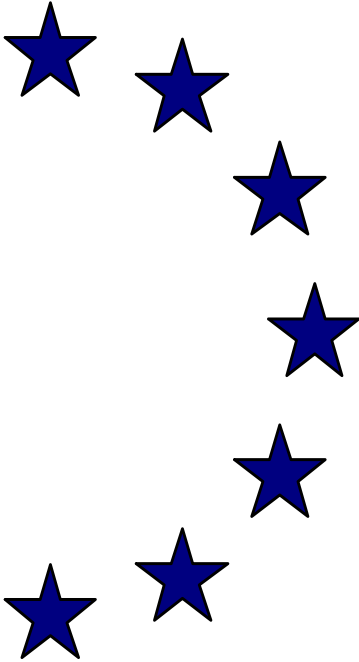
EUROPEAN ECONOMY

EUROPEAN COMMISSION
DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

ECONOMIC PAPERS



ISSN 1725-3187
http://ec.europa.eu/economy_finance/index_en.htm

Number 262 December 2006

Input of the US Advisory Panel on Federal International Tax Reform

by

Joann M. Weiner
(The George Washington University)

Economic Papers are written by the Staff of the Directorate-General for Economic and Financial Affairs, or by experts working in association with them. The "Papers" are intended to increase awareness of the technical work being done by the staff and to seek comments and suggestions for further analyses. Views expressed represent exclusively the positions of the author and do not necessarily correspond to those of the European Commission. Comments and enquiries should be addressed to the:

European Commission
Directorate-General for Economic and Financial Affairs
Publications
BU1 - -1/13
B - 1049 Brussels, Belgium

ISBN 92-79-03838-9

KC-AI-06-262-EN-C

©European Communities, 2006

Input of the U.S. Advisory Panel on

Federal International Tax Reform

Joann M. Weiner*

The George Washington University
Washington, D.C.

* The author is an adjunct professor of Economics at the George Washington University. Corresponding e-mail address: jmweiner@gwu.edu. Helpful comments from Emil Sunley on an earlier version of this paper are greatly appreciated. Any remaining errors are my own.

This paper was prepared for the Commission of the European Communities Directorate-General on Economic Affairs *Workshop on Corporation Income Tax Competition and Coordination in the European Union*, held in Brussels on September 25, 2006. I would like to thank the European Commission for its gracious invitation to participate in the conference.

Introduction

In November 2005, the U.S. President's Advisory Panel on Federal Tax Reform released a comprehensive Report titled "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System."[1] The Report addressed all aspects of the federal income tax treatment of households and businesses under both domestic and international rules. This paper focuses on the proposals dealing with international elements of federal tax reform that affect multinational businesses.

I. International Aspects of the Federal Tax Reform Panel's Plans

The report presents two broad Plans for improving the U.S. Internal Revenue Code in general and the international aspects of the Code in particular.[2] The Simplified Income Tax (SIT) Plan recommends moving toward a territorial-based income tax system that would exempt active foreign-source business income of foreign branches and controlled foreign subsidiaries at the corporate level and would tax mobile foreign-source income. The Growth and Investment Tax (GIT) Plan recommends moving toward a consumption-based tax system that would tax U.S. businesses on total sales less certain inputs. Interest and dividend receipts would be tax exempt to U.S. businesses so that consequently, interest and dividend payments would not be deductible.[3] Table 1 highlights the provisions under 2005 law and the main recommendations under the two Plans that affect large businesses (entities with more than $10 million in annual receipts).

In addition to the two SIT and GIT proposals, the Panel also considered options to replace the federal income tax with a national value added tax or with a broad-based national level retail sales tax. It rejected both of these comprehensive tax reform options. In addition, the Panel did not address moving to another fundamentally different option --- consolidated base taxation with formulary apportionment --- that is under discussion in the European Union.[4]

To highlight the essential aspects dealing with the income tax, this paper will focus on the Simplified Income Tax Plan.

---

[1] See the President's Advisory Panel on Federal Tax Reform, "Simple, Fair & Pro-Growth: Proposals to Fix America's Tax System," November 2005, available at http://www.taxreformpanel.gov/final-report. The Panel was constrained by the requirement that all proposals be revenue neutral. However, revenue neutrality was defined by a baseline that included the President's proposed tax cuts that were not enacted by Congress.

[2] For a comprehensive analysis of the Report, see Ernst & Young "Guide to Tax Reform Panel Report," *Tax Notes*, December 5, 2005, pp. 1255-1309. The Advisory Panel Report follows many of the international reforms presented by the Joint Committee on Taxation. See "Options to Improve Tax Compliance and Reform Tax Expenditures," JCS-02-05, Jan. 27, 2005.

[3] It is not clear whether this consumption-based tax would qualify for foreign income tax credits under U.S. tax treaties or whether it would be challenged under international trade practices.

