Taxation of Foreign Income by the U.S. and Other Governments

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American Taxation of Foreign Income.

- The U.S. practice of taxing foreign business income is unusual – in almost every respect – in the world today.
  - The United States taxes corporate income at very high rates compared to other countries.
  - The United States taxes active foreign business income, which is becoming a rarity.
  - The United States tightly restricts the ability of American firms to continue to defer U.S. taxation of unrepatriated foreign income.
  - The U.S. limits the extent to which firms with foreign income can effectively deduct general expenses incurred in the U.S.
- As a result, the U.S. system imposes significant tax burdens on the foreign business activity of U.S. companies.
- These tax burdens, since they are unusual, impact the competitive positions of U.S. companies.

American Business Taxation.

- The first notable attribute of U.S. business taxation is that the combined U.S. statutory corporate tax rate (35% federal, plus state taxes) is high by world standards.
- It was not always the case that the U.S. tax rate was so much higher than those of most other countries, but over the past 20 years foreign tax rates have fallen as the U.S. statutory tax rate has remained steady.

OECD Country	2008 corporate tax rate
Australia	30.00
Austria	25.00
Belgium	33.99
Canada	33.50
Czech Republic	21.00
Denmark	25.00
Finland	26.00
France	34.43
Germany	30.18
Greece	25.00
Hungary	20.00
Iceland	15.00
Ireland	12.50
Italy	27.50
Japan	39.54
Korea	27.50
Luxembourg	30.38
Mexico	28.00
Netherlands	25.50
New Zealand	30.00
Norway	28.00
Poland	19.00
Portugal	26.50
Slovak Republic	19.00
Spain	30.00
Sweden	28.00
Switzerland	21.17
Turkey	20.00
United Kingdom	28.00
United States	39.25

