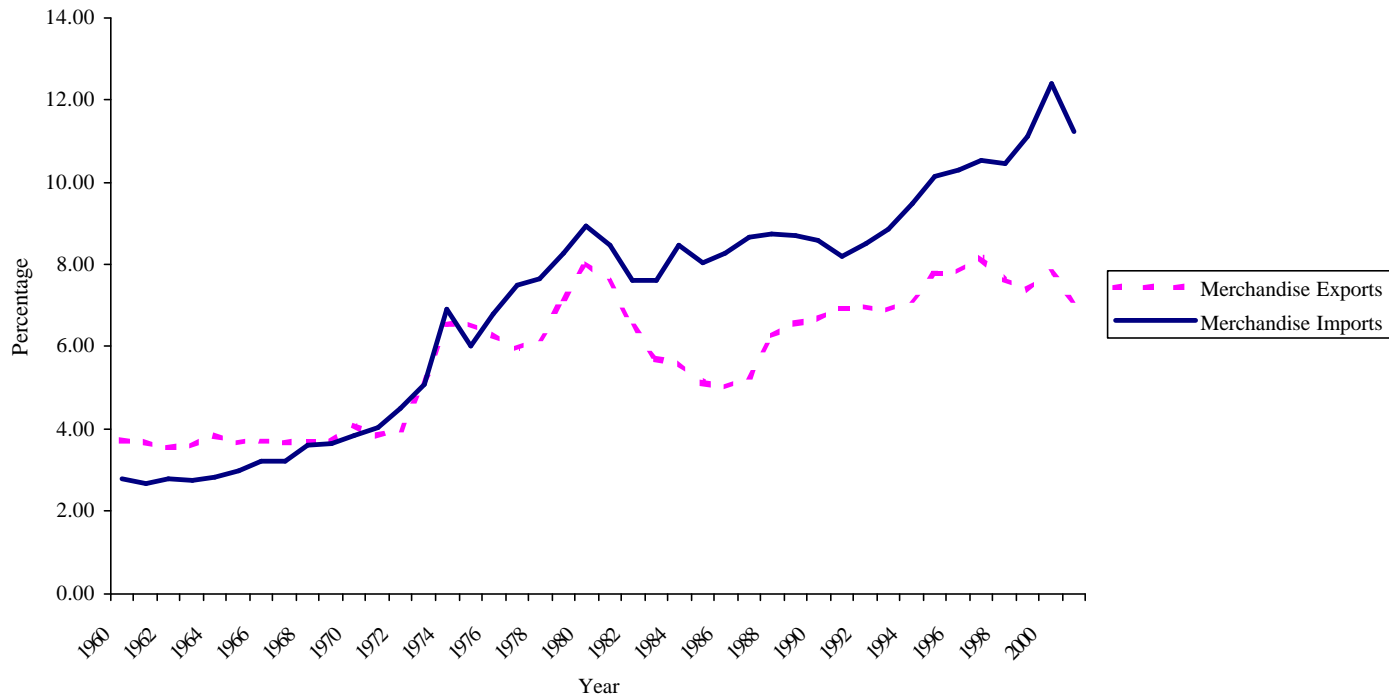
U.S. Merchandise Trade, 1960-2001
[millions nominal dollars]



Source: Department of Commerce, Department of Economic Analysis.

Figure 13

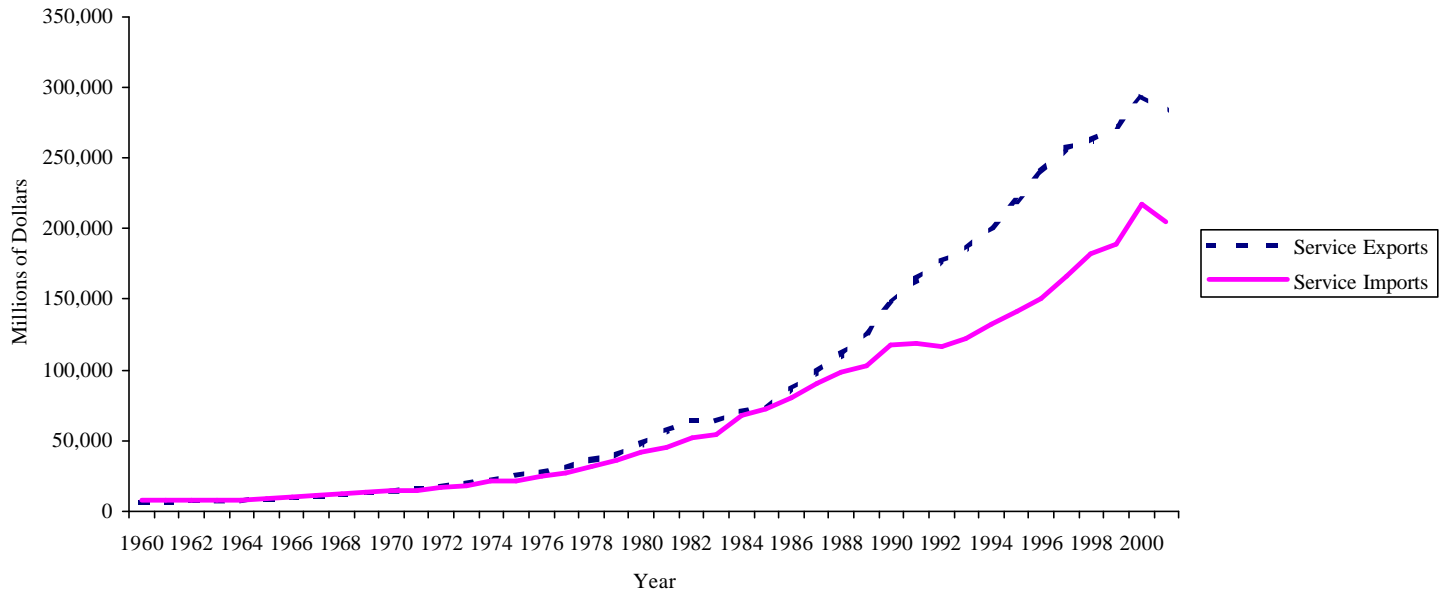
**U.S. Merchandise Trade as a Percentage of GDP, 1960-2001
(percent)**



Source: Department of Commerce, Bureau of Economic Analysis.

Figure 14

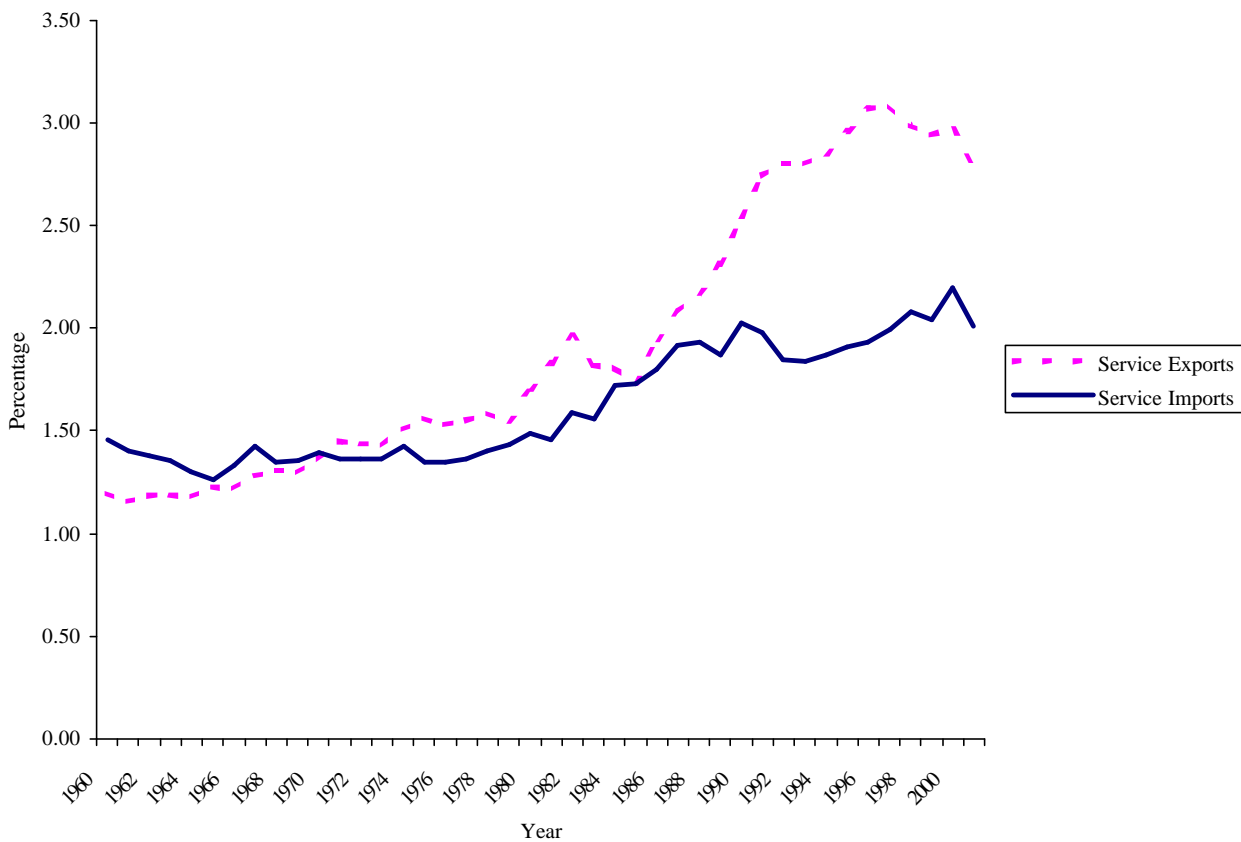
Trade in Services, 1960-2001
[millions nominal dollars]



Source: Department of Commerce, Bureau of Economic Analysis.

Figure 15

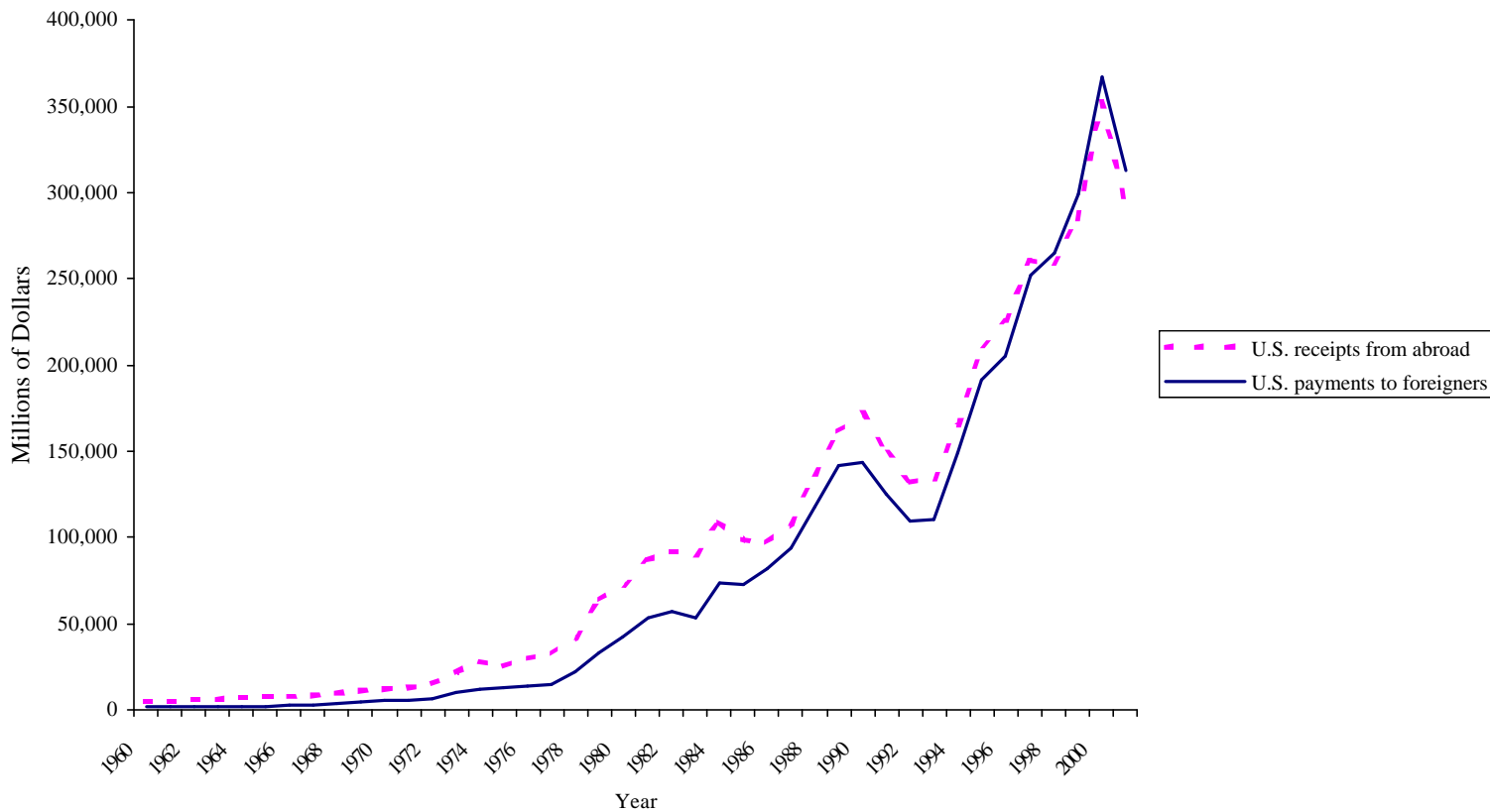
Trade in Services as a Percentage of GDP, 1960-2001
(percent)



Source: Department of Commerce, Bureau of Economic Analysis.

Figure 16

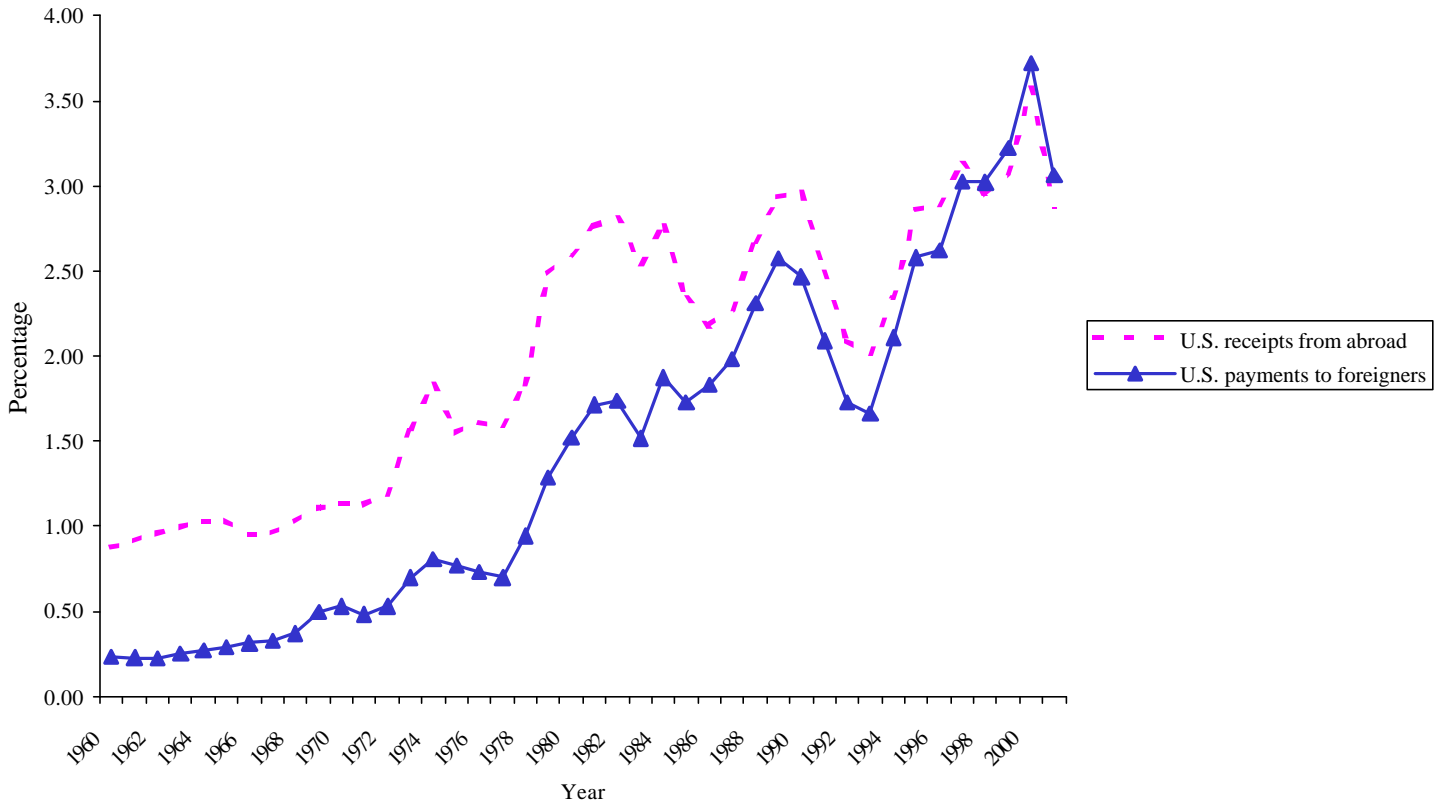
Receipts of Income from Abroad and U.S. Payments to Foreign Persons, 1960-2001
[millions nominal dollars]



Source: Department of Commerce, Bureau of Economic Analysis.

Figure 17

**Receipts of Income from Abroad and U.S. Payments to Foreign Persons
as a Percentage of GDP, 1960-2001
(percent)**



Source: Department of Commerce, Bureau of Economic Analysis.