[4] For an analysis of issues involved in implementing formulary apportionment in the European Union, see Joann Martens-Weiner *Company Tax Reform in the European Union. Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU* New York: Springer Science + Business Media (2006). For a critique of the Panel's failure to address formulary apportionment, see Lee Sheppard, "A Look at the Tax Reform Plan's International Provisions," *Tax Notes*, November 21, 2005, pp. 1002-1008. For details on the European Commission's plans, see the papers on the Commission's Taxation and Custom's Union website at http://www.ec.europa.eu/taxation_customs/taxation/index_en.htm

The outlook for fundamental federal tax reform

Although the Report has been widely debated since its release, there is little expectation that the debate will lead to fundamental tax reform in the near future. Neither the Administration nor the Congress has placed tax reform high on their agendas. In August, U.S. Treasury Secretary Henry Paulson indicated that tax reform is "intricately related" to the Bush administration's goals to reform federal entitlement programs, which given the difficulties in reforming these entitlement programs effectively places tax reform on the back burner. In June, a member of the House Ways and Means Committee expressed his view that Congress is unlikely to act on fundamental tax reform until at least 2009.[5]

Despite the relatively pessimistic outlook for comprehensive tax reform, there is a slightly greater possibility that *international* tax reform may occur. For example, the American Bar Association Section of Taxation's Task Force on International Tax Reform asserted that "a fundamental review of our rules of taxing foreign business income is long overdue."[6] Witnesses speaking before the House Select Revenue Subcommittee in June 2006 stressed the importance of restructuring the international tax system, claiming that the U.S. tax system is not consistent with global developments. Some business commentators have noted that the U.S. tax system is now generally more burdensome than the tax systems of many competing countries so that U.S. companies face a greater overall tax burden than comparable foreign multinational companies doing business in the same markets.[7]

The Federal Advisory Panel, itself, stressed that "our international tax rules are in need of major reform." The Report argued that a major reform, such as adopting a territorial system, could lead to efficiency and simplification gains. It would also address the "competitiveness" concerns of many U.S. multinational corporations by leveling the playing field between U.S. and foreign multinational companies.

II. Current U.S. international tax rules

The Unites States generally taxes its residents on their worldwide income, subject to a limited foreign tax credit with deferral for certain types of income.[8] The U.S. has applied this system essentially since adopting the federal income tax in the early 1900s.[9] The basic policy justification for subjecting both domestic and foreign income, rather than solely domestic

[5] The next U.S. presidential election is in November 2008. Thus, in 2009, the new President may be in a good position to put forward a new agenda. This timing corresponds relatively closely with the timing for company tax reform in the European Union. The European Commission expects to present a legislative proposal during 2008. For details, see the Commission's press release of 5 April 2006 (IP/06/448) and the accompanying Communication (COM\2006\157) on the TAXUD website.

[6] See the American Bar Association Section of Taxation Task Force on International Tax Reform "International Tax Reform: Objectives and Overview," *The Tax Lawyer*, vol. 59, no. 3 (Spring 2006).

[7] See, for example, the statement of Matthew McKenna, Senior Vice President of Finance, PepsiCo, presented to the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means.

[8] This summary is intentionally brief. For a detailed description of the U.S. rules, see Joint Committee on Taxation, *The Impact of International Tax Reform: Background and Selected Issues Related to U.S. International Tax Rules and the Competitiveness of U.S. Businesses* (JCX-22-06), June 21, 2006.

[9] For an analysis of the origin of the U.S. rules, see Michael J. Graetz and Michael M. O'Hear (1997), "The 'Original Intent' of U.S. International Taxation," 46 *Duke Law Journal* pp. 1021-1109.

income, to U.S. taxation is that U.S. residents should face the same rate of taxation on their income regardless of where they earn that income. By following this policy, the income tax system does not encourage foreign investment over domestic investment, or vice versa. The foreign tax credit is intended to eliminate the double taxation that would arise if both the source country and the residence country asserted the right to tax the income earned in the source country.

Deferral and Subpart F

While remaining within the general system of worldwide taxation, the U.S. has regularly modified its practices to reflect changes in the economic, business and political environments. One of the earliest changes, which occurred shortly after the federal government adopted the income tax, was to allow U.S. multinational companies to defer their U.S. tax liability on the active foreign-source income of certain controlled foreign subsidiaries until the subsidiaries repatriated that income to the U.S. parent company. By deferring current U.S. tax, the active business income earned by the foreign operations of U.S. multinational corporations is subject to taxation only in the host country.

A more recent change to the international tax rules occurred when Congress introduced rules to the tax code in the early 1960s that created a separate category of passive foreign-source that would no longer benefit from deferral of U.S. taxation. These rules are contained in Subpart F of the tax code and apply to controlled foreign corporations and their shareholders. Shareholders are subject to current U.S. tax on their pro rata shares of the subpart F income of their controlled foreign corporations. Subpart F income generally includes passive income, such as dividends, interest, rents, and royalties, and other highly mobile income.[10]

Foreign tax credit and foreign loss allocation

The United States offers a foreign tax credit (FTC) for foreign income taxes paid or accrued on foreign-source income, but limits the foreign tax credit to the amount of U.S. tax that would otherwise be due. Thus, subject to certain limitations, a U.S. corporation will pay the same tax whether it earns all of its income domestically or whether it earns some income in foreign countries and then obtains a credit against its U.S. tax liability for foreign income taxes paid.

As in all countries that offer foreign tax credits, the U.S. limits the credit to the domestic tax that would be due on that income to prevent taxpayers from offsetting taxes due on domestic income with their taxes paid on foreign income. If the company does not have enough foreign tax credits to offset its U.S. tax liability, which will generally be the case when the U.S. rate is above the relevant foreign tax rate, it will owe a residual U.S. tax. If the company has an excess of foreign tax credits, its U.S. liability will not be sufficient to offset its entire foreign tax burden.