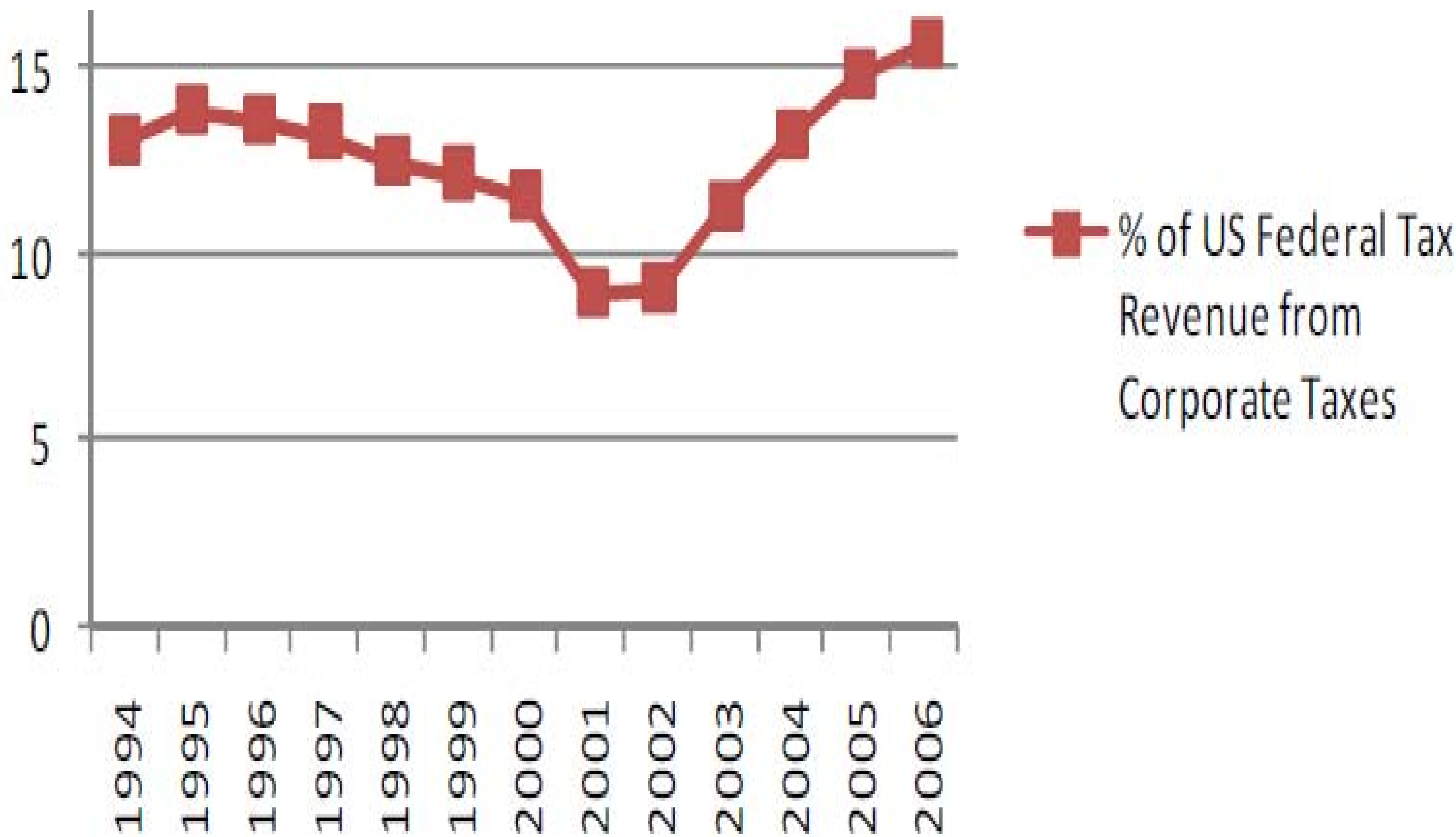
OECD Country	2008	2002	1997	1992	1988
Australia	30.00	30.0	36.0	39.0	39.0
Austria	25.00	34.0	34.0	30.0	55.0
Belgium	33.99	40.2	40.2	39.0	43.0
Canada	33.50	38.62	44.62	44.34	44.34
Czech Republic	21.00	31.0	39.0	-	-
Denmark	25.00	30.0	34.0	34.0	50.0
Finland	26.00	29.0	28.0	39.0	51.5
France	34.43	35.43	41.66	34.0	42.0
Germany	30.18	38.9	56.8	58.2	60.0
Greece	25.00	35.0	35.0	46 -- 35	49.0
Hungary	20.00	18.0	18.0	40.0	n.a.
Iceland	15.00	18.0	n.a.	n.a.	n.a.
Ireland	12.50	16.0	36.0	40.0	47.0
Italy	27.50	36.0	53.2	52.2	46.4
Japan	39.54	40.9	50.0	50.0	n.a.
Korea	27.50	29.7	n.a.	n.a.	n.a.
Luxembourg	30.38	30.38	n.a.	n.a.	n.a.
Mexico	28.00	35.0	34.0	35.0	39.2
Netherlands	25.50	34.5	35.0	35.0	42.0
New Zealand	30.00	33.0	33.0	33.0	28.0
Norway	28.00	28.0	28.0	28.0	50.8
Poland	19.00	28.0	38.0	40.0	n.a.
Portugal	26.50	33.0	37.4	39.6	48.08
Slovak Republic	19.00	25.0	40.0	-	-
Spain	30.00	35.0	35.0	35.0	35.0
Sweden	28.00	28.0	28.0	30.0	56.6
Switzerland	21.17	24.4	28.5	28.034	30.595
Turkey	20.00	33.0	n.a.	n.a.	n.a.
United Kingdom	28.00	30.0	31.0	33.0	35.0
United States	39.25	39.30	39.45	38.86	38.6

2008		2002		1997		1992		1988		1984	
39.54		40.9		56.8		58.2		60.0		61.8	
39.25	USA	40.2		53.2		52.2		56.6		60.0	
34.43		39.30	USA	50.0		50.0		55.0		56.6	
33.99		38.9		44.62		46.0		51.5		55.12	
33.50		38.62		41.66		44.34		50.8		55.0	
30.38		36.0		40.2		40.0		50.0		51.0	
30.18		35.43		40.0		40.0		49.0		50.8	
30.00		35.0		39.45	USA	40.0		48.1		50.0	
30.00		35.0		39.0		39.6		47.0		50.0	
30.00		35.0		38.0		39.0		46.4		49.8	USA
28.00		34.5		37.4		39.0		44.34		46.4	
28.00		34.0		36.0		39.0		43.0		46.0	
28.00		33.0		36.0		38.86	USA	42.0		45.0	
28.00		33.0		35.0		35.0		42.0		45.0	
27.50		33.0		35.0		35.0		39.2		45.0	
27.50		31.0		35.0		35.0		39.0		45.0	
26.50		30.38		34.0		34.0		38.6	USA	43.0	
26.00		30.0		34.0		34.0		35.0		42.0	
25.50		30.0		34.0		33.0		35.0		40.0	
25.00		30.0		33.0		33.0		30.595		35.0	
25.00		29.7		31.0		30.0		28.0		32.866	
25.00		29.0		28.5		30.0					
21.17		28.0		28.0		28.034					
21.00		28.0		28.0		28.0					
20.00		28.0		28.0							
20.00		25.0		18.0							
19.00		24.4									
19.00		18.0									
15.00		18.0									
12.50		16.0									

Statutory tax rates.