Intra-firm trade

These aggregate data also do not reveal the extent to which growing trade flows result from trade between related parties. For example, a domestic company might ship components manufactured in the United States to its foreign subsidiary for final assembly and sale. Such shipments would be counted as exports from the United States. A domestic company might produce components abroad and ship them to the United States for final assembly and sale. Such shipments would be counted as imports to the United States. Likewise, a foreign parent company might ship components from abroad to its U.S. affiliate for final assembly and sale in the United States. Such shipments would be counted as imports into the United States. The foreign affiliate might ship components to another country for assembly and sale. Such shipments would be counted as exports from the United States.

The preceding paragraph suggests that intra-firm trade involves the shipment of components across borders. Other intra-firm trade may involve the shipment of raw materials abroad for manufacture abroad or shipment of finished goods to a foreign sales affiliate. The data do not permit such distinctions to be drawn. Nevertheless, the extent of this intra-firm cross-border trade is large. In 1996, large foreign-owned domestic corporations reported sales of tangible goods to related foreign persons (exports) of \$68.6 billion, a figure representing 11.2 percent of total U.S. merchandise exports in 1996. Large foreign-owned domestic corporations reported purchases of tangible goods from related foreign persons (imports) of \$181.9 billion, a figure representing 22.6 percent of total U.S. merchandise imports in 1996.²⁰ Similarly, in 1996, U.S. multinational enterprises shipped \$162.4 billion of goods to their foreign affiliates, a figure representing 26 percent of U.S. merchandise exports in 1996. Foreign affiliates of U.S. multinational enterprises shipped \$136.1 billion of goods to their U.S. parent enterprise, a figure representing 16.9 percent of U.S. merchandise imports in 1996.²¹ Thus, in total, in 1996 intra-firm trade accounted for at least 37 percent of U.S. merchandise exports and 39 percent of U.S. merchandise imports.

Merchandise trade data by industry and geographic region

Intra-firm trade helps explain two other aspects of merchandise trade. First, sectors that are important sources of U.S. exports are often also substantial import sectors. For example, a U.S. manufacturer of computer equipment may produce some components in the United States and ship the components abroad for assembly before re-importing the product for sale in the United States. Such a business arrangement would produce exports from the computer and computer components sector and imports into the computer and computer component sector. Beyond intra-firm trade, competition in the market place also would result in the same sector being the source of exports and the recipient of imports. Figure 18 and Figure 19 detail the composition, by industry, of U.S. merchandise exports (Figure 18) and U.S. merchandise imports (Figure 19) for 2000. To highlight the example above, the data show that seven percent of U.S. exports were from the computer and peripherals industry and similarly seven percent of U.S. imports were in the computer and peripherals industry.

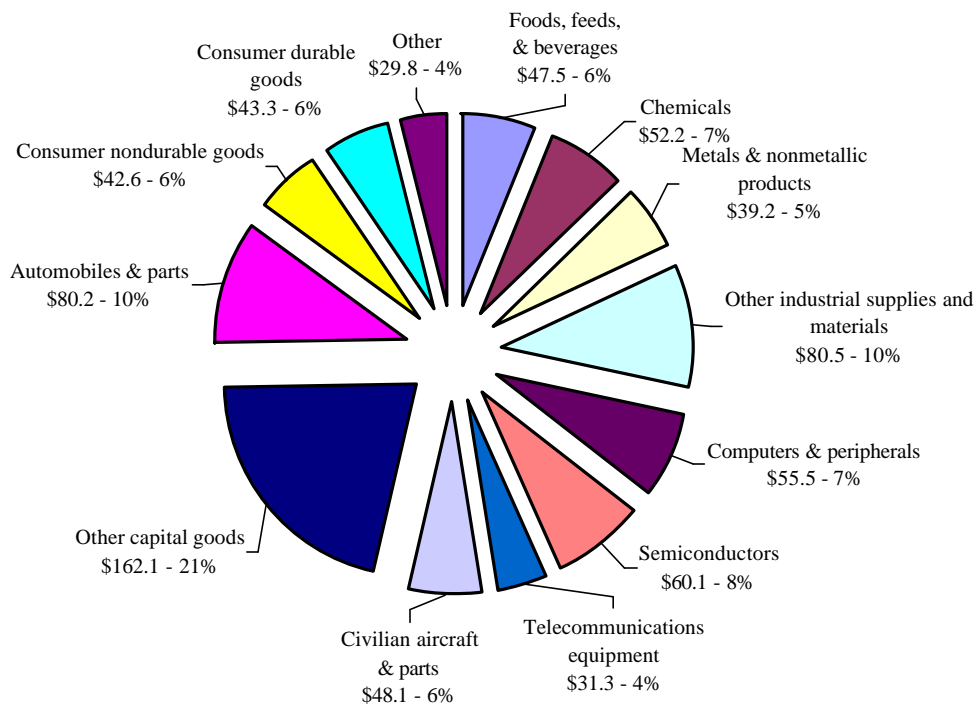
²⁰ Michael G. Seiders and Heather R. Duffy, "Transactions Between Large Foreign-Owned Domestic Corporations and Related Foreign Persons, 1996," *SOI Bulletin*, 19, Fall 1999, pp. 192-213. The data are from 545 foreign-owned domestic corporations, each with total receipts of \$500 million or more in 1996 or a prior year. The figures reported in the text are the sum of reported "sales of stock in trade" and "sales of other tangible property." In 1991, such inter-affiliate trade by large foreign-owned domestic corporations represented 11 percent of merchandise exports and 24 percent of merchandise imports. In 1994, such inter-affiliate trade by large foreign-owned domestic corporations represented 14 percent of merchandise exports and 27 percent of merchandise imports.

²¹ Raymond J. Mataloni, Jr. "U.S. Multinational Companies: Operations in 1996," *Survey of Current Business*, 78, September 1998, p. 54. Unlike the data cited above for foreign-owned U.S. corporations, these data are more inclusive of U.S. foreign affiliates, not being restricted by the size of the foreign affiliate.

Intra-firm trade also is a factor in understanding why countries or areas that are important export markets also often are significant points of origin of imports. Figure 20 and Figure 21 show the destinations of U.S. merchandise exports and the areas of origin of U.S. merchandise imports in 2000.²²

Figure 18

Composition, by Industry of U.S. Merchandise Exports, 2000
[Billions of Dollars and Percentage]

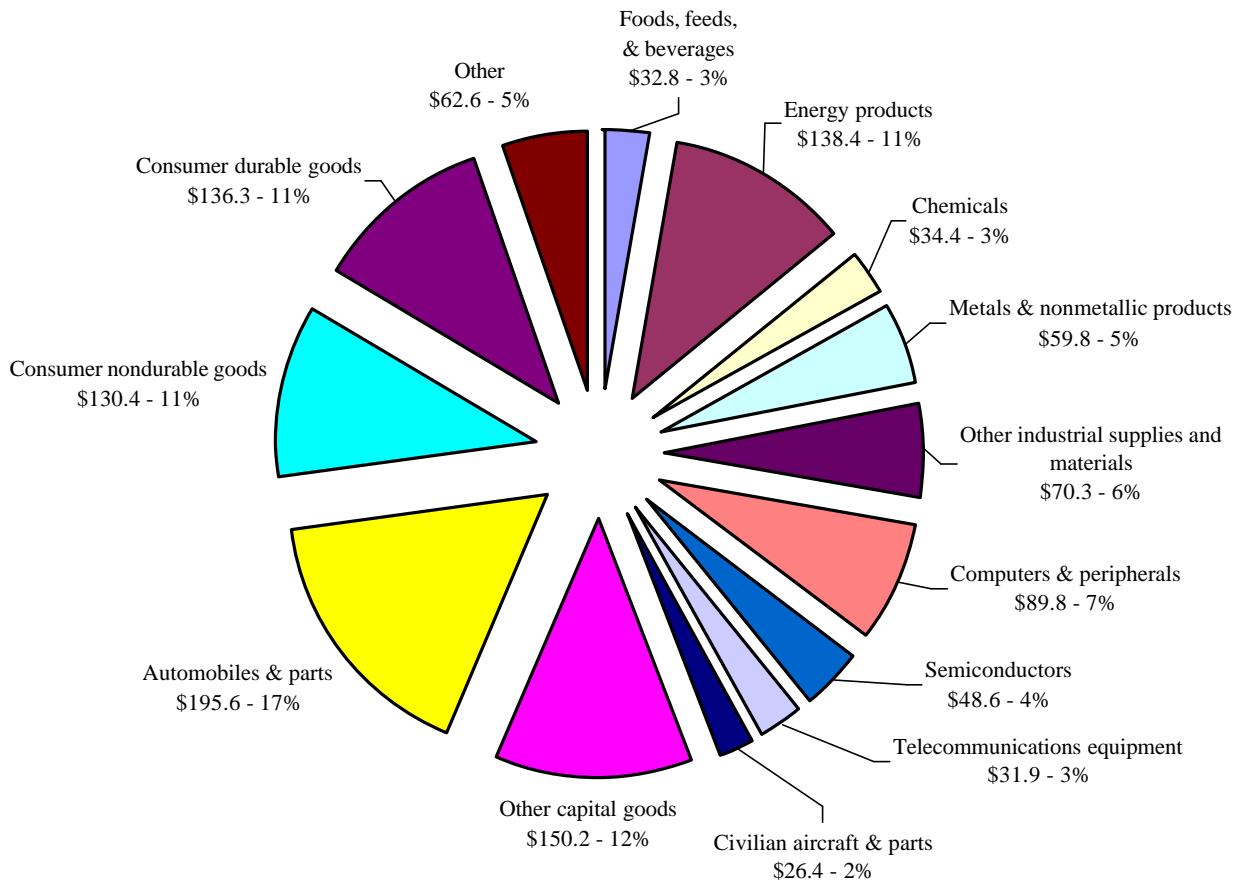


Source: Bureau of Economic Analysis, Department of Commerce and JCT staff calculations.

²² Data for Figure 18 through Figure 21 are found in Douglas B. Weinberg, "U.S. International Transactions, First Quarter 2001," *Survey of Current Business*, 81, July 2001, pp. 37-81.

Figure 19

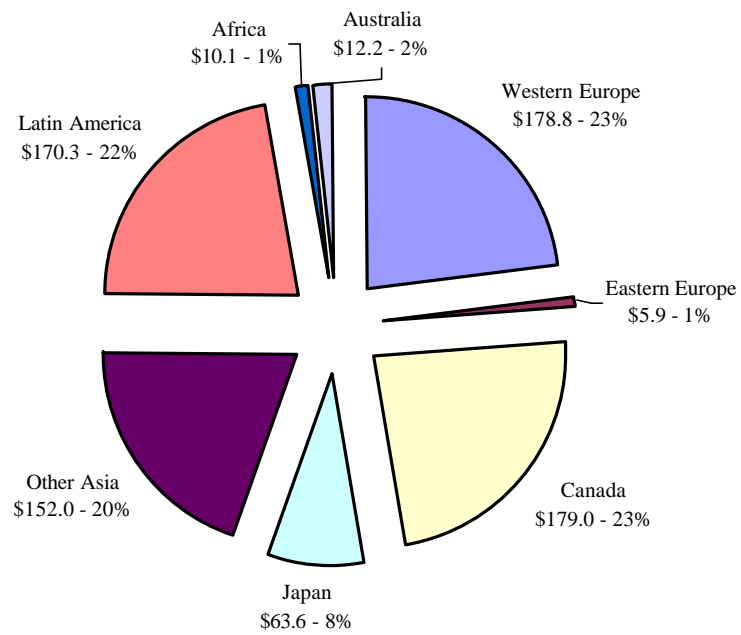
Composition, by Industry of U.S. Merchandise Imports, 2000
[Billions of Dollars and Percentage]



Source: Bureau of Economic Analysis, Department of Commerce and JCT staff calculations.

Figure 20

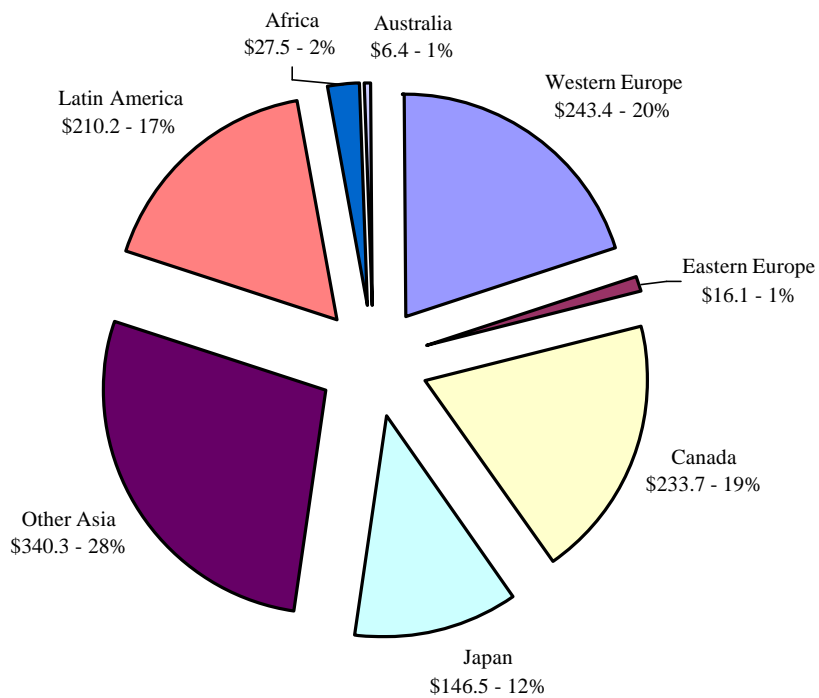
Destination of U.S. Merchandise Exports, 2000
[Billions of Dollars and Percentage]



Source: Bureau of Economic Analysis, Department of Commerce and JCT staff calculations.

Figure 21

Areas of Origin of U.S. Merchandise Imports, 2000
[Billions of Dollars and Percentage]



Source: Bureau of Economic Analysis, Department of Commerce and JCT staff calculations.

Foreign sales corporations and U.S. exports

Data on the role of foreign sales corporations in U.S. trade is limited. Figure 22 details foreign sales corporation (“FSC”) and domestic international sales corporation (“DISC”) dividends as a percentage of the profits of all U.S. corporations. While trending upwards over the last several years, FSC profits constitute less than 1.5 percent of total corporate profits. While a relatively small part of the overall profits of U.S. corporations, sales of goods and services through FSCs may represent a substantial share of U.S. exports. Figure 23 below reports the “foreign trade gross receipts” of FSCs as a percentage of total U.S. exports of goods and services for 1987, 1992, and 1996. “Foreign trade gross receipts” represent the receipts from the sale of export property, the lease payments on qualifying export property, and payments for services related to qualifying sales and leases. In general, these data measure the receipts derived from qualified export sales.²³ Figure 23 reports that qualifying FSC exports comprised one third of U.S. merchandise and service exports in 1996. These data give a picture of the scope of FSCs in U.S. exports but should not be over emphasized. On one hand, these data may overstate somewhat the role of FSCs as foreign trade gross receipts include the value of marketing and sales service performed abroad which would not normally be included as an export. On the other hand, the Statistics of Income Division of the Internal Revenue Service report that not all FSC tax returns report foreign trade gross receipts²⁴ and the imputation of the missing data is likely to understate the value of foreign trade gross receipts. Another factor to consider is that approximately 90 percent of FSC returns represent FSCs related to manufacturing industries. The percentages reported in Figure 23 compare FSC sales to exports of goods and services. FSC sales of manufactured goods is likely to constitute a higher percentage of merchandise exports than the percentages reported in the figure.

²³ “Foreign trade gross receipts also include payments for engineering and architectural services on foreign construction projects. In the case of a commission FSC, the foreign trade gross receipts of the related supplier are included in these data. FSCs reported \$84.3 billion in foreign trade gross receipts in 1987, \$152.3 billion in 1992, and \$185.9 billion in 1996. Cynthia Belmonte, “Foreign Sales Corporations, 1996, *SOI Bulletin*, 19, Spring 2000, pp. 87-122.

²⁴ A foreign sales corporation need not report “foreign trade gross receipts” in order to determine its tax liability.