To prevent companies from "cross crediting" foreign taxes paid in high-tax foreign jurisdictions against the residual U.S. tax due on low-taxed foreign source income, the FTC

[10] Certain passive-type income, such as dividends received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized, is exempt from Subpart F. The Congress also recently extended the exemption for so-called active financing income that was originally enacted in 1997 as a temporary measure for one taxable year.

limitation, until recently, applied to several different types of foreign-source income. The American Jobs Creation Act (AJCA) of 2004 eliminated one basket effective for tax years beginning in 2003 and further reduced the number of baskets to two beginning in 2007.[11] The reduction in the number of baskets has increased a multinational company's ability to cross credit high foreign taxes against U.S. tax liability on low-taxed foreign income.[12]

The U.S. also applies a system of loss allocation within the foreign tax credit rules. If a company has losses in one basket, it must allocate these losses pro rata over all other baskets. If the company has an overall foreign loss, it would not have any foreign tax credits available. If the company uses its foreign losses to reduce U.S. income and subsequently makes profits on its foreign operations, its foreign income would be re-characterized as U.S. income to avoid allowing foreign losses to offset U.S. source income.

Source of income and expense allocation rules

To determine the amount of available foreign tax credits, a multinational company must allocate its income and expenses between domestic and foreign sources. In general, gross income has a source where the activity generating the income is located. Expenses directly related to that income are subtracted to find net income in a location.

Since the source of many items of income and expenses can be difficult to locate, many specific items of income or expenses are allocated across locations according to pre-determined rules. In general, the greater the expenses allocated to foreign sources, the lower the net foreign income and the lower the potentially available foreign tax credits. For example, a U.S.-based multinational corporate group must allocate its interest expense between U.S. and foreign sources based on the ratio of gross assets in the U.S. relative to foreign assets.[13] Thus, the greater the assets abroad, the greater the interest expense allocated to foreign-source income and the lower the foreign tax credit limitation. Since foreign countries do not allow a deduction for interest expense allocated to foreign source income under U.S. rules, this allocation may lead to double taxation.

The interest allocation rules are based on the idea that money is fungible so that interest expenses should be attributed to all of the taxpayer's activities. All members of an affiliated group are treated as a single corporation (under the 'one-taxpayer' rule). The definition of an affiliated group is based on the rules for filing a consolidated return, from which foreign corporations are excluded.

III. The Simplified Income Tax plan

This section first describes the broad changes in the Simplified Income Tax Plan that affect all large businesses. It then describes the changes that affect multinational businesses and their shareholders.

---

[11] The American Jobs Creation Act of 2004, Public Law No. 108-357, 2004.

[12] The AJCA also modified the carry over and carry back period by allowing FTCs to be carried back for one year or to be carried forward for ten years.

[13] The AJCA modified the rules slightly to allow taxpayers to elect a worldwide method that allocates U.S. and foreign interest expenses.

Tax base

The Plan eliminates all credits and all special tax preferences, except for accelerated depreciation. The Plan simplifies the cost recovery system. Under current law, businesses depreciate assets according to nine different asset class lives, three different recovery methods, and three different applicable conventions. The Plan proposes replacing this system with one using four asset categories.

Inbound royalties are taxable and research and development expenses are allocated to U.S. sources. The panel considered a proposal to tax large business entities based on their financial statement net income, but rather than recommending this option, it suggested further study of the idea.

Corporate income tax rate

The Plan reduces the statutory corporate income tax rate to 31.5 percent from the current 35 percent. This reduction would be the first cut in the U.S. corporate income tax rate since the Tax Reform Act of 1986. All business entities would pay the tax regardless of their form of organization.

The Plan eliminates the deduction for state and local taxes. These taxes currently average around 6.6 percent, but the effective rate falls to about 4.5 percent after accounting for federal deductibility. Without federal deductibility, however, the new combined rate is not much lower than the current combined rate.

Definition of residence

In recent years, a few U.S. corporations have moved their legal residence outside the United States to avoid being treated as a U.S. resident for tax purposes. These "foreign" corporations, however, have maintained their business operations in the United States and are effectively U.S. corporations. The corporations have merely "inverted" their corporate structure.

The Plan eliminates this "tax-motivated ploy" by adding a second rule for determining a corporation's residency.[14] In addition to determining residence according to the location of the legal seat of incorporation, a foreign-incorporated enterprise would also be considered a U.S. resident if it is primarily managed and controlled in the United States.[15] This definition follows the protocol to the U.S.-Netherlands income tax treaty.[16]

---

[14] The Advisory Panel indicates its disdain for corporate inversions by noting that the proposal would require that companies whose daily business is managed in the United States "cannot avoid taxes simply by receiving mail and holding a few board meetings each year at an island resort (p. 135)."

[15] Since all U.S. tax treaties presently determine residence of a U.S. corporation based on its legal place of incorporation, the U.S. would have to modify its income tax treaties to account for the additional test.

[16] Sheppard, supra, p. 1003, suggests that if only one element of the international reforms is saved, it should be this re-definition of corporate residence.

International tax rules

In addition to the changes that affect all U.S. companies, the SIT Plan proposes changing the basic way that U.S. multinational corporations are taxed. Under the new territorial-based tax system, income earned abroad, whether by a foreign branch or a foreign controlled corporation, would be treated as either exempt foreign business income or as currently taxable foreign mobile income. Table 2 summarizes the main international elements of the Simplified Income Tax Plan.[17]

The Report notes that the SIT would "update our international tax regime by adopting a system that is common to many industrialized economies" that generally exempt foreign-source dividend income received by resident corporations.[18] The Report notes that many countries, including Canada, France, and Italy, apply predominantly "territorial" tax systems that exempt part or all of the foreign-source dividend income from foreign operations from home country tax.[19] For example, Canada exempts foreign-source dividends by treaty arrangements, while France and Italy exempt 95 percent of such dividends from home taxation.