- Tax bases also differ significantly among countries, so a simple comparison of statutory tax rates has the potential to give a misleading idea of tax burdens.
- The difficulty is that there is no simple method of comparing tax base definitions across countries.
- Tax collections, which can be compared across countries, offer a glimpse into relative tax burdens, but the problem with tax collection information is that heavy tax burdens prompt avoidance that then depresses tax payments – but may not relieve burdens very much.
- Separately, some methods of avoiding corporate taxes – use of debt, or establishing unincorporated businesses – trigger greater individual tax obligations that do not appear in revenue statistics for corporate taxes.
- U.S. corporate tax collections are typical of OECD countries as a fraction of total tax revenue, though low as a fraction of GDP.

Figure 1. Trends in U.S. Federal Corporate Income Tax Revenue


15
10
5
0
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
% of US Federal Tax Revenue from Corporate Taxes

American Taxation of Foreign Income.

- The United States taxes the worldwide incomes of American individuals and corporations.
- In particular, the United States taxes active foreign income earned by American corporations.
  - Taxes are in some cases deferred until income is repatriated in the form of dividends.
  - Taxpayers are entitled to claim foreign tax credits for foreign income tax payments.
- Few other OECD countries tax active foreign income earned by their resident companies.
  - Even the 2005 country listing by the Presidential Advisory Panel is now out of date, with a diminishing number of countries – notably including Japan and the U.K. – taxing active foreign income.

Table 1.5: Territorial vs. Worldwide Treatment of Foreign Dividend Income by Country, 2005

Territorial (Exemption)	Worldwide (Foreign Tax Credit)
Australia*	Czech Republic
Austria	Ireland
Belgium	Japan
Canada*	Korea
Denmark	Mexico
Finland	New Zealand
France**	Poland
Germany	United Kingdom
Greece*	United States
Hungary	
Iceland	
Italy**	
Luxembourg	
Netherlands	
Norway	
Portugal*	
Slovak Republic	
Spain	
Sweden	
Switzerland	
Turkey	

*Exemption by treaty agreement.
**Exemption of 95 percent.

Source: President's Advisory Panel on Federal Tax Reform (2005).

A bit more detail.

- Tax systems are not quite as stark as either "territorial" or "worldwide," though this distinction captures quite a bit of the essence.
- In part, the "territorial" v. "worldwide" distinction carries over to a number of the implementing details.
- The 2001 NFTC report describes then-existing differences among G-7 countries (with the Netherlands instead of Italy) this way:

Country	Basic method of taxation	Types of double taxation relief available	General limitations imposed on double tax relief
Canada	Worldwide income except income from treaty countries, which is exempt.	Mixed credit and exemption system.	Per country credit limitation with business and non-business baskets. Exemption limited to active business income earned in treaty countries.
France	Generally taxed only on French source income.	Primarily exemption system with limited use of credit system.	Exemption limited to active business income.
Germany	Worldwide income except income from treaty countries, which is exempt.	Mixed credit and exemption system.	Per country credit limitation with no basketing rules. Fifteen percent of exempt income subject to German tax. Exemption limited in some cases if income is not subject to foreign tax.
Japan	Worldwide income regardless of geographic origin.	Credit system.	Overall credit limitation. Certain high-rate taxes may not be creditable. Two-thirds of untaxed income excluded from numerator of calculation. Ninety percent maximum limitation ratio.
Netherlands	Generally taxed only on Dutch source income.	Primarily exemption system with limited use of credit system.	Exemption generally only applies to active business income subject to tax in a foreign jurisdiction.
United Kingdom	Worldwide income regardless of geographic origin.	Credit system.	Item-by-item credit limitation, but can be avoided on foreign dividends through use of onshore pooling regime.
United States	Worldwide income regardless of geographic origin.	Credit system.	Credit limitation computed for nine different baskets using detailed look-through rules.

Foreign Tax Credits.

- The primary U.S. method of preventing double taxation is the granting of foreign tax credits for foreign income tax payments.
- The U.S. limits foreign tax credits to U.S. tax liabilities on foreign income, in order to prevent taxpayers from offsetting U.S. tax liabilities on U.S. income with tax payments to foreign governments.
- In practice, the foreign tax credit limit has the potential significantly to influence U.S. tax burdens on foreign income.