Figure 22

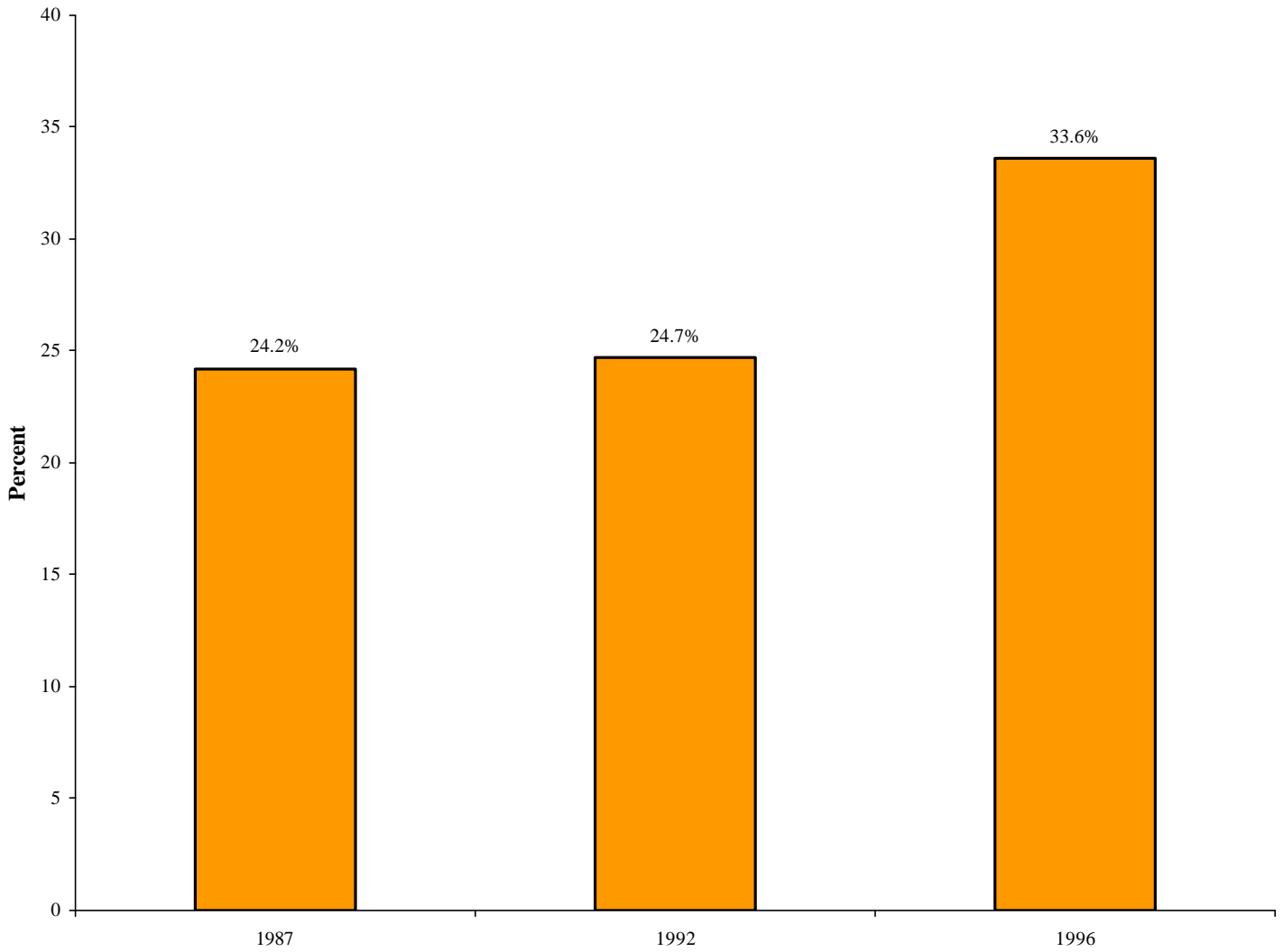
**FSC and DISC Dividends as a Percentage of Corporate Profits,
1983-1998**



Source: Statistics of Income, Internal Revenue Service and JCT staff calculations.

Figure 23

FSC Exports of Goods and Services as a Percentage of Total U.S. Exports of Goods and Services, 1987, 1992, and 1996



Source: Statistics of Income, Internal Revenue Service and JCT staff calculations.

C. Trends in the United States' Financial Account

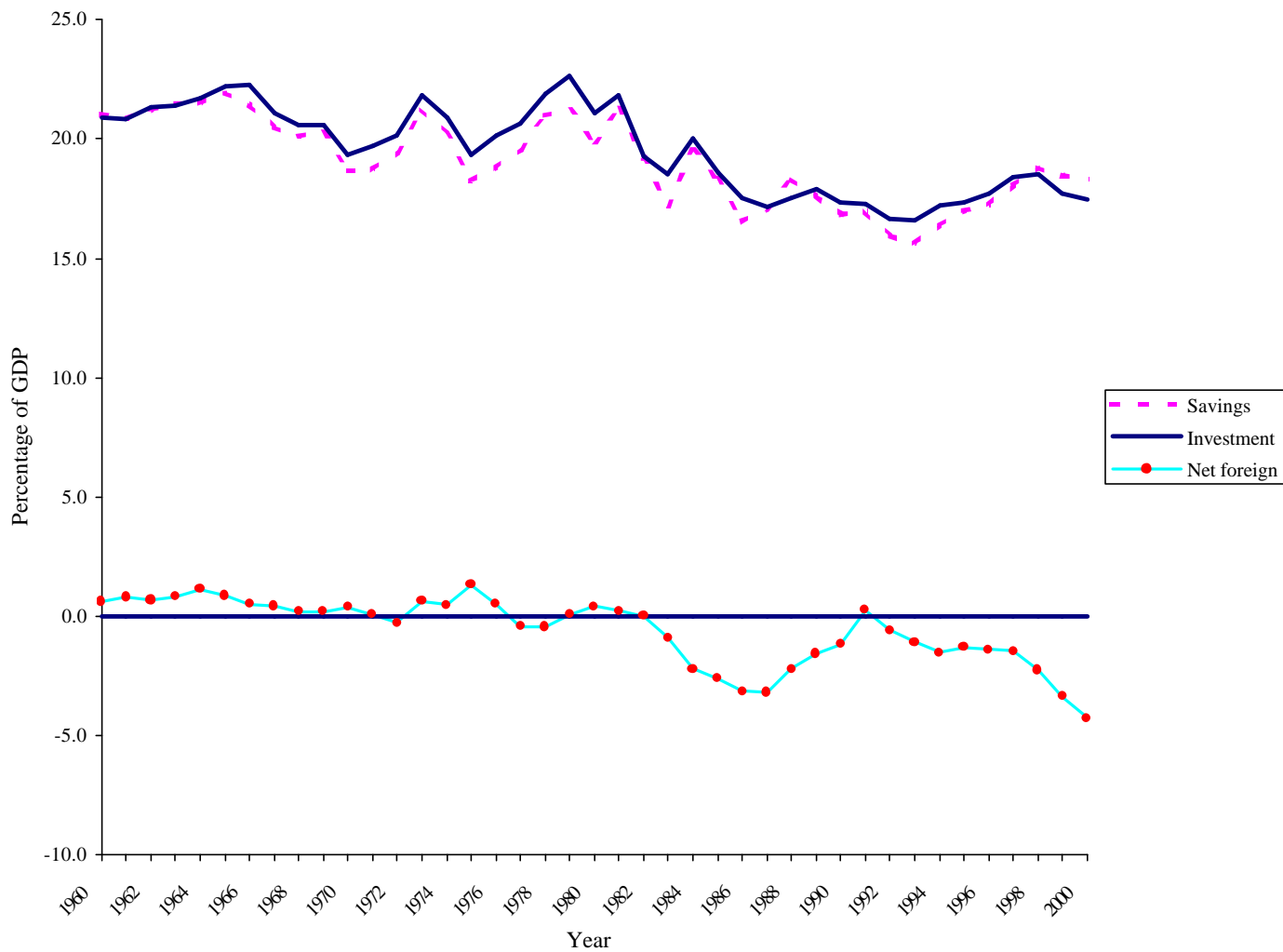
Overview of the United States' financial account

As explained 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 10, Figure 11, and Table 6 document, the United States' current account has been in deficit since the early 1980s. Figure 24 plots gross (before depreciation) U.S. investment and gross U.S. saving as a percentage of GDP for the period 1960-2000.²⁵ Figure 24 also plots net foreign investment as a percentage of GDP. In Figure 24, 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 2000, gross investment in the United States was \$1,741 billion and net foreign investment was \$428 billion, or 24.6 percent of gross domestic investment. In 1993, net foreign investment comprised 8.9 percent of gross domestic investment.

²⁵ Data for Figure 24 are from the U.S. Department of Commerce, Bureau of Economic Analysis and are reprinted in Appendix Table 3.

Figure 24

Saving, Investment, and Net Foreign Investment as a Percentage of GDP, 1960-2000

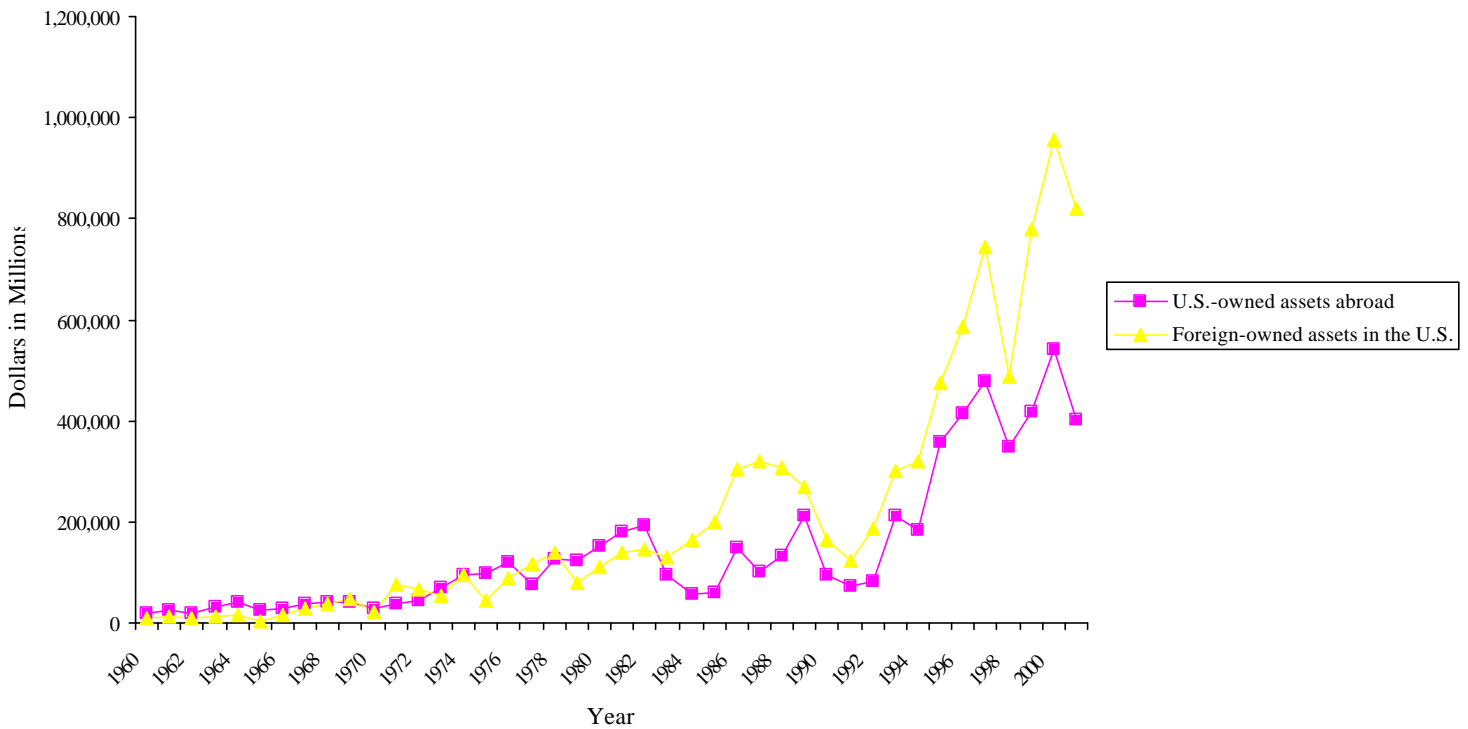


Source: Department of Commerce, Bureau of Economic Analysis.

The net foreign investment in the United States is measured by the United States' financial account. The financial account measures the increase in U.S. assets abroad compared to the increase in foreign assets in the United States. Figure 25 plots the annual increase of U.S. assets abroad and of foreign assets in the United States in constant dollars for the period 1960-2001.²⁶ Foreign assets in the United States increased by \$814 billion in 1999, \$1,024 billion in 2000, and \$895 billion in 2001 in nominal dollars. At the same time, foreign assets owned by U.S. persons increased by \$437 billion in 1999, \$581 billion in 2000, and \$400 billion in 2001 (nominal dollars).

Figure 25

**Annual Increase in U.S. Assets Abroad and in Foreign Assets in U.S.,
1960-2001, in Constant 1996 Dollars**



Source: Department of Commerce, Bureau of Economic Analysis.

²⁶ Data for Figure 25 are from the U.S. Department of Commerce, Bureau of Economic Analysis and are reprinted in Appendix Table 4.

Growth in foreign-owned assets in the United States and U.S.-owned assets abroad

Overview

Measured in nominal dollars, the amount of foreign-owned assets in the United States grew more than 700 percent between 1975 and 1988²⁷ and by nearly 400 percent between 1980 and 2000. The total amount of foreign-owned assets in the United States exceeded \$8 trillion by the end of 2000.²⁸ 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 \$162 billion. By 2000, the amount of foreign-owned assets in the United States exceeded U.S.-owned assets abroad by \$1.8 trillion.²⁹ These investments are measured at their so-called “current cost.”³⁰ 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.³¹ Figure 26 and Figure 27 display the value of U.S.-owned assets abroad and foreign-owned assets in the United States for selected years measured under both current 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 25.

²⁷ 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.

²⁸ *Ibid.*

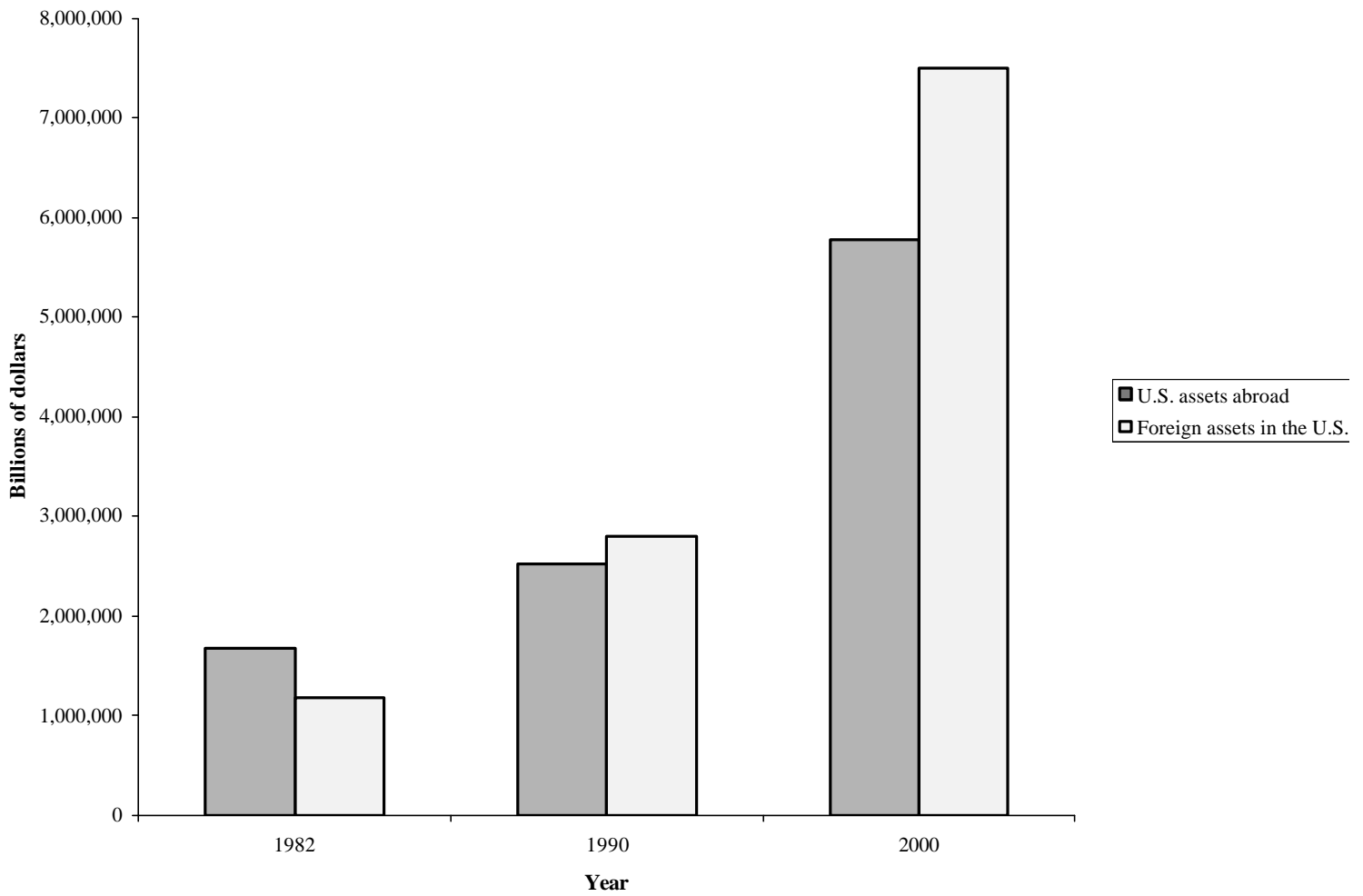
²⁹ *Ibid.*

³⁰ The Bureau of Economic Analysis estimates the values of U.S. foreign direct investment abroad and foreign direct investment in the United States using three different bases: historical cost, current cost, and market value. Using the historical cost base, assets are measured according to values carried on taxpayers’ books. Thus, investments reflect the price level of the year in which the asset was acquired. Under the current cost measure, a parent’s share of its affiliates’ tangible assets (property, plant, and equipment and inventories) is revalued from historical cost to replacement cost. Under the market value measure, an owner’s equity in foreign assets is revalued to current market value using indexes of stock prices.