Since foreign business income would now be exempt from U.S. corporate taxation, the SIT Plan modifies the expense allocation rules relating to this income. Expenses that are allocated to exempt foreign-source income would not be deductible against U.S. income, while expenses allocated to foreign-source taxable income would be deductible. Interest expense would be allocated to foreign-source income according to the worldwide fungibility approach adopted in 2004.

The Plan would treat foreign branches under the same rules that apply to controlled foreign corporations, thus eliminating the distinction between the tax treatment of branches and subsidiaries. As a result, income repatriated from foreign operations would generally not be taxed currently to the U.S. parent or head office regardless of the form of foreign organization.

Individual shareholders would be subject to tax on dividends paid from foreign corporations. The share of dividends attributable to foreign earnings would be determined according to the ratio of adjusted taxable income (which measures domestic income) and worldwide financial income (which measures worldwide income). Capital gains received by individuals from domestic stock would be 25 percent taxable while such gains received from foreign stock would be fully taxable at ordinary rates.

The Plan replaces the foreign tax credit basket system with a single foreign tax credit for foreign taxes paid on mobile income. This proposed change would return the FTC system to the system that essentially existed before the Tax Reform Act of 1986.

---

[17] This table is drawn from Peter Merrill, Oren Penn, Hans-Martin Eckstein, David Grosman, and Martijn van Kessel (2006), "Restructuring Foreign-Source Income Taxation: U.S. Territorial Tax Proposals and the International Experience," *Tax Notes,* May 15, 2006, p. 799.

[18] See Panel Report, supra, page 132 and Table A.2 on page 243.

[19] Among the 30 industrialized OECD countries, nine operate a foreign tax credit system with respect to foreign source dividend income. These countries are the Czech Republic, Iceland, Ireland, Japan, Korea, Mexico, New Zealand, Poland, the United Kingdom, and the United States. All of the EU-15 member states belong to the OECD, but not all of the current 25 EU member states belong to the OECD.

Finally, the Report makes a practical two-pronged suggestion. U.S. multinational corporations should file with their tax return a schedule showing their consolidated pre-tax worldwide revenues and income and then reconcile the consolidated revenues and income reported on their financial statements with the taxable revenues and income reported on their tax returns. The Plan notes that this disclosure would increase the transparency of the tax system.

IV. Analysis of key issues in the Simplified Income Tax Plan

1. Tax Competition: The corporate income tax rate and corporate tax revenues

The SIT Plan cuts the corporate tax rate to 31.5 percent. Although this cut will narrow the gap between the U.S. rate and the rates in the European Union countries, after taking into account local taxes but not taking into account the planned reductions in EU countries, the U.S. rate would still be above the rate in nearly all EU countries.[20]

Chart 1 ranks the 25 EU member states and the United States according to the combined federal-local statutory corporate income tax rate in 2006. Within the European Union, Cyprus has the lowest rate at 10 percent and Germany has the highest rate at 38.6 percent. The U.S. combined rate of 39.3 percent is not only above the average EU-25 member state rate, but also it is above the rate in each of the 25 EU member states.

As part of the Tax Reform Act of 1986, the United States cut the corporate income rate from 46 percent to 34 percent. This move was nearly concurrent with rate reductions in the UK and Canada that further spurred a worldwide reduction in corporate income tax rates.

However, while most countries have continued to reduce their rates over the past two decades, the United States has gone in the other direction, increasing its statutory tax rate by one percentage point in 1993 and maintaining the rate at 35 percent since then.[21] By contrast, since 1995, the average combined corporate tax rate in the EU-15 member states has fallen by 8.5 percentage points, so that the average rate in these countries is just under 30 percent. The average rate in the ten new EU member states has fallen by more than 10 percentage points during that period, so that the average rate in these countries is now slightly over 20 percent.[22] (See Chart 2).

Whereas the U.S. became a leader in moving toward low tax rates following the tax rate reductions of 1986, two decades later, the United States seems locked in place as a high-rate

[20] Slovenia announced plans to reduce its corporate income tax rate from 25 percent to 23 percent in 2007 and to 20 percent by 2010. Germany is also considering reducing its corporate income tax rate from 25 percent to 19 percent.

[21] The relatively minor changes in the combined U.S. rate are due entirely to changes at the state level. The average U.S. state corporate income tax rate is roughly 4.5 percent (after accounting for the deductibility of state income taxes against federal income tax.). The unweighted average state corporate tax rate rose from 6.68 percent in 1990 to 6.75 percent in 2005. See Martin A. Sullivan, "On Corporate Tax Reform, Europe Surpasses the U.S.," *Tax Notes*, May 29, 2006, pp. 992-995. State tax rate data are from the Tax Foundation, www.taxfoundation.org/taxdata/show/230.html.