Foreign Tax Credit Limitation

- Historically, the US has had various rules for computing the FTC limit, including: overall limit; per-country limit; greater or lesser of overall and per-country limit; and separate limitations by type of income (e.g., passive).
- FTC limitation currently is calculated separately for two main categories:
  - Passive income
  - General income (i.e., other than passive)
- Additional limitations apply to certain income (e.g., oil & gas extraction income)
- The purpose of the FTC “baskets” is to prevent averaging of taxes among different types of income.

Other U.S. Foreign Tax Credit Rules

- Look through rules for basketing income.
- Indirect FTC applicable to dividends paid through no more than six tiers of foreign corporations.
- Loss rules
  - Recharacterization of income between domestic and foreign source following domestic or overall foreign losses
  - Spreading of losses and recharacterization of income among foreign tax credit baskets
- Person allowed to claim FTC ("technical" taxpayer rule).
- Holding period requirements.

Expense Allocation Rules.

- U.S. taxpayers are entitled to claim deductions for expenses that can be definitely allocated to foreign or domestic income production.
- What about more general expenses, such as…
  - Research and Development
  - Interest
  - General and Administrative expenses
- These must be allocated between U.S. and foreign source in calculating foreign tax credit limits.
  - Allocation is based on relative foreign and domestic activity.
  - In practice what this means is that U.S. taxpayers with excess foreign tax credits lose the benefits of any portion of these deductions allocated to foreign income.

Implications of Expense Allocation Rules.

- These rules burden outbound investment, since firms with greater foreign activity are required to allocate higher portions of their domestic deductions against foreign income. If these firms have excess foreign tax credits, they lose the benefits of the deductions, thus pay higher taxes.
- These rules also discourage taxpayers from incurring allocable costs in the United States, if they have significant foreign activity.
- No other country has rules like the U.S. rules.

Country	Interest allocation rules	Loss resourcing rules	Credit carryover rules
Canada	Detailed rules do not exist. Interest expense related to exempt holdings is deductible.	No loss resourcing rules. However, if domestic loss prevents use of the credit, taxpayer can transform credit into an equivalent NOL amount.	No carryover for excess non-business credits, but excess may be deducted. Excess business credits may be carried back three years and forward seven.
France	Detailed rules do not exist. Interest expense related to exempt holdings is deductible.	No loss resourcing rules.	Limited use of credit system. Credit system allows for a five year carryforward of unused credits.
Germany	Detailed rules do not exist. Interest expense related to exempt holdings is deductible.	No loss resourcing rules.	Excess credits may not be carried back or forward, but excess can be deducted.
Japan	Detailed rules do not exist.	No loss resourcing rules.	Both excess credits and excess limitation can be carried forward three years.
Netherlands	Interest on loans entered into within six months may not be deductible if related to the acquisition of a foreign participation. Otherwise detailed rules do not exist.	Both foreign and domestic loss recapture rules apply to proportional deduction on branch income.	Limited use of credit system. Credit system allows for indefinite carryover of unused credits.
United Kingdom	Detailed rules do not exist.	No loss resourcing rules.	No carryover for unused credits except for excess "EUFT" under the onshore pooling regime, which can be carried back three years and forward indefinitely.
United States	Detailed rules requiring allocation of interest on a water's edge basis using adjusted bases or fair market values of assets.	Detailed rules require only resourcing of foreign source income subsequent to an overall foreign loss. Similar rules for domestic losses offsetting foreign income do not exist.	Excess taxes carried back two years and forward five years.

Impact of U.S. Expense Allocation.

- Significant amounts of domestic expenses ($110.8 b in 2004) are allocated against foreign income each year.
- For this and other reasons, U.S. firms may wind up with significant excess foreign tax credits that cannot be used to reduce U.S. tax obligations on foreign income – even though average foreign tax rates are below the U.S. tax rate.
- 9.4b in 1998 out of 47.6b current taxes; in 2000, 12.4 b out of 52.5 b. 2002: 17.5 b out of 57.1 b