³¹ 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 26

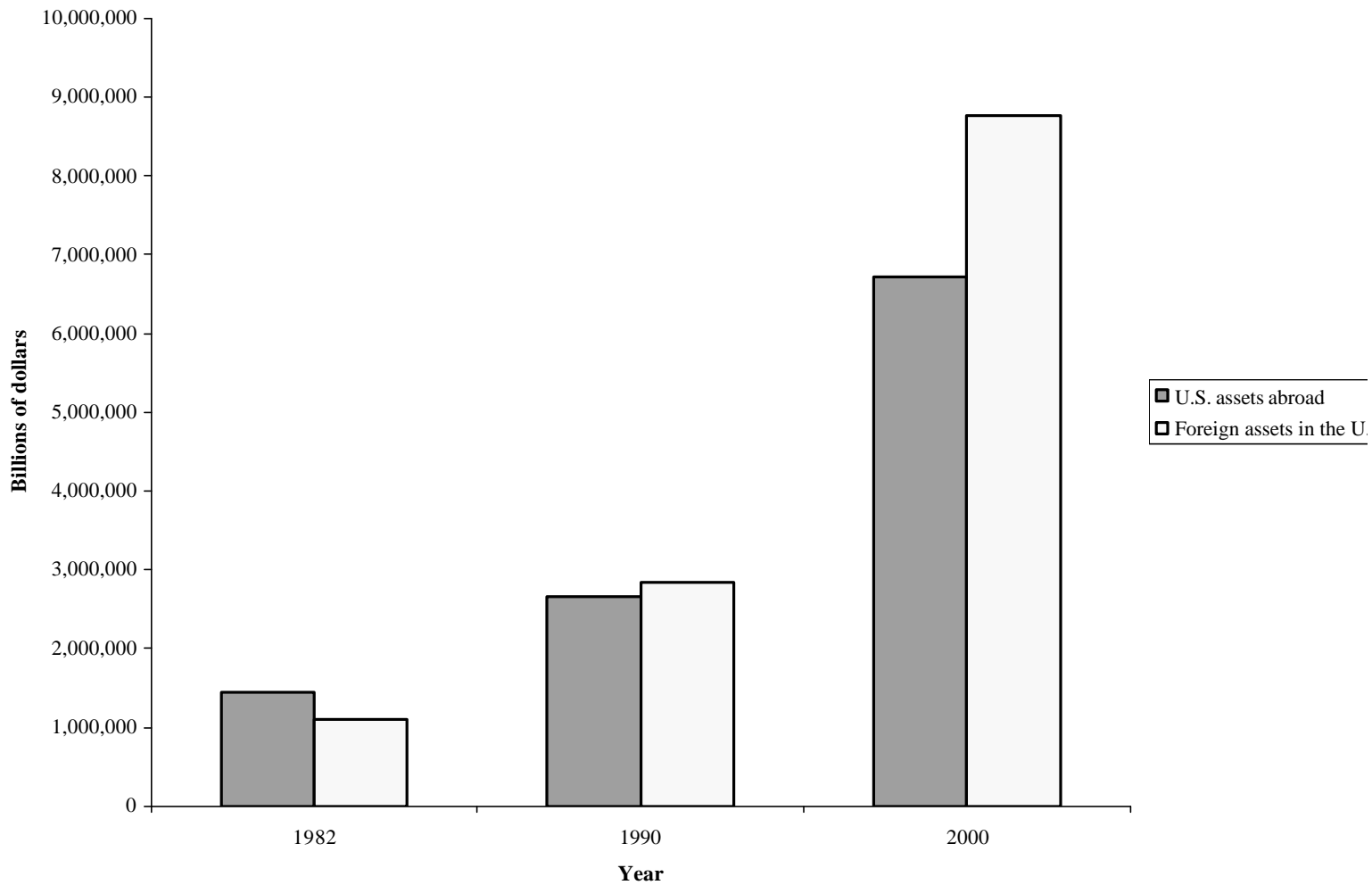
**International Investment Position of the United States,
1982, 1990, and 2000 in Constant 1996 Dollars
(direct investment at current cost)**



Source: Department of Commerce, Bureau of Economic Analysis.

Figure 27

**International Investment Position of the United States,
1982, 1990, 2000 in Constant 1996 Dollars
(direct investment at market value)**



Source: Department of Commerce, Bureau of Economic Analysis.

Direct investment, non-direct (portfolio) investment, and official investment

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 \$1.37 trillion in the United States in 2000, having grown from \$127 billion in 1980.³²

The largest category of investment is non-direct investment held by private (non-governmental) foreign investors, commonly referred to as portfolio investment. For most of the past decade foreign portfolio investment annually has exceeded foreign direct investment, making portfolio investment responsible for the majority of growth in foreign ownership of U.S. assets. (See Figure 28) Foreign portfolio investment 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 2000, portfolio assets of foreign persons in the United States were more than triple the recorded value of direct investment, \$4.74 trillion compared to \$1.37 trillion, respectively.³³ Bank deposits account for approximately one-quarter of this total, and reflect, in part, the increasingly global nature of banking activities. Figure 29 reports the dollar value of foreign holdings of selected U.S. assets, both portfolio investment and direct investment, for 1982, 1990, and 2000.³⁴ 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.

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.

The value of investments by private U.S. persons abroad has grown from \$693 billion in 1980 to \$5.95 trillion in 2000.³⁵ This growth has not been as rapid as the growth in the value of investments by foreign persons in the United States. As has been the case for foreign investors in U.S. assets, over the past decade U.S. investors portfolio holdings of foreign assets has increased more rapidly than U.S. foreign direct investment. (See Figure 30.)³⁶ At year-end

³² King, "The International Investment Position of the United States at Yearend 2000."

³³ *Ibid.*

³⁴ See Appendix Table 5.

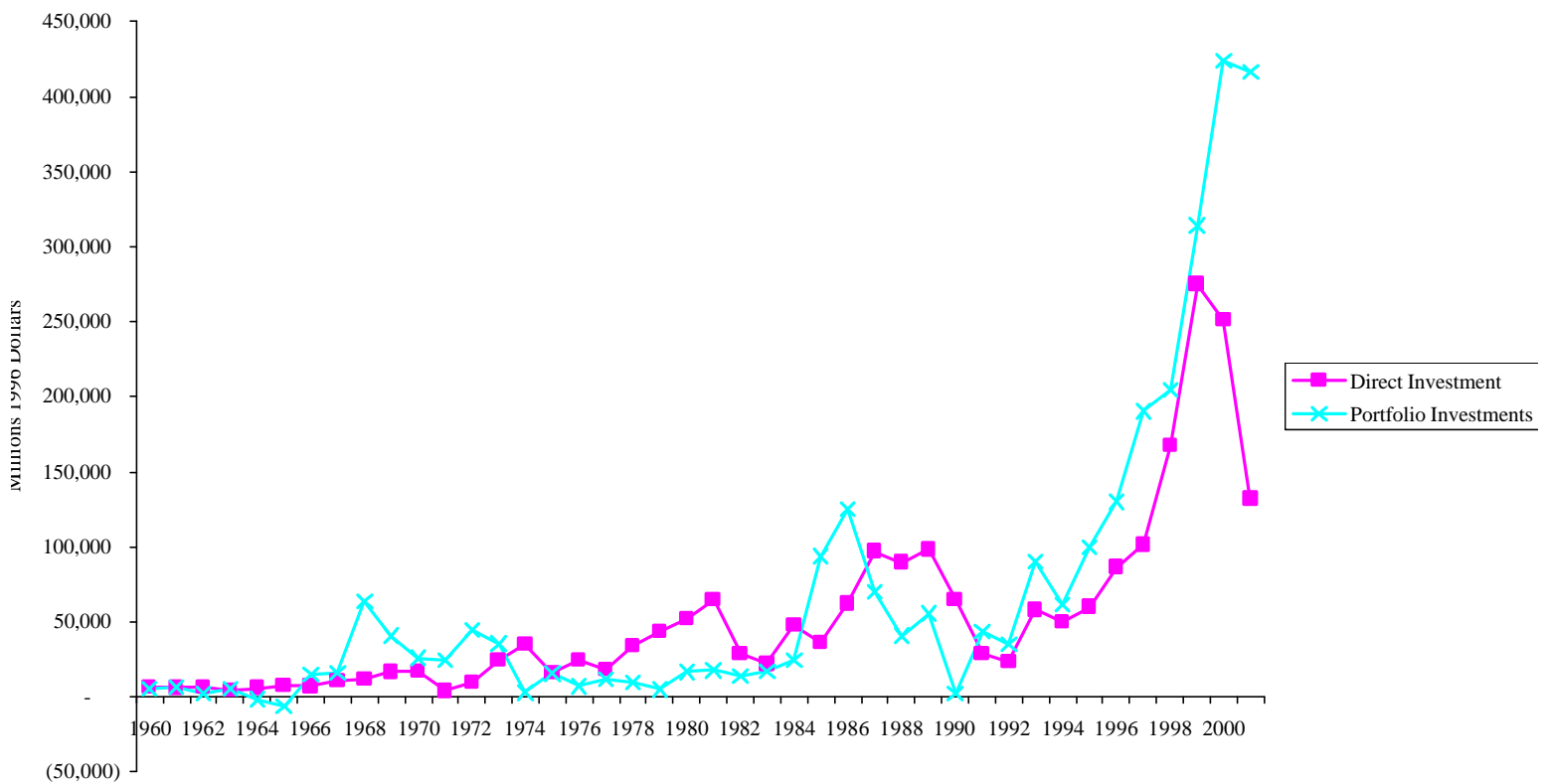
³⁵ King, "The International Investment Position of the United States at Yearend 2000."

³⁶ See Appendix Table 6.

2000, U.S. foreign direct investment constituted approximately one-quarter of U.S. ownership of foreign assets (with direct investment measured at current cost).³⁷ Measured at current cost, the value of U.S. direct investment abroad has remained above the value of foreign direct investment in the United States. (See Figure 31.) Measured at market value, the value of foreign direct investment in the United States has modestly surpassed the value of U.S. direct investment abroad since 1998. (See Figure 32.)

Figure 28

Annual Increase in Foreign Direct Investment in the United States and Foreign (Non-Treasury Security) Portfolio Investment, 1960-2001, In Constant 1996 Dollars

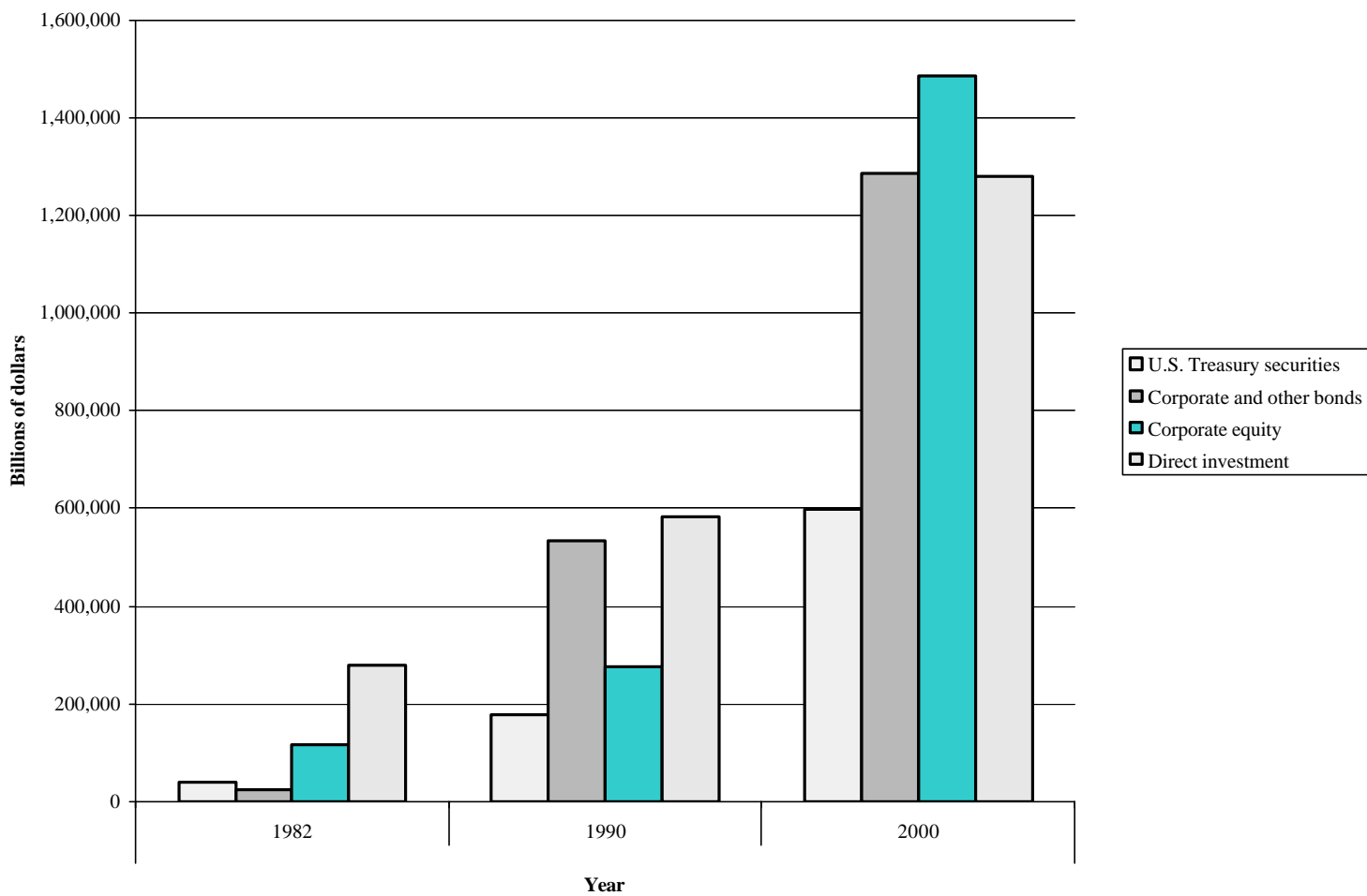


Source: Department of Commerce, Bureau of Economic Analysis.

³⁷ King, "The International Investment Position of the United States at Yearend 2000."

Figure 29

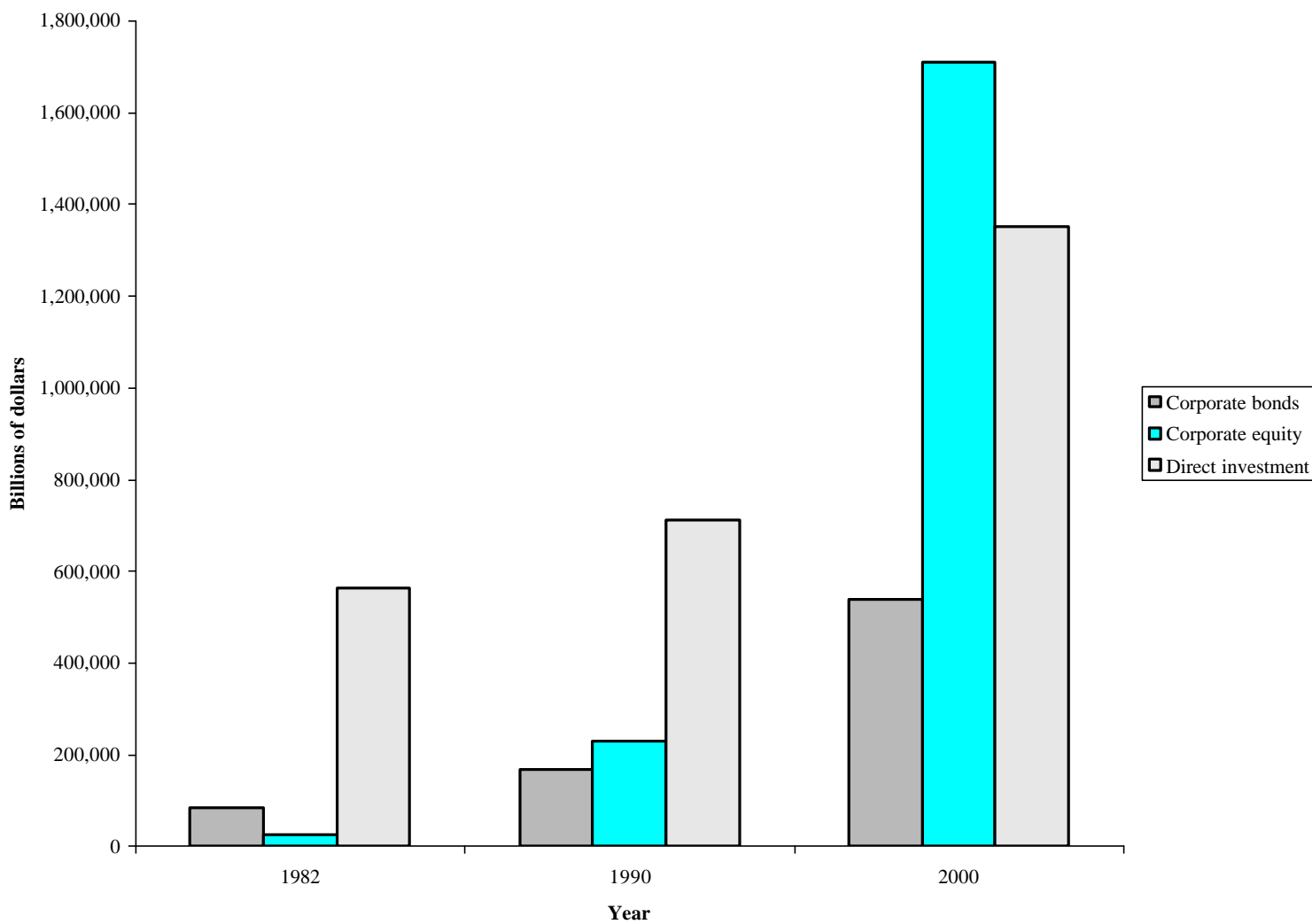
**Selected Nongovernmental Foreign Holdings of United States' Assets, Both Portfolio and Direct Investments,
1982, 1990, 2000 in Constant 1996 Dollars
(direct investment at current cost)**



Source: Department of Commerce, Bureau of Economic Analysis.