[22] Malta has not reduced its rate since 1995. Estonia eliminated the tax on retained earnings in 2000; distributed earnings are taxed at 23 percent. For detailed data, see European Commission Directorate-General Taxation and Customs Union, Tax Policy (2006) *Structures of the Taxation Systems in the European Union, 1995-2004*, TAXUD E4/2006/DOC/3201.

country. The U.S. statutory tax rate is now more than 13 percentage points above than the EU-25 average and more than 6 points higher than the EU-15 average.[23]

This stagnation appears even starker when the U.S. rate is compared to individual EU countries. For example, Chart 3 compares the U.S. with two of the EU-15 Member States. A decade ago, the U.S. had the lowest combined federal and state/local rate of the three countries. Germany's rate was particularly high, approaching 60 percentage points. Since that time, both Germany and Ireland have significantly cut their tax rates. The combined rate in Germany has fallen by more than 18 percentage points since 1995 and in Ireland by more than 27 percentage points since 1995.[24] Germany now taxes corporate profits at roughly the same rate as the United States while Ireland applies a significantly lower rate than both Germany and the United States.

The high tax rate in the U.S. does not necessarily translate to high revenue from the corporate income tax. Chart 4 shows the ratio of corporate income tax revenue to GDP for the U.S. and the EU from 1995 to 2004. Chart 5 shows the ratio of corporate income tax to total tax over the same period. These charts show volatility in corporate income tax revenues in the United States and other countries, but no clear connection between high tax rates and high tax revenues.

2. Taxing on a territorial basis

Many members of the U.S. business community have encouraged a debate on the merits of moving away from the worldwide income tax system to a territorial-based income tax system. They have based their arguments on the importance of improving the "competitiveness" of American multinationals doing business in foreign countries. In particular, by exempting foreign-source income from home country taxation, the U.S. would promote the idea that all income earned within a country should face the same tax rate. This system contrasts with the idea that all income earned by a resident of the home country should be taxed at the same rate regardless of where it is earned.

Some have expressed a concern that the tax base may shift to low-tax countries if the U.S. moves to a territorial system. However, the data show that there is no clear relationship between corporate tax rate and whether a country taxes on a worldwide or a territorial basis. Table 3 shows that the average tax rate among the 9 OECD countries with a basic worldwide system with foreign tax credits is roughly equal to the average rate in the 21 OECD countries with a basic territorial system that exempts foreign-source dividends.

Table 4 restricts the analysis to the EU members of the OECD and shows that the average tax rate in the four worldwide countries is 24 percent, which is below the 29 percent average in the EU members of the OECD that tax on a territorial basis.[25] The 12.5 percent rate in Ireland drives the average rate for the worldwide EU countries significantly down. Without Ireland, the average in the other three countries rises to 27.8 percent, which is roughly equal to the average in the EU territorial countries. The U.S. rate of 39 percent is well above the rate in any of the EU member states.

---

[23] These rates are unweighted rates. Using rates weighted by GDP, the US rate is more than 6 percentage points above the EU-25 average rate.

[24] Ireland offered a preferential ten percent rate to manufacturing in certain areas; Ireland replaced that targeted rate with a 12.5 percent rate that applies to all companies.

[25] See Table II-5.1 in European Commission (2006). The rates are unweighted averages.

Proponents of worldwide taxation argue that it promotes "efficiency" better than territorial taxation since it taxes investment income at the same rate wherever earned. By facing the same tax rate wherever they invest, the tax system does not distort the investment location decisions and multinational companies allocate capital to its most efficient location rather than to its most tax-favored location. By contrast, proponents of a territorial system argue that it promotes "competitiveness" better than worldwide taxation since it taxes all investment in a country at the same rate.

In practice, the differences in the tax systems between the countries that tax on 'predominantly' a worldwide basis and those that tax on 'predominantly' a territorial basis are minimal. For example, since the U.S. allows tax deferral of active foreign business income, that type of income is generally treated as if on a territorial basis. Likewise, because territorial countries generally tax the passive income of foreign operations, their income is generally taxed as if on a worldwide basis.

There is an important difference between the basic worldwide system and the basic territorial system. The territorial system would eliminate the "repatriation" tax that currently applies when CFCs repatriate foreign earnings to their U.S. parent companies. In testimony before the House Subcommittee on Select Revenue Measures, Yale law professor Michael Graetz, for example, argues that the main reason to move to an exemption system is to remove the repatriation tax and to remove the tax barrier to investing in the United States.

Despite the Subpart F rules, U.S. multinational corporations may repatriate income to the U.S. without paying additional U.S. tax as long as they are able to use effective tax planning to find these tax-favored channels. As the Panel Report notes, "the U.S. tax on dividend payments can be though of as elective, much like the tax on capital gains (p. 103)." Thus, the outcome is roughly the same under territorial and worldwide systems as implemented, but the territorial exemption system achieves this result at a lower cost to U.S. multinationals and, therefore, has an advantage over the worldwide system.

Finally, since the Panel did not propose any major reductions to the corporate income tax rate, the U.S. statutory corporate income tax rate remains well above the typical foreign tax rate. Thus, many U.S. multinational companies benefit from the policy of deferral. As long as the U.S. remains a high-tax country, the benefits from moving toward a territorial system are likely to be lower than expected.

3. Pressure on source rules and transfer pricing

Exempting foreign-source income may encourage U.S. companies to attribute a greater share of their income to foreign sources than to domestic sources. Thus, there will be increased pressure on the source rules to establish where income was earned. Moreover, the tax authorities will have to strengthen enforcement of the transfer pricing rules to combat against abusive income shifting practices.

