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MAKING TAX LEMONADE OUT OF WTO LEMONS

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The European Union (EU) has been arguing that certain provisions of the U.S. tax code—the Extraterritorial Income Exclusion Act (ETI) and its predecessor, the Foreign Sales Corporation (FSC) law—are illegal export subsidies. The Brussels-based bureaucracy has petitioned the World Trade Organization (WTO) to declare that these sections of tax law violate international treaty obligations, and on four separate occasions the WTO has sided with the EU.

The EU has now won for a fifth time. The WTO announced late last month that the EU is allowed to impose $4 billion of compensatory taxes on U.S. exports if the ETI/FSC provisions are not repealed. This was a defeat for the U.S. government, which had argued those punitive tariffs should not exceed $1.1 billion.

The WTO decision has caused understandable anxiety among U.S. policymakers. Some question whether the WTO should be allowed to exercise any authority over non-tariff tax matters. Others wonder if the process is fair, since EU nations have a policy of rebating the value-added tax on exports, which provides a much larger tax preference than does the ETI/FSC provisions. But even if these concerns are justified, they do not change the fact that the United States has suffered five consecutive defeats and has no realistic hope of reversing the WTO's position. The real issue, then, is how the Administration should react to the WTO ruling.

Limited Choices. U.S. policymakers have only three options:

1. **Ignore** the ruling and maintain existing law. Although the WTO cannot force the United States to make any tax law changes, this "do-nothing" approach would give the EU a green light to impose the $4 billion of taxes on American products exported to Europe.
2. **Repeal** the ETI/FSC provisions of the U.S. code. Although eliminating these provisions would bring U.S. law into compliance with the ruling, this "capitulation" option would mean a significant tax increase for export-oriented U.S. companies.
3. **Repeal** the ETI/FSC provisions and shift to a territorial tax system. This is known as the "level playing field" option since most European nations use this approach. Firms would not receive a tax preference for exports in a territorial tax regime, but the U.S. government would no longer subject U.S. companies to taxes on their foreign earnings.

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Two of the three options are clearly bad. The "do-nothing" alternative would mean higher taxes on U.S. exports and therefore fewer sales for U.S. producers. The "capitulation" option would mean higher taxes on U.S. exporters, which presumably would make American companies less competitive.

The "level playing field" option is the only attractive alternative. Indeed, the WTO decision may be a blessing in disguise if it provides impetus for a long-overdue reform of America's international tax policy. Under the current system, American-based companies are subject to "worldwide" taxation. This means that the foreign earnings of companies are taxed both by the IRS and by the country where the income is earned. If lawmakers switched to a territorial system, the U.S. government would only tax income earned inside U.S. borders, and American companies would no longer suffer a disadvantage in the world market.

Table 1 EM834

How U.S. Companies Suffer a Competitive Disadvantage

	Profit	Local Tax	"Home Country" Tax	Total Tax
U.S. company	$100	$10	$25 to IRS	$35
Local company	$100	$10	N/A	$10
Dutch company	$100	$10	$0	$10

Source: Heritage Foundation calculations.

An Uncompetitive System. Even though U.S. companies sometimes can defer the tax on their foreign income and often can claim a credit for taxes paid to foreign governments, worldwide taxation makes it very difficult for American firms to compete internationally. For example, an American-based company operating in Ireland is at a competitive disadvantage since its profits are subject to the 35 percent U.S. corporate income tax, as well as Ireland's corporate tax. A Dutch firm, by contrast, only pays Ireland's low corporate tax rate of between 10 percent and 16 percent, since Holland has a territorial tax system.

The adverse impact of America's worldwide tax regime is magnified by high tax rates. According to a recent KPMG survey, the U.S. corporate income tax rate is the fourth highest in the developed world. And since Belgium and Italy have announced tax rate reductions, the United States soon may have the dubious distinction of having the industrial world's second highest corporate tax rate. The combination of high rates and worldwide taxation puts U.S. firms at a serious disadvantage. For example, even if the U.S. company is allowed to fully benefit from a $10 foreign tax credit, thus reducing the U.S. tax to $25, the company may still pay two or three times as much tax as its foreign counterparts on overseas income. (See Table 1.)

Tax Reform. Territorial taxation would allow U.S. companies to compete on a level playing field in foreign markets. Like companies based in most other nations, they would not pay domestic taxes on foreign income. Instead, that income would be subject only to the tax rates imposed by the governments where the income was earned. Territorial taxation is much simpler to administer and yields compliance savings to the government and private sector. Companies could refocus the resources allocated to legal, accounting, and consulting on projects that improve performance.

Territorial taxation also would solve the alleged problem of "corporate expatriation." Because America's system of worldwide taxation hinders competitiveness, some companies re-charter in foreign jurisdictions with better tax laws. Certain politicians have attacked such companies as "unpatriotic," but fixing the underlying problem in the tax code would be more constructive. The White House should take the lead and push for international tax reform. The WTO decision creates a golden opportunity, particularly since other options are so unpalatable. Territorial taxation has an added advantage in that it is the only pro-growth way of ending the incentive for corporate expatriation.

Without the Administration's leadership, reform will be much harder to achieve. The Chairman of the House Ways and Means Committee, William Thomas (R–CA), has proposed a bill (H.R. 5095) to repeal the FSC/ETI provisions and use the revenue to fix some of the worst aspects of worldwide taxation. This bill would improve the tax law substantially, but greater progress would be possible with active White House participation.

Conclusion. It is important for America to comply with WTO treaty obligations. It is also important to deal with corporate expatriation in a positive manner. For these reasons, worldwide taxation should be repealed. Territorial taxation is good tax policy that would improve the competitiveness of American companies. Workers, consumers, and shareholders would reap the benefits. Such tax reform is vital to America's interests.

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NOTE: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.