Figure 30

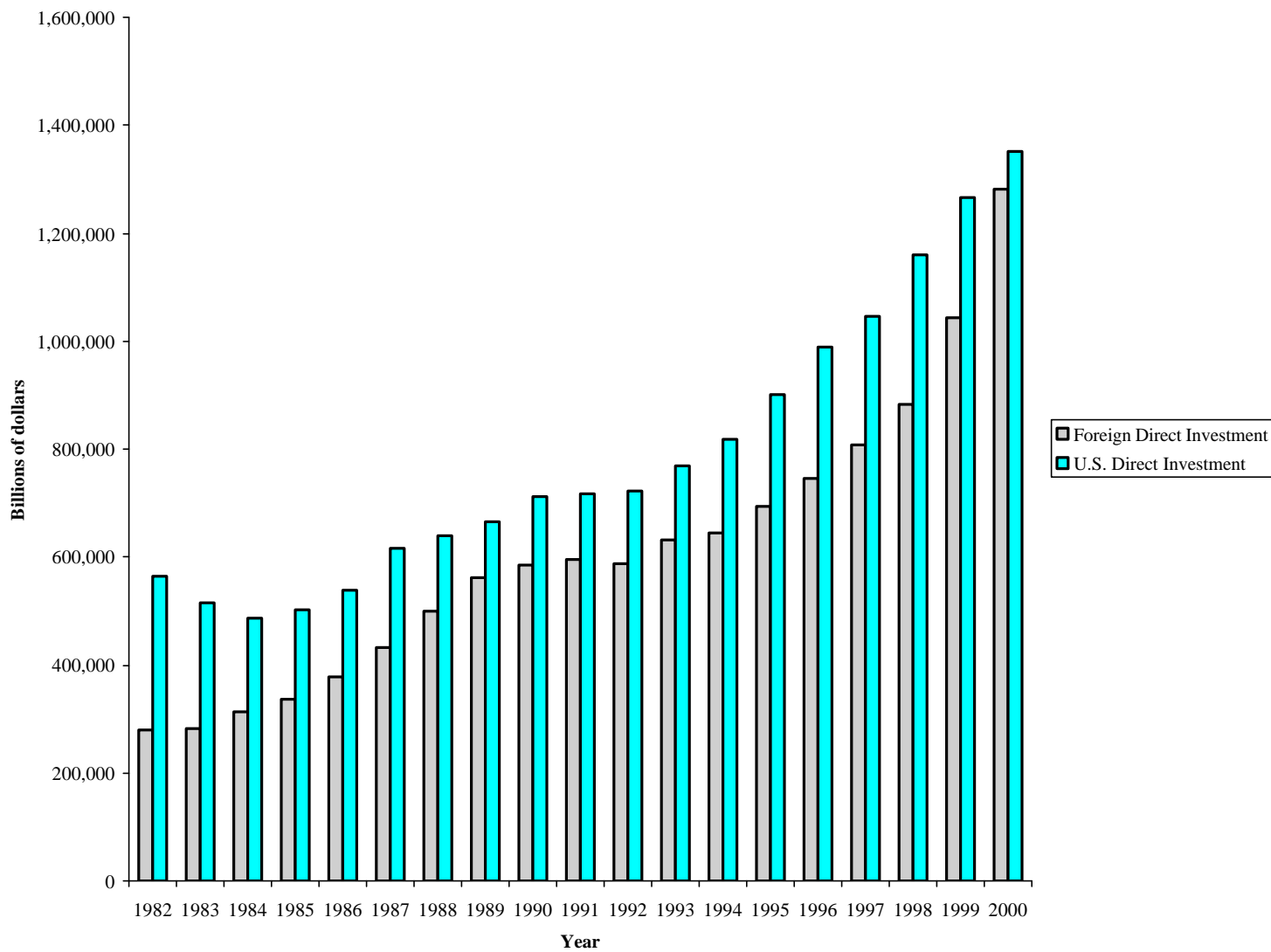
**Selected United States' Holdings of Foreign Assets, Both Portfolio and Direct Investments, 1982, 1990, 2000, in Constant 1986 Dollars
(direct investment at current cost)**



Source: Department of Commerce, Bureau of Economic Analysis.

Figure 31

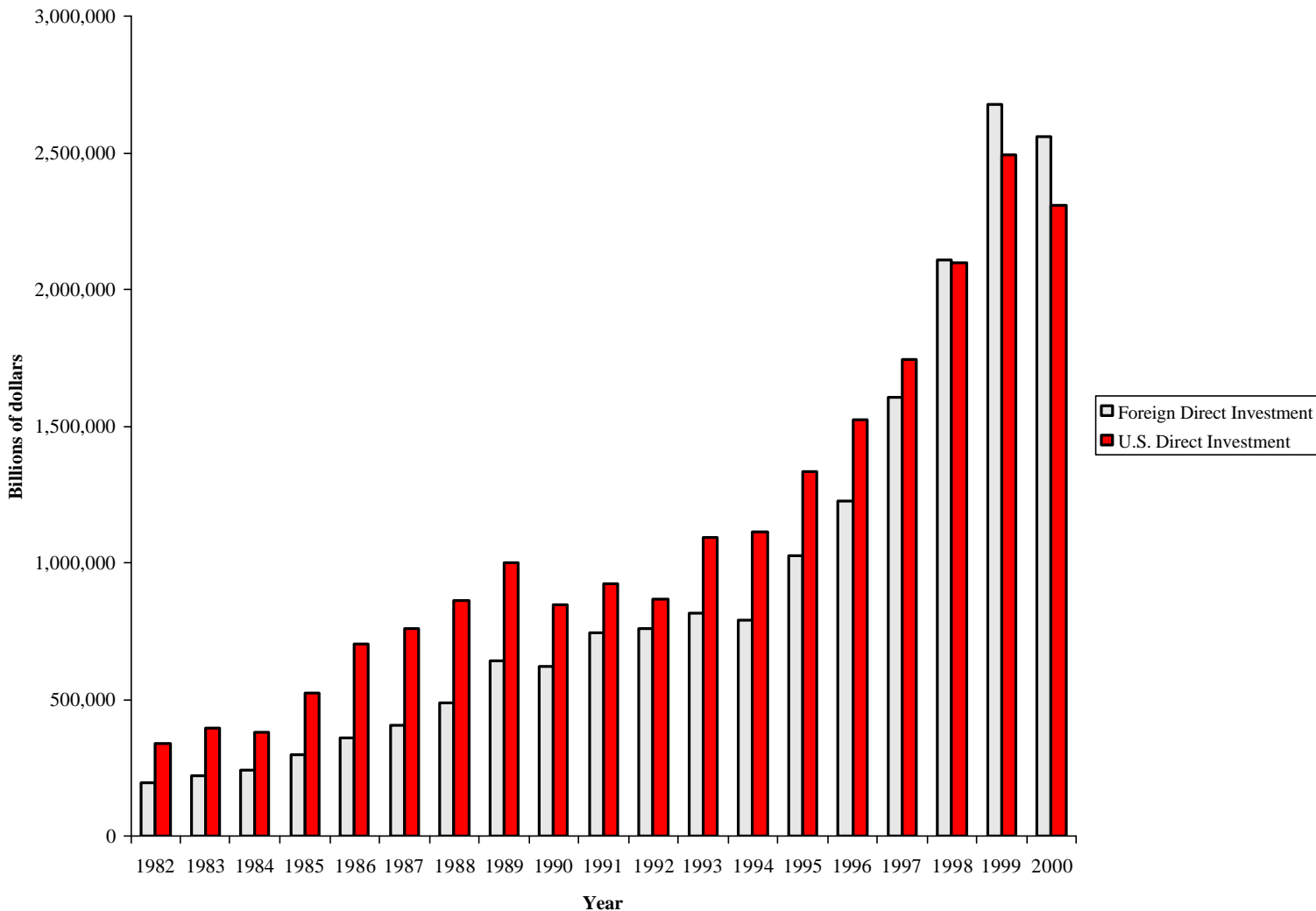
**Year-End Value of Foreign Direct Investment in the United States
and U.S. Direct Investment Abroad, 1982-2000**
[Billions of Nominal Dollars at Current Cost]



Source: Department of Commerce, Bureau of Economic Analysis.

Figure 32

**Year-End Value of Foreign Direct Investment in the United States
and U.S. Direct Investment Abroad, 1982-2000**
[Billions of Nominal Dollars at Market Value]



Source: Department of Commerce, Bureau of Economic Analysis.

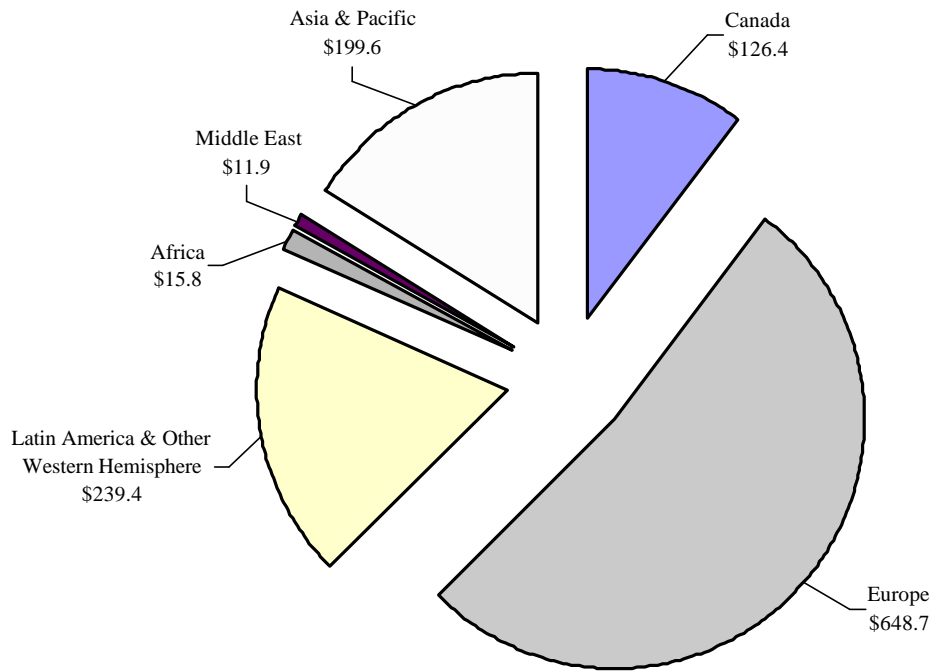
Cross border investment by geographic region and industry³⁸

Most cross border investment by developed countries is located in other developed countries. Measured on an historical cost basis, more than 50 percent of U.S. direct investment abroad is located in Europe and more than 10 percent is located in Canada. (See Figure 33.) Similarly, European persons account for more than 70 percent of foreign direct investment in the United States on an historical cost basis, and Canadian persons account for more than eight percent of foreign direct investment in the United States. (See Figure 34.) The single largest country hosting U.S. foreign direct investment abroad is the United Kingdom, followed by Canada, the Netherlands, and Germany. The United Kingdom is the single largest source country for foreign direct investment in the United States, followed by Japan, the Netherlands, and Germany. (See Figure 35 and Figure 36.) More than one quarter of U.S. direct investment abroad has been devoted to manufacturing. More than 40 percent of foreign direct investment in the United States is in the manufacturing sectors. Other significant sectors in which U.S. persons make direct investments abroad and in which foreign persons make direct investments in the United States are finance, insurance, and petroleum. (See Figure 37, Figure 38 and Figure 39).

³⁸ The data in the text below and accompanying figures is from Maria Borgo and Raymond Mataloni, Jr., "Direct Investment Positions for 2000: Country and Industry Detail," *Survey of Current Business*, 81, July 2001, pp. 16-29.

Figure 33

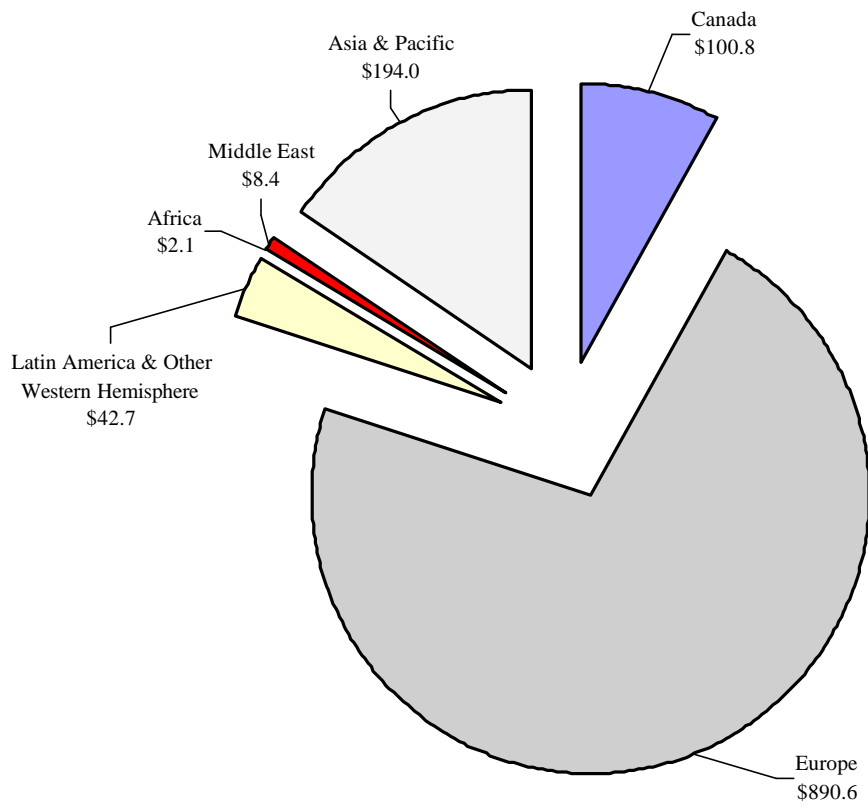
U.S. Direct Investment Abroad, 2000
[Billions of Dollars]



Source: Department of Commerce, Bureau of Economic Analysis.

Figure 34

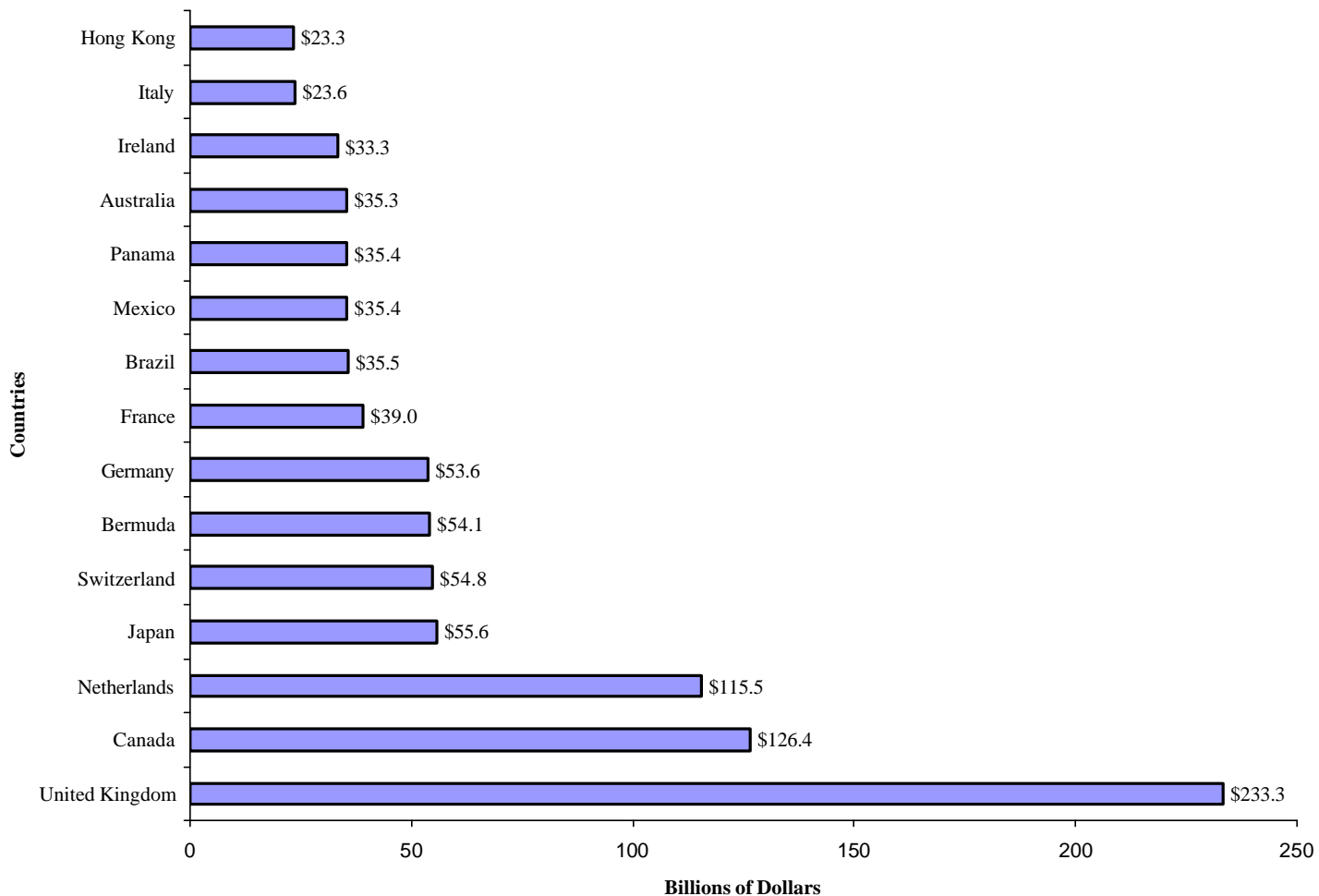
**Foreign Direct Investment in the United States, 2000 Historical Cost Basis
[Billions of Dollars]**



Source: Department of Commerce, Bureau of Economic Analysis.