The Panel report admits that the pressures to attribute income to foreign countries are greater under a territorial system than under a worldwide system. Although dividend payments would be exempt, service fees, rents, royalties and interest payments would be taxable when paid by a controlled foreign corporation to a U.S. corporate shareholder (this is the practice under

current law and is consistent with the idea that these payments are deductible in the host country.).

Therefore, U.S. corporations would have an incentive to price these amounts artificially low either to reduce the residual U.S. tax due on these payments or to convert them to tax-favored dividend payments.[26] U.S. multinationals would also have an incentive to shift income to their CFCs by setting artificially low transfer prices for the intercompany sale of goods so that the parent company could then receive tax-free dividend payments in return.

[26] For empirical evidence, see Harry Grubert, "Enacting Dividend Exemption and Tax Revenue," 54(4) *National Tax Journal* 816 (December 2001).

V. Conclusion

The U.S. Advisory Panel on Federal Tax Reform presented a Simplified Income Tax Plan designed to reduce the complexity of the international income tax rules and to improve the competitiveness of U.S. multinational enterprises. In many respects, the Plan achieved its goals by proposing to exempt active foreign business income from U.S. taxation and to simplify the foreign tax credit system.

In other aspects, however, it did not reach its goals. For example, the Plan marginally reduces the statutory corporate tax rate and requires increased enforcement of the already complex anti-abuse transfer pricing and related rules. Moreover, the broad-based business support that is essential to implement international tax reform is lacking, thus, making the prospects for such reform remote.

Table 1. Summary of the U.S. tax system in 2005 and the Simplified Income Tax and the Growth and Investment Tax plans

	Current law (2005)	**Simplified Income Tax Plan**	**Growth and Investment Tax Plan**
Large Business			
Tax rates	8 brackets, 15% to 35%	One rate, 31.5%	One rate, 30%
Investment	Accelerated depreciation	Simplified accelerated depreciation	Expensing for all new investment
Interest paid	Deductible	No change	Not deductible (except for financial institutions)
Interest received	Taxable (except tax exempt bonds)	Taxable	Not taxable (except for financial institutions)
International tax system	Worldwide with deferral of active income; Foreign tax credits	Territorial tax system	Destination-basis (border tax adjustments)
Corporate AMT	Yes	Repealed	Repealed

Source: Executive Summary to the *Report of the President's Advisory Panel on Federal Tax Reform*, pp. xvi-xvii.

Table 2. International Elements of the Simplified Income Tax Plan

Item	SIT Plan
1. Taxation of corporate shareholders	
- Dividends paid from active foreign business income	Exempt or currently taxation, depending on whether income is classified as "mobile."
-Foreign subsidiary passive income	Taxed currently
- Foreign subsidiary non-passive "mobile" income	Subpart F regime continues to apply, but with a permanent exception for active financial services income
- Gain on disposition of foreign subsidiary stock	Exempt to the extent of undistributed earnings and profits
- Domestic expenses allocable to exempt income	General and administrative and interest expenses allocable to exempt income would not be deductible. Interest would be allocated based on rules adopted in the American Jobs Act of 2004.
2. Foreign partnership and branch income	
	Foreign branches treated the same as foreign corporations; no proposal regarding foreign partnerships
3. Taxation of individual shareholders	
- Dividends from domestic corporations	A fraction is exempt based on prior year share of U.S. taxable income in worldwide income
- Dividends from foreign corporations	Taxable regardless of extent of corporation's U.S. earnings
- Capital gains on domestic stock	25% taxable
- Capital gains on foreign stock	Fully taxable

Source: Table 1 in Peter Merrill, Oren Penn, Hans-Martin Eckstein, David Grosman, and Martijn van Kessel (2006), "Restructuring Foreign-Source Income Taxation: U.S. Territorial Tax Proposals and the International Experience," *Tax Notes*, May 15, 2006.

Table 3. Tax Rates and Systems: Members of the Organization for Economic Cooperation and Development, 2005

Country	Tax Rate	Country	Tax Rate
Territorial		*Worldwide*	
Hungary	16.0%	Ireland	12.5%
Iceland	18.0	Czech Rep.	26.0
Slovak Rep.	19.0	Korea	27.5
Switzerland	21.3	Poland	27.5
Austria	25.0	Mexico	30.0
Portugal	25.0	United Kingdom	30.0
Finland	26.0	New Zealand	33
Norway	28.0	United States	39.3
Sweden	28.0	Japan	39.5
Denmark	28.0	**AVERAGE**	**29.5**
Australia	30.0	**Avg., w/o Ireland**	**31.6**
Turkey	30.0		
Luxembourg	30.4		
Netherlands	31.5		
Greece	32.0		
Italy	33.0		
France	33.8		
Belgium	34.0		
Spain	35.0		
Canada	36.1		
Germany	38.9		
AVERAGE	**28.4**		

Note: The combined corporate income tax rate includes the basic central government corporate income tax rate adjusted for any surtaxes and sub-central government corporate income taxes.
Source: Organization for Economic Cooperation and Development (2006), *Taxation in OECD Countries*, OECD: Paris.

Table 4. Tax rates and Systems: EU members of the OECD, 2005

Country	Tax Rate	Country	Tax Rate
Territorial		*Worldwide*	
Hungary	16.0%	Ireland	12.5%
Slovak Republic	19.0	Czech Rep.	26.0
Austria	19.0	Poland	27.5
Portugal	25.0	United Kingdom	30.0
Finland	26.0	**AVERAGE**	**24.0**
Sweden	28.0	**Avg., w/o Ireland**	**27.8**
Denmark	28.0		
Luxembourg	30.4	United States	39.3%
Netherlands	31.5		
Greece	32.0		
Italy	33.0		
France	33.8		
Belgium	34.0		
Spain	35.0		
Germany	38.9		
AVERAGE	**29.0**		

Source: European Commission (2006).

