



Springing Tax Reform From a Bad WTO Case

Tax Notes

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In its recent Foreign Sales Corporation decision, the Appellate Body of the World Trade Organization trashed legal history. Deciding for the European Union and against the United States, the Appellate Body ignored a settlement negotiated 20 years ago.⁽¹⁾ Yet this bad decision gives Congress a springboard to historic tax reform.

European countries (and many others) routinely exempt their exports from value added tax. This saves European exporters about \$100 billion a year of tax payments on export sales. European firms routinely sell these same exports through tax-haven sales subsidiaries located in exotic places like Bermuda and Hong Kong. This saves European exporters another \$10 billion a year of corporate income tax. By comparison, the Foreign Sales Corporation saves U.S. exporters about \$3.5 billion a year. Most of the 6,000 firms that use the FSC are small and medium-sized exporters with little or no production abroad.

Parallel tax savings are not available to U.S. exporters. The main reason is that the WTO honors an archaic tax distinction that has no economic basis. WTO rules allow corporate taxes measured by value added (Europe) to be excused on exports and imposed on imports. But WTO rules forbid similar adjustments for corporate taxes measured by income (United States) -- even though the distinction between the two tax bases is more form than substance.

In response to the WTO ruling, Congress will not simply repeal the FSC and leave U.S. exporters at an even greater tax disadvantage. The practical question is whether Congress will redress the bad WTO decision by endorsing a small fix, or by attacking the root through tax reform. A small fix is better than nothing. But we urge Congress to use the WTO decision as a springboard for historic tax reform.

Unlike the United States, most other countries have adopted territorial systems of taxation: they do not tax overseas investment. For example, if a French company makes and sells products in the United States (pharmaceuticals, banking, or telecommunications, it doesn't matter), France doesn't tax the income.

The United States, by contrast, has an impractical general rule: it taxes worldwide income. If a U.S. company makes and sells products in France, the U.S. taxes the income. The rule is justified by emotion, not logic: "Every U.S. corporation should pay U.S. tax, whether it operates in Indiana or India, New Mexico or old Mexico." Carried to its extreme, the general rule would render U.S. firms totally noncompetitive in a global economy, both as exporters and producers.

Successive Congresses, in their wisdom, have modified the general rule with practical exceptions, ranging from the foreign tax credit, to deferral, to the FSC. But the tensions between the impractical general rule and the practical exceptions have created an extraordinarily complex U.S. tax code -- a dream for tax lawyers and a nightmare for everyone else.

Meanwhile, old and new problems fester in the world of international taxation. An old problem is the "runaway plant," rechristened by Ross Perot as "the great sucking sound." Will U.S. firms pull up stakes and move to developing countries, and then sell back into the United States -- free of U.S. corporate tax? A new problem is e-commerce. Will U.S. firms be taxed on their Internet sales to customers abroad?

Congress could, in a single historical stroke, level the field of export taxation, end anxiety about runaway plants, resolve the looming debate over e-commerce, and discard the hideously complex corporate income tax. It could achieve all these goals by replacing the corporate income with the model USA tax, jointly sponsored by former Senator Sam Nunn, D-Ga., Sen. Pete Domenici, R-N.M., and Rep. Phil English, R-Pa.

Under the USA business tax, taxable income would be determined by subtracting permitted deductions from taxable receipts. Taxable receipts cover revenue from sales in the United States, but not exports or production abroad. Permitted deductions cover all costs of business purchases from taxpaying U.S. firms. Payments for imports are either taxed directly or disallowed as a permitted deduction. By excluding exports from taxable receipts, and by taxing imports directly or excluding them from deductible expenses, the USA business tax provides a "border tax adjustment" -- just as in Europe.

The USA business tax would level the field of export taxation, eliminate the tax motive for runaway plants, resolve the looming e-commerce debate, and radically simplify the U.S. income tax code. How so?

- The steep tilt in export tax practices is leveled because U.S. companies, like their European counterparts, would pay no tax on exports.
- The runaway plant motive would disappear because any firm that produces abroad and sells in the U.S. market effectively pays the same tax as a competitor located in the United States.
- The looming debate over e-commerce is resolved because sales to foreign buyers are not taxable receipts and purchases from foreign sellers are taxed directly or not allowed as a deductible expenses.

Congress can neither slice bread nor build the Internet. But it can launch a tax triumph from an awful WTO decision.

FOOTNOTE

1. For a critique of the WTO decision, see Gary Hufbauer, "A Critical Assessment," Institute for International Economics, Mar. 11, 2000, <http://www.iie.com>