Figure 35

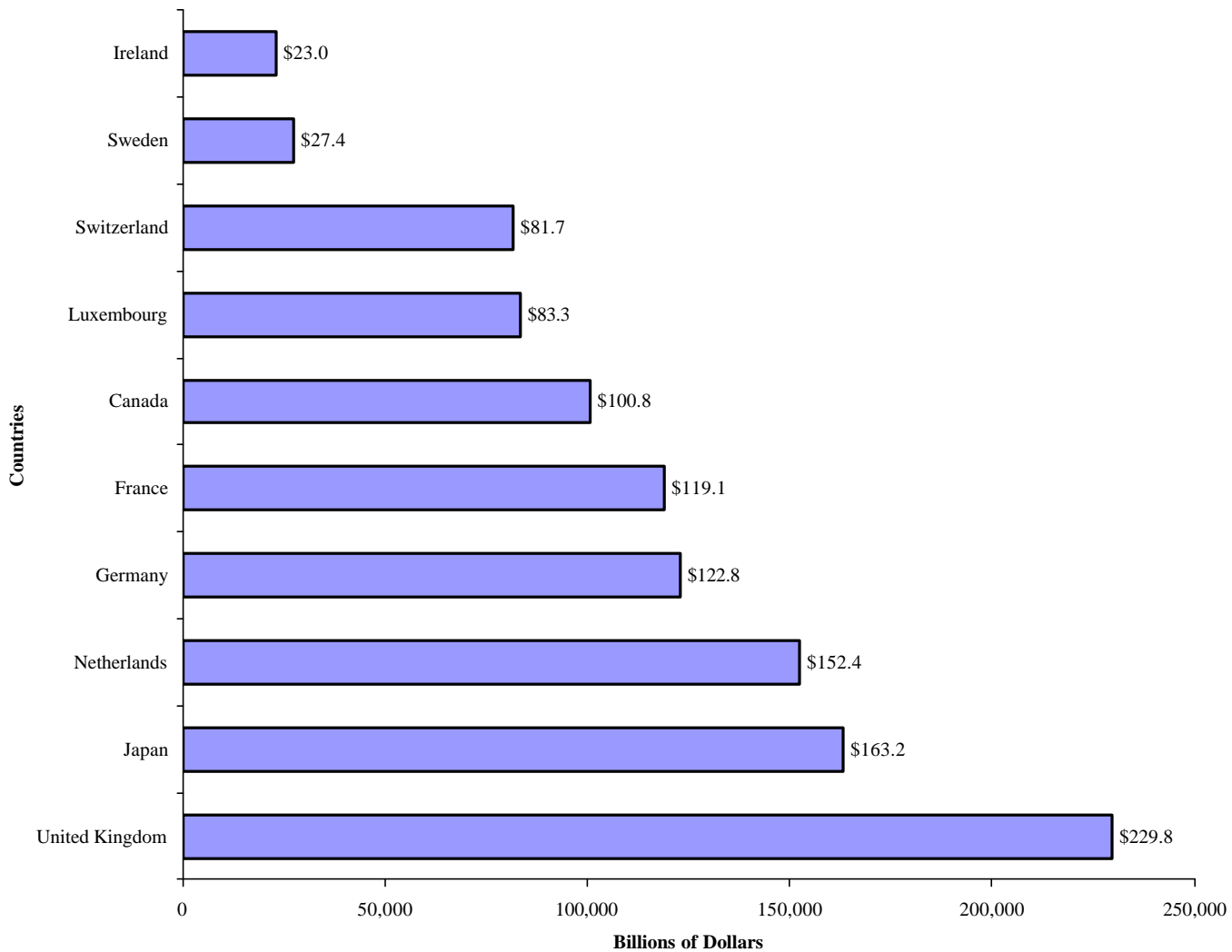
15 Largest Host Countries of U.S. Direct Investment Abroad, 2000
[Billions of Dollars]



Source: Department of Commerce, Bureau of Economic Analysis.

Figure 36

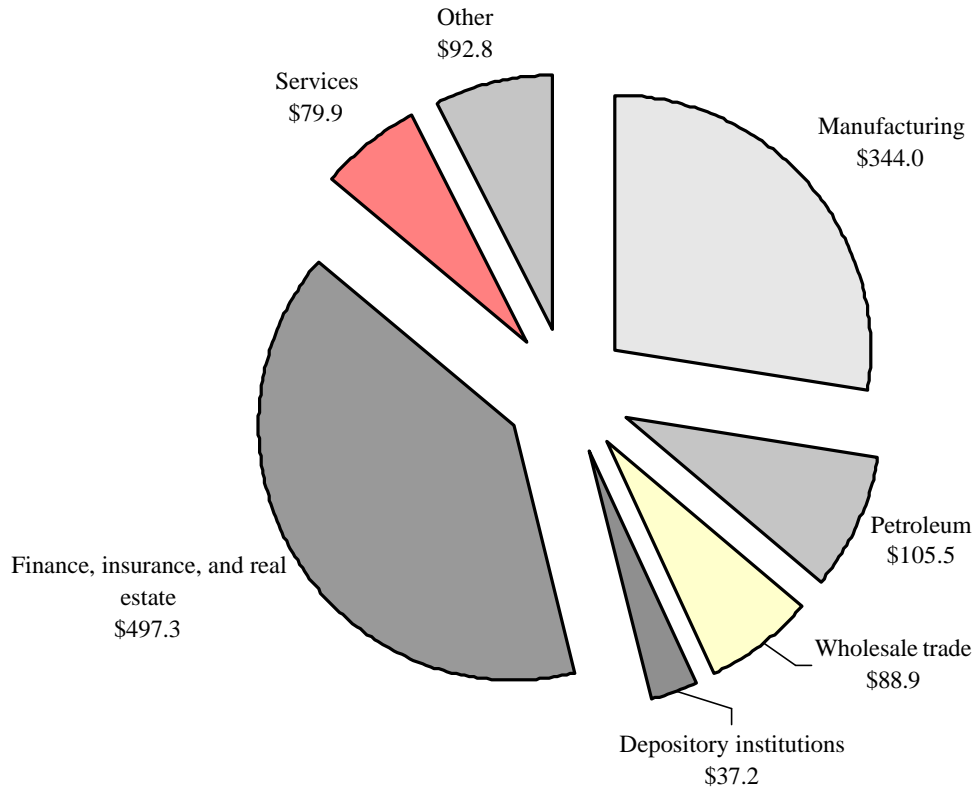
**10 Largest Home Countries of Foreign Direct Investment
in the United States, 2000
[Billions of Dollars]**



Source: Department of Commerce, Bureau of Economic Analysis.

Figure 37

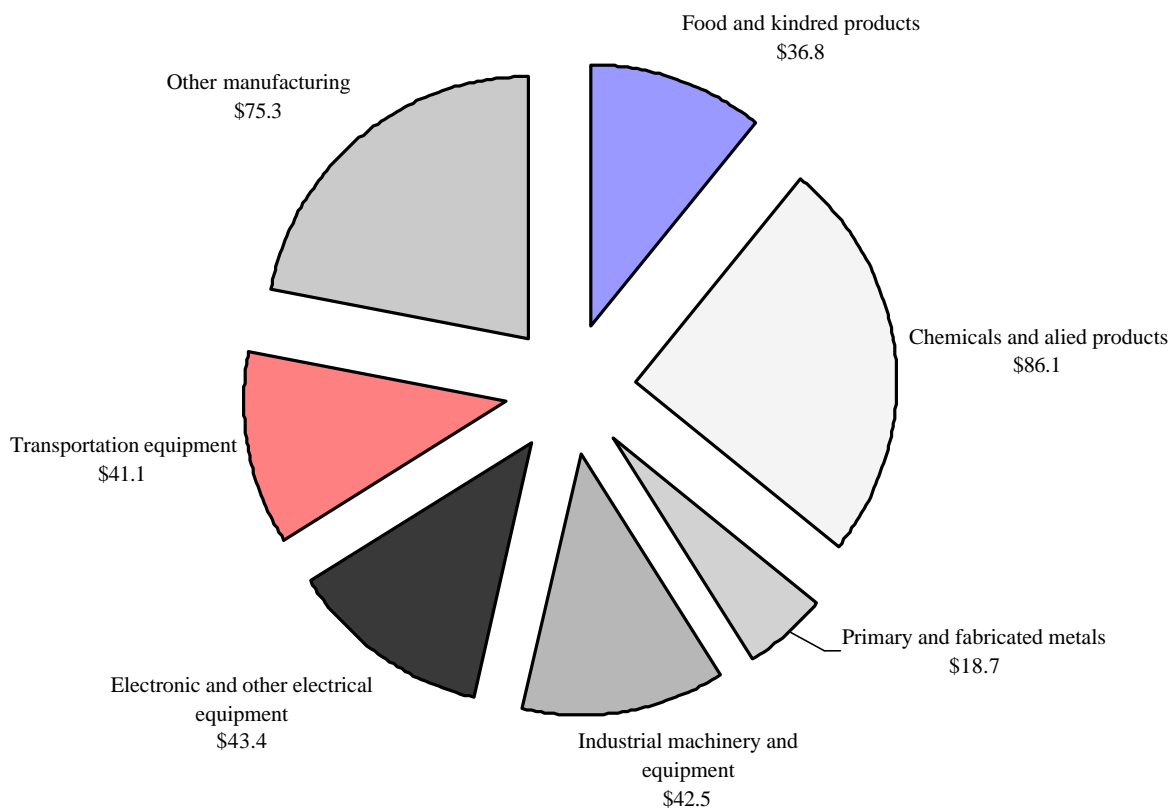
**U.S. Direct Investment Abroad at Year-End 2000
by Industry on an Historical Cost Basis
[Billions of Dollars]**



Source: Department of Commerce, Bureau of Economic Analysis.

Figure 38

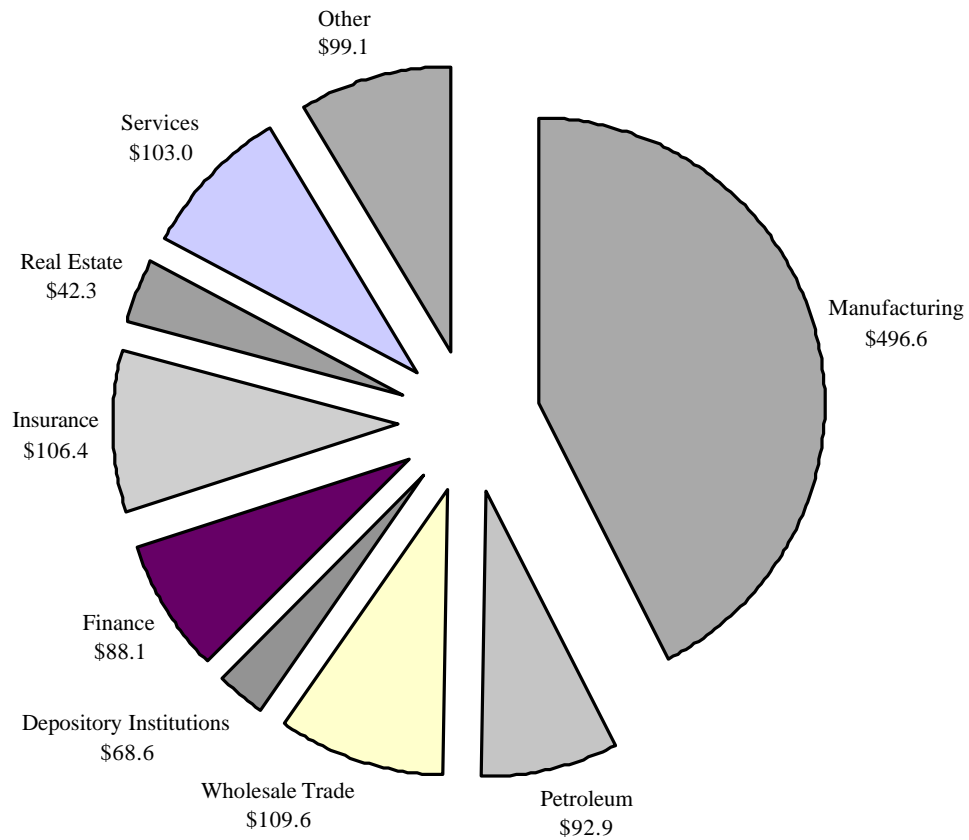
**U.S. Direct Investment in Manufacturing Abroad at
Year-End 2000 by Manufacturing Industry on an
Historical Cost Basis
[Billions of Dollars]**



Source: Department of Commerce, Bureau of Economic Analysis.

Figure 39

Foreign Direct Investment in the United States by Industry, 2000
[Billions of Dollars]



Source: Department of Commerce, Bureau of Economic Analysis.

Cross-border merger activity

Cross-border merger activity is one means by which changes occur in the financial account. Figure 40 below details the dollar value of foreign investor acquisitions of U.S. companies and the U.S. investor acquisitions of foreign companies via merger or acquisition. All of these mergers would represent direct, rather than portfolio, investment, as all involve 100-percent acquisitions.³⁹ Figure 40 shows that the dollar value of such cross-border acquisitions was comparable with U.S. acquisitions slightly lower for the period 1991 through 1997. Subsequent to 1997 foreign acquisitions of U.S. companies has more than doubled U.S. acquisitions of foreign companies, although throughout the entire period U.S. acquisitions generally have exceeded foreign acquisitions in terms of number of companies purchased.⁴⁰

The greatest plurality of cross-border mergers and acquisitions has involved U.S. companies and companies of the United Kingdom, consistent with the data presented above showing the extent of U.K. direct investments in the United States and U.S. direct investments in the United Kingdom. In 2000, the investors domiciled in the United Kingdom accounted for nearly 34 percent of foreign acquisitions of U.S. companies (valued at \$114.3 billion).⁴¹ Approximately 35 percent of U.S. investor acquisitions of foreign companies involved companies domiciled in the United Kingdom (valued at \$47.9 billion).⁴² The next four largest foreign acquirers of U.S. companies in 2000 were France (\$39.8 billion, 11.7 percent of the total), Switzerland (\$35.6 billion, 10.5 percent of the total), the Netherlands (\$31.8 billion, 9.4 percent of the total), and Canada (\$29.2 billion, 8.6 percent of the total). After the United Kingdom the next largest sites of U.S. investor acquisitions in 2000 were Canada (\$13.8 billion, 10.2 percent of the total), Italy (\$11.8 billion, 8.7 percent of the total), Japan (\$10.7 billion, 7.9 percent of the total), and Germany (\$6.7 billion, 5.0 percent of the total).⁴³ Measured by dollar value, approximately 17 percent of foreign acquisitions were of U.S. firms engaged in investments and commodities and another 15 percent of foreign acquisitions were of U.S. firms engaged in providing business services.⁴⁴ The foreign industry receiving the greatest U.S. investor purchases was telecommunications, accounting for nearly 13 percent of U.S. foreign

³⁹ An investment is considered a “direct investment,” rather than a “portfolio investment,” if at least a 10-percent interest is acquired.

⁴⁰ See Appendix Table 7.

⁴¹ *Mergers & Acquisitions Almanac*, February 2001, pp. 38.

⁴² *Ibid.*

⁴³ *Ibid.*

⁴⁴ *Ibid.* U.S. firms in the oil and gas industry accounted for nearly 12 percent of year 2000 foreign acquisitions and U.S. firms in the food industry accounted for nine percent of foreign acquisitions. No other industry accounted for more than five percent of foreign acquisitions measured in dollars.

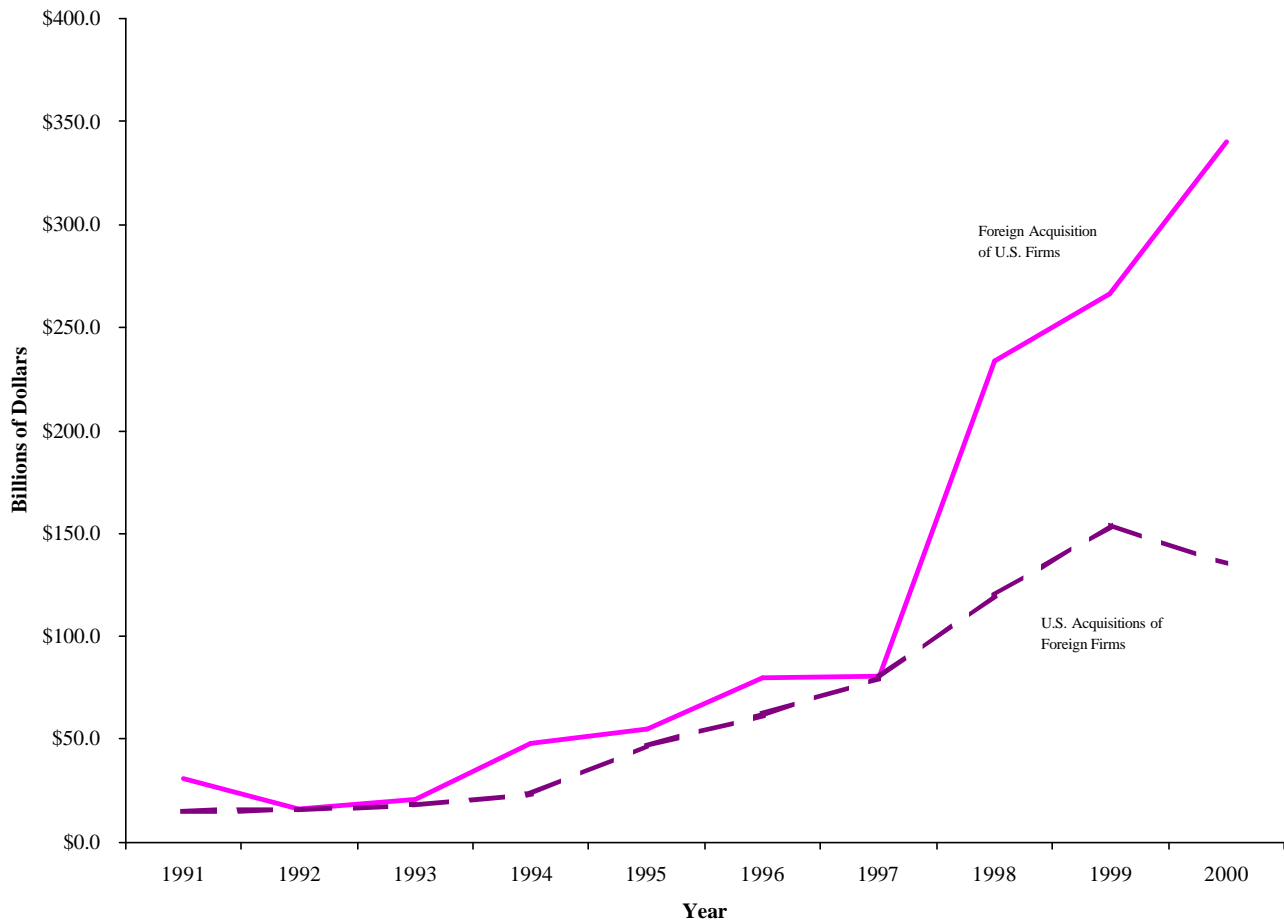
acquisitions. Foreign utilities constituted nearly 10 percent of U.S. acquisitions of foreign companies in 2000.⁴⁵

Table 7, Table 8, Table 9, and Table 10, below, list the 25 largest foreign acquisitions of U.S. companies in 2000 (Table 7) and 1999 (Table 9) and the 25 largest U.S. acquisitions of foreign companies in 2000 (Table 8) and 1999 (Table 10). The tables list the target company, the acquiring company, the domicile of the companies, the line of business of the target company, and estimated dollar value of the merger or acquisition.