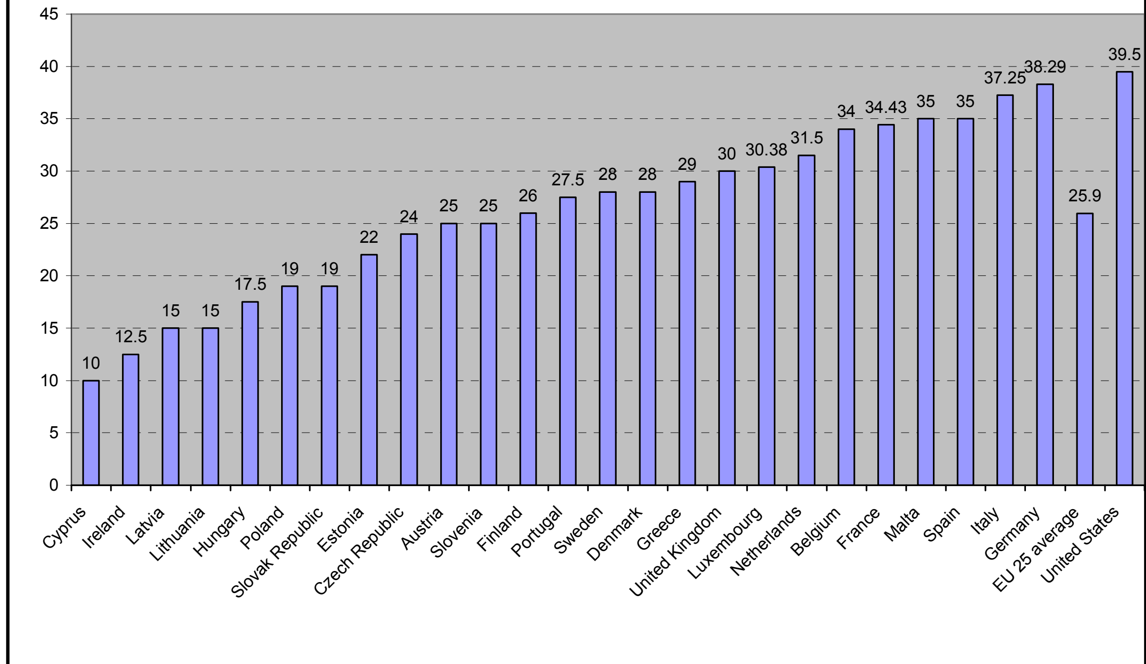


Chart 1. Corporate Income Tax Rates
in the EU and the US, 2006
45
40
35
30
25
20
15
10
5
0
10
12.5
15
15
17.5
19
19
22
24
25
25
26
27.5
28
28
29
30
30.38
31.5
34
34.43
35
35
37.25
38.29
25.9
39.5
Cyprus
Ireland
Latvia
Lithuania
Hungary
Poland
Slovak Republic
Estonia
Czech Republic
Austria
Slovenia
Finland
Portugal
Sweden
Denmark
Greece
United Kingdom
Luxembourg
Netherlands
Belgium
France
Malta
Spain
Italy
Germany
EU 25 average
United States