⁴⁵ *Ibid.* Acquisitions of foreign investment and commodity companies comprised 9.5 percent of U.S. acquisitions abroad in 2000. Acquisitions of foreign radio and television companies comprised 7.5 percent of U.S. acquisitions abroad, acquisitions of foreign business service companies comprised 6.4 percent, acquisitions of foreign metal and metal product companies comprised 6.1 percent, acquisitions of foreign oil and gas companies comprised 5.3 percent, and acquisitions of foreign electronic and electrical equipment companies comprised five percent of U.S. acquisitions abroad in 2000. No other sector accounted for more than three percent of U.S. acquisitions of foreign companies in 2000.

Figure 40

Dollar Value of Cross Border Mergers and Acquisitions, 1991-2000



Source: Mergers and Acquisitions Almanac, see Appendix Table 7.

Table 7 – Top 25 Foreign Acquisitions of U.S. Companies – 2000

Acquirer	Domicile of Acquirer	Target	Target Industry	Price (\$ Billions)
BP Amoco PLC	United Kingdom	Atlantic Richfield Co.	Oil and gas	\$27.2
Unilever PLC	United Kingdom	Bestfoods	Food products	25.1
UBS AG	Switzerland	PaineWebber Group Inc.	Investment banking	16.5
Credit Suisse Group	Switzerland	Donaldson, Lufkin & Jenrette Inc.	Investment banking	13.5
Cap Gemini SA	France	Consulting business of Ernst & Young LLP	Consulting services	11.8
ING Groep NV	Netherlands	Financial services and international businesses of Aetna Inc.	Insurance financial services	7.6
Nortel Networks Corp.	Canada	Alteon Websystems Inc.	Internet infrastructure products	7.1
Terra Networks SA	Spain	Lycos Inc.	Internet search engine	6.2
ING Groep NV	Netherlands	ReliaStar Financial Corp	Insurance	6.0
Nippon Telephone & Telegraph Corp.	Japan	Remaining 90% of Verio Inc.	Internet service provider	5.7
France Telecom SA	France	25% of NTL Inc.	Cable TV systems, radio stations, telecom services	5.5
PowerGen PLC	United Kingdom	LG&E Energy Corp.	Electric and gas utility	5.4
WPP Group PLC	United Kingdom	Young & Rubicam Inc.	Advertising agency	5.0
Tyco International Ltd.	Bermuda	Mallinckrodt Inc.	Diagnostic products	4.4
France Telecom SA	France	Remaining 71% of Global One Co.	Telecommunications	4.3
Sema Group PLC	United Kingdom	LHS Group Inc.	Billing and customer care services	4.3
National Grid Group PLC		New England Electric System	Electric utility; oil and gas	4.2
Stora Enso Oyj	Finland	Consolidated Papers Inc.	Paper products	4.0
BASF AG	Germany	Agricultural products business of American Home Products Corp	Crop protection products	3.9
Koninklijke Ahold NV	Netherlands	US Foodservice Inc.	Grocery products wholesaling	3.6
Rodamco North America NV	Netherlands	Urban Shopping Centers Inc.	Mall development and management	3.4
Nortel Networks Corp.	Canada	Xros Inc.	Fiber-optic network switching equipment	3.3
Nortel Networks Corp.	Canada	Otera Corp.	Fiber-optic telecommunication equipment	3.3
Cia Cementos Mexicanos SA	Mexico	Southdown Inc.	Cement; limestone mining	2.8
Global Crossing Ltd.	Bermuda	IPC Communications Inc. unit of Citigroup Inc.	Integrated communication systems and services	2.8

Table 8 – Top 25 U.S. Acquisitions of Foreign Companies – 2000

Acquirer	Target	Domicile of Acquirer	Target Industry	Price (\$ Billions)
NTL Inc.	CWC Consumer Co unit of Cable and Wireless Communications PLC	United Kingdom	Telecommunication, cable TV, and internet services	11.0
Chase Manhattan Corp.	Robert Fleming Holdings Ltd.	United Kingdom	Merchant banking	7.7
NTL Inc.	Cablecom Holding AG	Switzerland	Cable TV services	3.7
Corning Inc.	90% of the optical components and device business of Pirelli SpA	Italy	Optical network components	3.6
Callahan Associates International LLC et al	55% of the North Rhine Westphalia cable network of Deutsche Telekom AG	Germany	Telecommunication services	2.8
Ford Motor Co.	Land Rover business of BMW AG	United Kingdom	Motor vehicles	2.7
General Motors Corp.	20% of the Fiat Auto SpA unit of Fiat SpA	Italy	Automobiles	2.4
General Electric Co.	Toho Mutual Life	Japan	Insurance	2.3
Citigroup Inc.	Worldwide investment banking business of Schroders PLC	United Kingdom	Investment banking	2.2
Cisco Systems Inc.	Fiber-optic networking operations of Pirelli SpA	Italy	Fiber-optic network development	2.2
AES Corp.	Additional 80.2% of Ca La Electricidad de Caracas SACA	Venezuela	Electric utility	1.7
Nationwide Mutual Insurance Co.	Ganmore Investment Management PLC unit of Royal Bank of Scotland Group PLC	United Kingdom	Investment management services	1.6
Corning Inc.	Optical fiber, cable and related equipment businesses of Siemens AG	Germany	Fiber-optic cables	1.4
Smurfit-Stone Container Corp.	St. Laurent Paperboard Inc.	Canada	Paperboard products	1.4
Intel Corp.	Giga A/S unit of NKT Holding	Denmark	Telecommunication network components	1.3
Reliant Energy Inc.	Remaining 48% of Energieproduktiebedrijf UNA NV	Netherlands	Electric utility	1.2
Kohlberg, Kravis Roberts & Co.	Non-speciality organics operations of Laporte PLC	United Kingdom	Pigments, additives, chemical compounds	1.2
AES Corp.	Additional 35.6% of Electopaulo	Brazil	Electric utility	1.1

Acquirer	Target	Domicile of Acquirer	Target Industry	Price (\$ Billions)
	Metropolitana Electricidade de San Paulo SA			
Diamond Technology Partners, Inc.	Cluster Consulting	Spain	Business consulting services	1.1
General Motors Corp.	17.7% of Fuji Heavy Industries Ltd.	Japan	Motor vehicles	1.1
Microsoft Corp.	MediaOne Group Inc.'s 60% stake in Titus Communications Corp.	Japan	CableTV networks	0.9
ADC Telecommunications, Inc.	Altitun AB	Sweden	Semiconductor laser modules	0.9
Delphi Automotive Systems Corp.	Lucas Diesel Systems unit of TRW Inc.	France	Diesel fuel-injection systems	0.9
Siebel Systems Inc.	Janna Systems Inc.	Canada	Electronic systems services	0.9

Table 9 –Top 25 Foreign Acquisitions of U.S. Companies – 1999

Acquirer	Domicile of Acquirer	Target	Target Industry	Price (\$ Billions)
Merger: Vodadone Group PLC	United Kingdom	AirTouch Communications	Mobile telecom and paging services	\$60.3
Scottish Power PLC	United Kingdom	PacificCorp	Electric utility company	12.6
Aegon NV	Netherlands	TransAmerica Corp.	Insurance	10.6
Global Crossing Ltd.	Bermuda	Frontier Corp.	Telecommunications	10.1
Deutsche Bank AG	Germany	Bankers Trust New York Corp.	Bank holding company	9.1
HSBC Holdings PLC	United Kingdom	Republic New York Corp.	Bank holding company	7.7
Vivendi SA	France	United States Filter Corp.	Water and wastewater treatment systems	6.3
New Holland MV	Netherlands	Case Corp.	Farm machinery	6.3
Roche Holding AG	Switzerland	Remaining 33% of Genentech Inc.	Drugs based on DNA and gene, technology	4.8
General Electric Co. P.L.C	United Kingdom	FORE Systems Inc.	Network interfaces and LAN products	4.2
Suez Lyonnaise des Eaux-Dumez SA	France	Nalco Chemical Co.	Water treatment compounds, lubricants, chemicals	4.1
ACE Ltd.	Bermuda	U.S. and international property and casualty units of CIGNA Corp.	Insurance	3.5
Quebecor Printing Inc.	Canada	World Color Press Inc.	Printing services	2.9
Fortis AG	Belgium	American Bankers Insurance Group Inc.	Insurance	2.8
Verengigd Bezit VNU	Netherlands	Nielsen Media Research Inc.	TV audience measurement services	2.8
Koninklijke Numico NV	Netherlands	General Nutrition Cos.	Vitamin and nutrition supplement stores	2.5
Buhrmann NV	Netherlands	Corporate Express Inc.	Office supplies	2.3
General Electric Co. PLC	United Kingdom	Reltec Corp.	Telcommunication systems	2.1
Stagecoach Holdings PLC	United Kingdom	Coach USA Inc.	Motorcoach sightseeing services	1.8
Alcatel SA	France	Xylan Corp.	High-bandwidth switching systems	1.8
News Corp Ltd.	Australia	Remaining 50% of Fox/Liberty Networks	Sports TV network	1.8

Acquirer	Domicile of Acquirer	Target	Target Industry	Price (\$ Billions)
Kensington Acquisition Sub Inc.	Italy and Germany joint venture	Cellular Communications International	Cellular communication services	1.7
Atlas Copco AB	Sweden	Rental Service Corp.	Equipment rental services	1.6
EMAP PLC	United Kingdom	Petersen Cos.	Magazine publishing	1.5
Accor SA	France	Red Roofs Inns. Inc.	Hotels	1.1
Dyckerhoff AG	Germany	Lone Star Industries Inc.	Cement	1.1
Thyssen AG	Germany	Elevator business of Dover Corp.	Elevators	1.1

Table 10 – Top 25 U.S. Acquisition of Foreign Companies – 1999

Acquirer	Target	Domicile of Acquirer	Target Industry	Price (\$ Billions)
Wal-Mart Stores Inc.	ASDA Group PLC	United Kingdom	General-merchandise retailing	\$10.8
TRW Inc.	LucasVarity PLC	United Kingdom	Engineering services; motor vehicle equipment	6.8
General Electric Co.	Japan Leasing Corp. Ltd.	Japan	Business credit services	6.6
Ford Motor Co.	Worldwide passenger vehicle business of Volvo AB	Sweden	Automobiles, trucks, and parts	6.5
Texas Pacific Group Inc.	U.K. retailing business of Allied Domecq PLC	United Kingdom	Pubs	4.3
Ameritech Corp.	20% of Bell Canada	Canada	Telecommunications	3.4
Uniphase Corp.	JDS Fitel Inc.	Canada	Fiber-optic connectors polishing machinery	3.1
AES Corp.	National Power Drax Ltd. unit of National Power PLC	United Kingdom	Electricity generation	3.0
Huntsman Corp.	Polyurethane, titanium dioxide, and selected petrochemical businesses of Imperial Chemical Industries PLC	United Kingdom	Industrial organic chemicals	2.85
CIT Group Inc.	Newcourt Credit Group Inc.	Canada	Equipment financing and leasing services	2.7
Burlington Resources Inc.	Poco Petroleum Ltd.	Canada	Oil and gas	2.5
US West Inc.	9.02% of Global Crossing Ltd.	Bermuda	Internet and telecommunication services	2.5
Weyerhaeuser Co.	MacMillan Bloedel Ltd.	Canada	Paper, pulp products; freight transportation services	2.3
Edison International Corp.	Two power stations of PowerGen PLC	United Kingdom	Electricity-generating power stations	2.1
Du Pont Co.	Herberts Paints GmbH unit of Hoechst AG	Germany	Automobile paints; chemical preparations	1.9
NTL Inc.	Diamond Cable Communications	United Kingdom	Cable TV services	1.9
Electronic Data Systems Corp.	MCI Systemhouse Inc. unit of MCI WorldCom Inc.	Canada	Computer systems	1.7
Ford Motor Co.	Kwik-Fit Holdings PLC	United Kingdom	Auto parts and repair shops	1.6
Gannett Co. Inc.	Newsquest PLC	United Kingdom	Publish newspapers	1.4
Principal Financial Group	BT Funds Management, BT	Australia	Investment banking	1.4

Acquirer	Target	Domicile of Acquirer	Target Industry	Price (\$ Billions)
	Portfolio Services, BT Margin Lending, and BT Investment Banking Business units of Deutsche Bank AG		services	
Energy Partnership Group	Ikon Energy/Multinet Gas	Australia	Natural gas distribution	1.3
Tyco International Inc.	Siemens Electromechanical Components AG unit of Siemens AG	Germany	Relays and electromechanical components	1.1
Global TeleSystems Group Inc.	Esprit Telecom Group PLC	United Kingdom	Telecommunications	0.9
General Electric Co.	Heavy-duty gas turbine business of Alstom SA	Netherlands	Gas turbines	0.9
General Motors Corp.	Arriva Automotive Solutions unit of Arriva PLC	United Kingdom	Vehicle leasing; fleet management	0.8

APPENDIX

DATA ON U.S. FEDERAL TAX REVENUE AND U.S. INTERNATIONAL TRANSACTIONS

Appendix Table 1 – Federal Tax Receipts by Source, 1940-2001
(Billions of Nominal Dollars)

Fiscal Year	Individual Income Tax Receipts	Total Payroll and Self- Employment Tax Receipts	Corporate Income Tax Receipts	Excise Tax Receipts	Estate & Gift Tax Receipts
2001	994.3	693	151.1	66.1	28.4
2000	1,004.5	653	207.3	68.9	20.0
1999	879.5	612	184.7	70.4	27.8
1998	828.6	572	188.7	57.7	24.1
1997	737.5	539	182.3	56.9	19.8
1996	656.4	509	171.8	54.0	17.2
1995	590.2	484	157.0	57.5	14.8
1994	543.1	461	140.4	55.2	15.2
1993	509.7	428	117.5	48.1	12.6
1992	476.0	414	100.3	45.6	11.1
1991	467.8	396	98.1	42.4	11.1
1990	466.9	380	93.5	35.3	11.5
1989	445.7	359	103.3	34.4	8.7
1988	401.2	334	94.5	35.2	7.6
1987	392.6	303	83.9	32.5	7.5
1986	349.0	284	63.1	32.9	7.0
1985	334.5	265	61.3	36.0	6.4
1984	298.4	239	56.9	37.4	6.0
1983	288.9	209	37.0	35.3	6.1
1982	297.7	201	49.2	36.3	8.0
1981	285.9	183	61.1	40.8	6.8
1980	244.1	158	64.6	24.3	6.4
1979	217.8	139	65.7	18.7	5.4
1978	181.0	121	60.0	18.4	5.3
1977	157.6	106	54.9	17.5	7.3
1976	131.6	91	41.4	17.0	5.2
1975	122.4	85	40.6	16.6	4.6
1974	119.0	75	38.6	16.8	5.0
1973	103.2	63	36.2	16.3	4.9
1972	94.7	53	32.2	15.5	5.4
1971	86.2	47	26.8	16.6	3.7
1970	90.4	44	32.8	15.7	3.6
1969	87.2	39	36.7	15.2	3.5
1968	68.7	34	28.7	14.1	3.1
1967	61.5	33	34.0	13.7	3.0
1966	55.4	26	30.1	13.1	3.1
1965	48.8	22	25.5	14.6	2.7
1964	48.7	22	23.5	13.7	2.4
1963	47.6	20	21.6	13.2	2.2
1962	45.6	17	20.5	12.5	2.0

Fiscal Year	Individual Income Tax Receipts	Total Payroll and Self-Employment Tax Receipts	Corporate Income Tax Receipts	Excise Tax Receipts	Estate & Gift Tax Receipts
1961	41.3	16	21.0	11.9	1.9
1960	40.7	15	21.5	11.7	1.6
1959	36.7	12	17.3	10.6	1.3
1958	34.7	11	20.1	10.6	1.4
1957	35.6	10	21.2	10.5	1.4
1956	32.2	9	20.9	9.9	1.2
1955	28.7	8	17.9	9.1	0.9
1954	29.5	7	21.1	9.9	0.9
1953	29.8	7	21.2	9.9	0.9
1952	27.9	6	21.2	8.9	0.8
1951	21.6	6	14.1	8.6	0.7
1950	15.8	4	10.4	7.6	0.7
1949	15.6	4	11.2	7.5	0.8
1948	19.3	4	9.7	7.4	0.9
1947	17.9	3	8.6	7.2	0.8
1946	16.1	3	11.9	7.0	0.7
1945	18.4	3	16.0	6.3	0.6
1944	19.7	3	14.8	4.8	0.5
1943	6.5	3	9.6	4.1	0.4
1942	3.3	2	4.7	3.4	0.4
1941	1.3	2	2.1	2.6	0.4
1940	0.9	2	1.2	2.0	0.4

Source: Office of Management and Budget, Historical Tables, Budget of the United States Government, Fiscal Year 2003.