Chart 2. Average EU-25, EU-15, EU-10 and US Combined Corporate Income Tax Rates

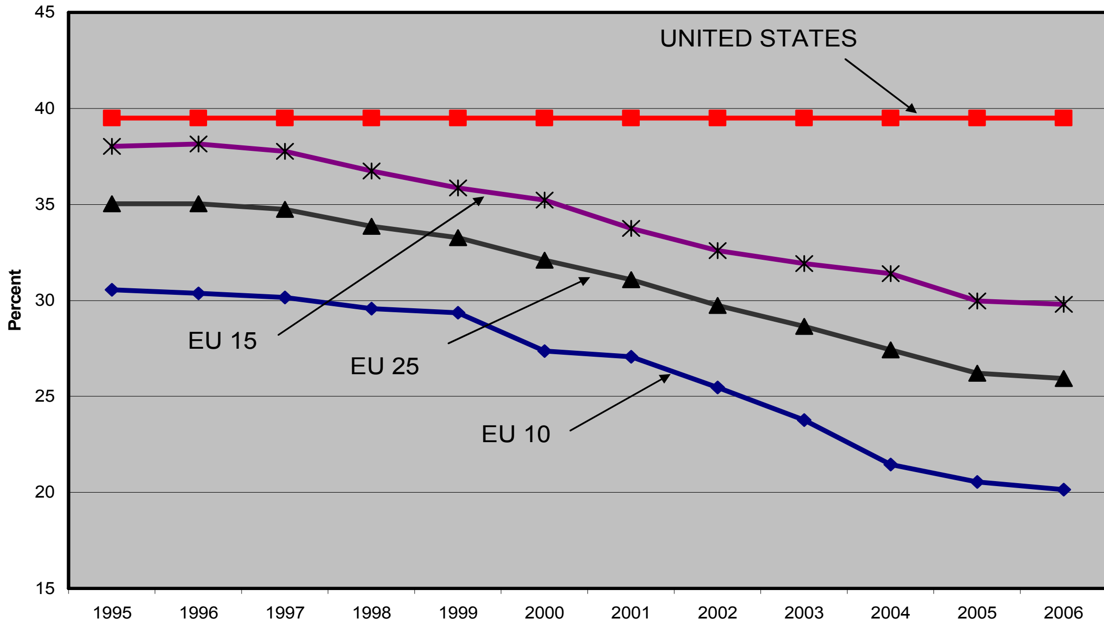


Chart 3. CORPORATE INCOME TAX RATES IN GERMANY, IRELAND, AND THE UNITED STATES

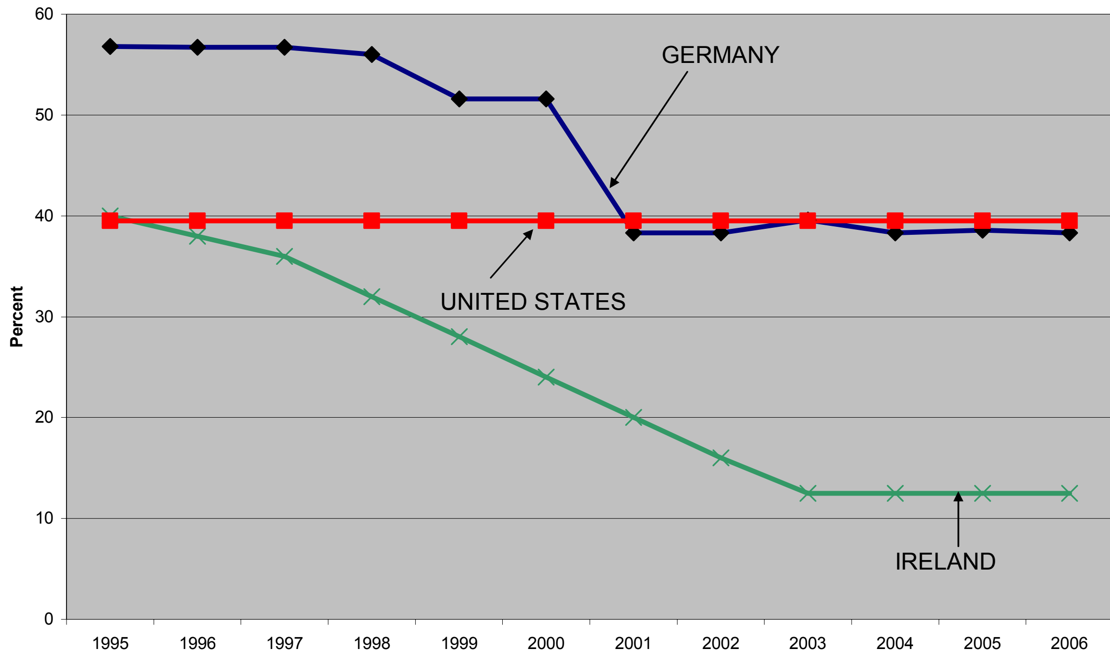


Chart 4. Corporate Income Tax Receipts as a Share of GDP

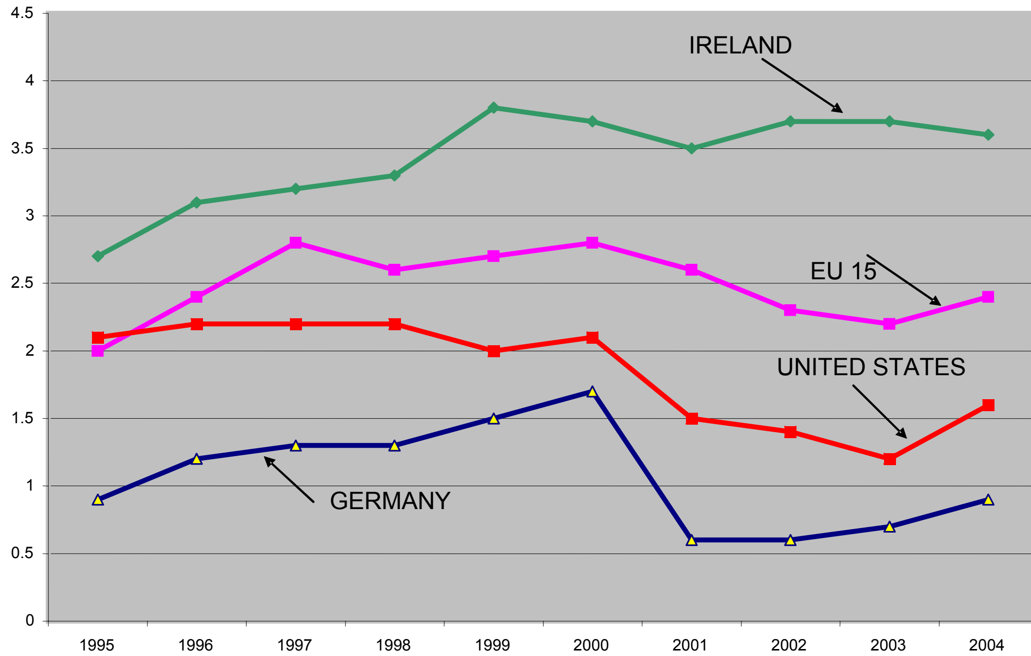


Chart 5. Corporate Income Tax as a Share of Total Tax Receipts