Appendix Table 2 – U.S. International Transactions, 1960-2001
(\$ millions of nominal dollars)

Year	Exports of Goods Services and Income Receipts	Merchandise Adjusted Excluding Military	Services	Income Receipts on U.S. Assets Abroad	Imports of Goods Services and Income Payments	Merchandise Adjusted Excluding Military	Services	Income Payments on Foreign Assets in the U.S.	Unilateral Transfers Net
	1960	30,556	19,650	6,290	4,616	23,670	14,758	7,674	1,238
1961	31,402	20,108	6,295	4,999	23,453	14,537	7,671	1,245	4,127
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	366,983	211,157	64,079	91,747	355,975	247,642	51,749	56,583	16,544
1983	356,106	201,799	64,307	90,000	377,488	268,901	54,973	53,614	17,310
1984	399,913	219,926	71,168	108,819	473,923	332,418	67,748	73,756	20,335
1985	387,612	215,915	73,155	98,542	483,769	338,088	72,862	72,819	21,998
1986	407,098	223,344	86,689	97,064	530,142	368,425	80,147	81,571	24,132
1987	457,053	250,208	98,661	108,184	594,443	409,765	90,787	93,891	23,265
1988	567,862	320,230	110,919	136,713	663,741	447,189	98,526	118,026	25,274
1989	648,290	359,916	127,087	161,287	721,607	477,665	02,479	141,463	26,169

Year	Exports of Goods Services and Income Receipts	Merchandise Adjusted Excluding Military	Services	Income Receipts on U.S. Assets Abroad	Imports of Goods Services and Income Payments	Merchandise Adjusted Excluding Military	Services	Income Payments on Foreign Assets in the U.S.	Unilateral Transfers Net
1990	706,975	387,401	147,832	171,742	759,287	498,435	17,659	143,192	26,654
1991	727,557	414,083	164,261	149,214	734,563	491,020	18,459	125,084	-10,752
1992	748,603	439,631	176,916	132,056	762,105	536,528	16,476	109,101	35,013
1993	777,044	456,943	185,941	134,159	821,930	589,394	122,281	110,255	37,637
1994	869,328	502,859	201,031	165,438	949,312	668,690	131,878	148,744	38,260
1995	1,005,935	575,204	219,229	211,502	1,081,776	749,374	141,447	190,955	34,057
1996	1,077,966	612,113	240,007	225,846	1,158,822	803,113	150,850	204,859	40,081
1997	1,195,538	678,366	256,614	260,558	1,294,553	876,485	166,260	251,808	40,794
1998	1,191,932	670,416	262,278	259,238	1,364,962	917,112	182,410	265,440	44,427
1999	1,242,655	684,553	272,800	285,302	1,518,106	1,029,987	189,204	298,915	48,913
2000	1,418,568	772,210	293,492	352,866	1,809,099	1,224,417	217,024	367,658	54,136
2001	1,298,397	720,831	283,758	293,808	1,665,325	1,147,446	204,953	312,926	50,501

Source: U. S. Department of Commerce, Bureau of Economic Analysis, May 2001, and U.S. Department of Commerce, news release, "U.S. International Transactions: Fourth Quarter and Year 2001," March 14, 2002.

Note: Dollar figures in millions of current year dollars. Figures for 2001 are preliminary.

**Appendix Table 3 – U.S. Gross Domestic Product, Gross Saving, Gross Investment,
and Net Foreign Investment, 1960-2000**
(billions of nominal dollars)

Year	GDP	Gross Saving	Gross Investment	Net foreign investment
1960	527.4	110.9	110.4	3.2
1961	545.7	113.9	113.8	4.3
1962	586.5	124.6	125.3	3.9
1963	618.7	132.8	132.4	5.0
1964	664.4	143.0	144.2	7.5
1965	720.1	158.1	160.0	6.2
1966	789.3	169.1	175.6	3.9
1967	834.1	171.1	175.9	3.5
1968	911.5	183.3	187.6	1.7
1969	985.3	199.8	202.7	1.8
1970	1,039.7	194.3	201.2	4.0
1971	1,128.6	211.4	222.7	0.6
1972	1,240.4	241.6	250.3	-3.6
1973	1,385.5	294.6	302.6	8.7
1974	1,501.0	304.0	314.0	7.1
1975	1,635.2	298.4	316.1	21.4
1976	1,823.9	342.7	367.2	8.9
1977	2,031.4	398.2	419.8	-9
1978	2,295.9	481.6	502.6	-10.4
1979	2,566.4	544.9	580.6	1.4
1980	2,795.6	555.5	589.5	11.4
1981	3,131.3	666.5	684.0	6.3
1982	3,259.2	625.7	628.2	-0.2
1983	3,534.9	608.0	655.0	-32.0
1984	3,932.7	769.4	787.9	-87.0
1985	4,213.0	772.5	784.2	-110.9
1986	4,452.9	735.9	779.8	-140.6
1987	4,742.5	810.4	813.8	-152.0
1988	5,108.3	936.2	894.0	-113.2
1989	5,489.1	967.6	983.9	-86.7
1990	5,803.2	977.7	1008.2	-69.2
1991	5,986.2	1015.8	1035.4	14.9
1992	6,318.9	1007.4	1051.1	-38.7
1993	6,642.3	1039.4	1103.2	-72.9
1994	7,054.3	1155.9	1214.4	-108.3
1995	7,400.5	1257.5	1284.0	-98.0
1996	7,813.2	1349.3	1382.1	-110.7
1997	8,318.4	1502.3	1532.1	-123.1
1998	8,790.2	1654.4	1629.6	-199.1
1999	9,299.2	1717.6	1645.6	-313.2
2000	9,963.1	1825.1	1741.3	-427.9

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

**Appendix Table 4 – Increase in U.S. Assets Abroad and
Foreign Assets in the United States, 1960-2001**
(millions of nominal dollars)

Year	Increase in U.S. Assets Abroad	Increase in Foreign Assets in U.S.
1960	4,099	2,294
1961	5,538	2,705
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	8,470	6,359
1971	11,758	22,970
1972	13,787	21,461
1973	22,874	18,388
1974	34,745	35,341
1975	39,703	17,170
1976	51,269	38,018
1977	34,785	53,219
1978	61,130	67,036
1979	64,915	40,852
1980	85,815	62,612
1981	113,054	86,232
1982	127,882	96,589
1983	66,373	88,694
1984	40,376	117,752
1985	44,752	146,115
1986	111,723	230,009
1987	79,296	248,634
1988	106,573	246,522
1989	175,383	224,928
1990	81,234	141,571
1991	64,388	110,808
1992	74,410	170,663
1993	200,552	282,040
1994	176,056	305,989
1995	352,376	465,684
1996	413,923	586,038
1997	487,599	759,290
1998	359,632	504,464
1999	437,067	813,744
2000	580,952	1,024,218
2001	439,563	895,459

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

Note: Data for 2001 are preliminary.

**Appendix Table 5 – Selected Nongovernmental Foreign Holdings
of U.S. Assets, Both Portfolio and Direct Investment, 1982-2000
(billions of nominal dollars)**

Year	U.S. Treasury Securities	Corporate and Other Bonds	Corporate Equity	Direct Investment
1982	25,758	16,709	76,279	184,842
1984	62,121	32,421	96,056	223,538
1986	96,078	140,863	168,940	284,701
1988	100,877	191,314	200,978	401,766
1990	152,452	238,903	221,741	505,346
1992	197,739	299,287	300,160	540,270
1994	235,684	368,077	371,618	617,982
1996	502,562	588,044	611,417	745,619
1998	729,738	902,153	1,110,276	912,187
2000	639,684	1,374,259	1,589,714	1,369,505

Source: Harlan W. King, "The International Investment Position of the United States at Year end 2000," "Survey of Current Business, 81, July 2001, pp. 7-29.

Note: Direct investment at current cost.

**Appendix Table 6 – Selected United States Holdings of Foreign Assets,
Both Portfolio and Direct Investment, 1982-2000
(billions of nominal dollars)**

Year	Foreign Corporate Bonds	Foreign Corporate Equity	Direct Investment
1982	56,604	17,442	374,059
1984	62,810	25,994	348,342
1986	85,724	72,399	404,818
1988	104,187	128,662	513,761
1990	144,717	197,596	616,655
1992	200,817	314,266	663,830
1994	321,208	627,460	786,565
1996	465,057	1,002,928	989,810
1998	576,745	1,476,184	1,196,765
2000	577,694	1,828,810	1,445,177

Source: Harlan W. King, "The International Investment Position of the United States at Yearend 2000," Survey of Current Business, 81, July 2001, pp. 7-29.

Note: Direct investment at current cost.

Appendix Table 7 – Cross Border Mergers and Acquisitions, 1991-2000

Year	Foreign Acquisitions of U.S. Companies		United States Acquisitions of Foreign Companies	
	Number of Transactions	Dollar Value (billions)	Number of Transactions	Dollar Value (billions)
1991	539	\$30.8	482	15.3
1992	406	16.1	548	15.6
1993	394	21.0	635	18.2
1994	513	48.2	762	23.4
1995	634	55.2	1,032	46.8
1996	684	79.7	1,160	62.0
1997	837	80.9	1,401	79.8
1998	982	234.0	1,688	119.7
1999	1,151	266.5	1,617	153.8
2000	1,196	340.0	1,502	135.2

Source: Mergers and Acquisitions Almanac, February 2001, p.37.

GLOSSARY

Anti-deferral regimes - special sets of rules (such as the subpart F regime) that act as exceptions to the general rule permitting deferral of tax on income earned through a foreign corporation. Such special rules generally tax residents of a country on their share of certain types of passive or mobile income earned through the foreign corporation.

Balance of payments - balance of payments accounts are analogous to a sources and uses of funds statement of the United States with the rest of the world. They consist of the current account balance, the capital account balance, and the financial account balance.

Business transfer tax (or subtraction-method VAT) - a form of consumption tax in which a statutory tax rate is applied to the difference between an enterprise's taxable sales and its purchases of taxable goods and services from other enterprises.

Capital account - a component of the national income and product accounts, the capital account consists of capital transfers and the acquisition and disposal of non-produced, non-financial assets. For example, the newly defined capital account includes such transactions as forgiveness of foreign debt, migrants' transfers of goods and financial assets when entering or leaving the country, transfers of title to fixed assets, and the acquisition and disposal of non-produced assets such as natural resource rights, patents, copyrights, and leases.

Capital expenditure - an amount paid for permanent improvements or betterments that have a value to the purchaser substantially beyond the taxable year (e.g., a cost to substantially prolong the useful life of property). The cost of a capital expenditure is deducted over a period of years.

Capital export neutrality - an economic theory that posits that income earned by a resident of a country should be taxed at the same rate, whether earned locally or abroad, in order to promote the policy that investment location decisions should be based on business rather than tax considerations.

Capital import neutrality - an economic theory that posits that all income earned within a particular country should be taxed at the same rate, regardless of the residence of the investor, in order to promote the ability of different investors to compete with each other.

Cascading - a consequence of providing certain exclusions from a consumption tax base in which the statutory exemption of a particular transaction in the production and distribution process results in the imposition of multiple layers of tax with respect to the total final purchase price. Cascading violates the fundamental VAT principle that the cumulative amount of tax paid with respect to a good or service at all levels of production and distribution should equal the sales price of the good or service to the ultimate consumer multiplied by the statutory VAT rate.

Classical income tax - an income tax in which corporate earnings are taxed twice: first to the corporation when it earns income, and second to the corporation's shareholders when they receive dividends or sell their shares.

Consumption tax - a generic description for a system that taxes purchases of goods and services by consumers rather than taxing income.

Controlled foreign corporation - a foreign corporation controlled by residents of a particular country (for U.S. tax purposes, more than 50 percent (by vote or value) of the foreign corporation must be owned by U.S. 10-percent shareholders).

Corporate expatriation - the ability of corporations to move their country of residence to another country (through mergers or acquisitions with another company or through other means), often to take advantage of more beneficial tax rules provided in the other country (see also “Inversion Transaction”).

Credit-invoice value added tax - a form of consumption tax in which a statutory tax rate is applied to gross sales with credits provided for taxes previously paid on gross purchases.

Cross-validation - a compliance feature of some (but not all) consumption tax systems in which the proper amount of tax liability at a particular point in the production and distribution process can be verified by reference to the amount of tax already paid at earlier stages in the process.

Current account - a component of the national income and product accounts, the current account measures the trade surplus or deficit; the current account measures the value of imported goods and services, the value of exported goods and services, payments made to foreign persons as a return on their investment in assets located in the United States, and payments made to U.S. persons by foreign persons as a return on U.S. investment in assets located abroad.

Deferral - the ability of a resident of a country to earn income through a foreign corporation and defer paying tax to the residence country until the earnings are repatriated in the form of a dividend.

Destination principle - a consumption tax principle pursuant to which imports are taxed and exports are exempt from tax through border tax adjustments, on the premise that goods and services should be taxed where they are consumed.

Direct investment - investment is labeled a “direct investment” 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.

Dividend exclusion - one type of integration method to reduce or eliminate double taxation of corporate earnings. Under this method, a shareholder simply excludes from gross income dividends received from a corporation.

Domestic corporation - a corporation that is incorporated within the United States.

Domestic international sales corporation (“DISC”) - a regime that was a predecessor to the foreign sales corporation regime and that provided deferral from U.S. tax for certain export transactions. The regime was thought to violate trade rules under the General Agreement on Tariffs and Trade.

Domestic-source income - income that a taxpayer earns or is treated as earning for purposes of a country's tax laws within such country's borders. For U.S. tax purposes, it is income earned or treated as earned within the United States.

Economic depreciation - the actual decline in the value of a capital expenditure over a specified period of time taking into account all relevant factors.

Economic incidence of tax - the financial burden of a tax as determined by changes in market price, wages, and rates of return on investment. For example, although the statutory incidence of a retail sales tax requires actual collection and payment of the tax by retailers, retail customers may actually bear the economic incidence of tax to the extent that retailers can pass the tax that they collect on to customers by increasing prices without losing sales.

Extraterritorial income exclusion ("ETI") - an exclusion from U.S. tax for certain foreign-source sales income. The exclusion was recently held to violate WTO rules.

Financial account - a component of the national income and product accounts, the financial account measures U.S. investment abroad and foreign investment in the United States.

Foreign corporation - a corporation that is incorporated outside the United States.

Foreign direct investment - ownership or control, directly or indirectly, by a single foreign person of at least 10 percent of the voting securities or equivalent interests of a business or assets located in the United States.

Foreign sales corporation ("FSC") - a regime that provided certain exemptions from U.S. tax for export transactions derived through a foreign corporation. The WTO ruled that the regime violated WTO rules.

Foreign-source income - income that a taxpayer earns or is treated as earning for purposes of a country's tax laws outside such country's borders. For U.S. tax purposes, it is income earned or treated as earned outside the United States.

Foreign tax credit - a method employed by many countries to mitigate the possibility of double taxation of foreign-source income through the allowance of a credit against taxes imposed by one country for foreign taxes paid to another country.

Foreign tax credit limitation - a limitation on the amount of foreign tax credits allowed by a country to preserve the taxation of income earned within its borders.

Gross Domestic Product ("GDP") - the value of all final goods and services produced within a country.

Gross National Product ("GNP") - GNP is GDP plus the net factor income received by residents of the United States from abroad. For example, 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.

Imputation credit - one type of integration method to reduce or eliminate double taxation of corporate earnings. Under this method, shareholders of a corporation that receive dividends are entitled to a credit for corporate taxes paid with respect to the dividend.

Integration - an income tax system that significantly reduces or eliminates double taxation of corporate earnings.

Intra-firm trade - trade between related parties. For example, a domestic company might ship components manufactured in the United States to its foreign subsidiary for final assembly and sale. Such shipments would be counted as exports from the United States. A domestic company might produce components abroad and ship them to the United States for final assembly and sale. Such shipments would be counted as imports to the United States.

Inversion transaction - a transaction in which a U.S. corporation effectively reincorporates as a foreign corporation, perhaps in a tax haven, in part to remove its foreign operations from U.S. taxing jurisdiction.

Merchandise trade - imports and exports of goods.

Origin principle - a consumption tax principle pursuant to which domestic production of goods and services is taxed and imported goods are exempt from tax, on the premise that goods and services should be taxed where they are produced.

Participation exemption systems - a feature of some countries' tax systems in which dividends received by a resident company from certain foreign subsidiaries are exempt (either partially or fully) from tax in the residence country.

Portfolio investment - portfolio investment 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.

Retail sales tax - a form of consumption tax in which a statutory tax rate is applied to retail sales (i.e., sales to end-use consumers) of taxable goods and services.

Statutory exemption - a means of providing an exclusion from the tax base of a consumption tax whereby a sale is exempt from the imposition of tax.

Statutory incidence of tax - the legal burden to collect and remit tax. For example, the statutory incidence of a retail sales tax requires actual collection and payment of the tax by retailers, who may not necessarily bear the economic incidence of the tax if they can pass the tax on to customers by increasing prices without losing sales.

Subpart F - a U.S. anti-deferral regime in which U.S. 10-percent shareholders of a controlled foreign corporation are currently taxed on certain mobile or passive income earned by the foreign corporation.

Subtraction method value added tax - a form of consumption tax in which a statutory tax rate is applied to the difference between an enterprise's taxable sales and its purchases of taxable goods and services from other enterprises, also referred to as a business transfer tax.

Territorial tax system - a tax system in which a country taxes only income derived within its borders, irrespective of the residence of the taxpayer.

Transfer pricing rules - rules established to ensure that transactions between commonly controlled entities are based on arm's-length terms.

Value added tax ("VAT") - a form of consumption tax (using either the credit-invoice method or the subtraction method) in which tax is imposed and collected on the "value-added" at every stage in the production and distribution process of a good or service.

World Trade Organization ("WTO") - a multilateral body based in Geneva that oversees international trade.

Worldwide tax system - a tax system in which a country taxes its citizens or resident individuals and entities on their worldwide income.

Zero-rating - a means of providing an exclusion from the tax base of a consumption tax whereby a sale is considered to be taxable, but the statutory rate of tax is zero percent.