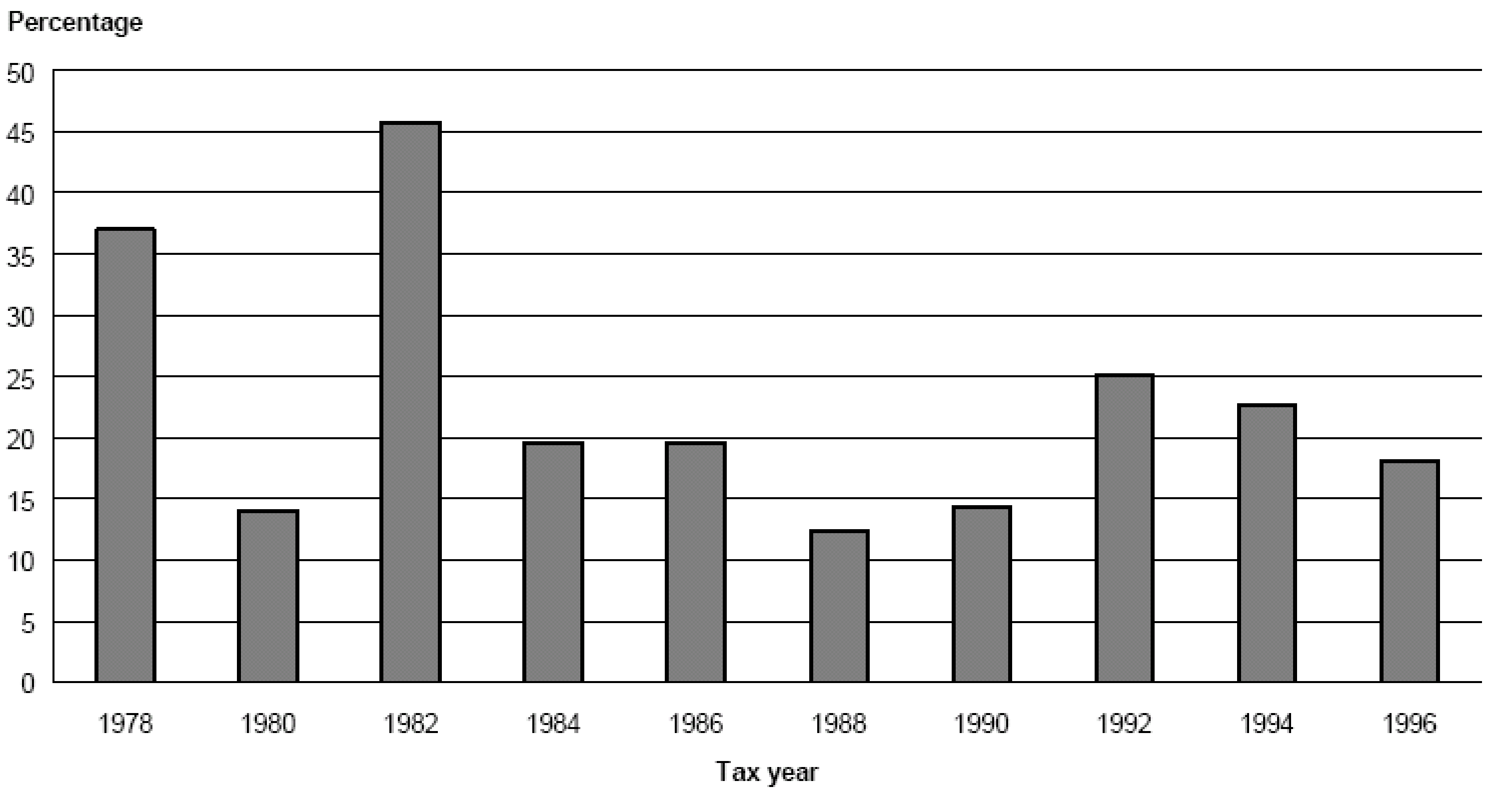
Year	Number of returns	Deductions not allocable to specific types of income				Taxable foreign income (less loss) before adjustments	Foreign tax credit claimed
		Total	Research and development	Interest	Other		
1992	5,147	46,074,597	3,322,556	22,125,537	17,546,722	86,924,737	21,532,736
1993	6,322	56,490,849	3,031,964	26,319,175	26,706,975	94,687,024	22,894,610
1994	7,199	60,002,879	4,937,048	26,629,892	26,872,347	101,521,278	25,418,684
1995	6,710	79,650,578	8,198,150	35,916,338	34,779,814	120,517,753	30,415,605
1996	6,100	88,355,742	9,232,584	35,536,186	41,326,284	150,826,345	40,254,937
1997	6,569	94,428,510	9,565,637	43,342,264	40,176,836	157,989,290	42,222,743
1998	5,927	94,247,133	9,876,318	49,478,293	32,808,117	147,116,869	37,338,380
1999	5,789	102,542,312	9,539,700	51,322,499	41,287,061	165,712,961	38,271,294
2000	5,917	125,377,761	11,364,335	63,781,017	49,133,088	196,675,289	48,355,433
2001	5,478	109,909,312	9,122,373	52,679,130	47,638,165	164,753,343	41,358,458
2002	4,767	79,729,471	9,118,649	32,748,184	36,911,292	160,855,609	42,419,115
2003	5,409	93,226,238	11,961,592	32,120,658	47,669,031	205,129,663	49,963,270
2004	5,502	110,817,387	13,485,504	42,001,568	54,391,211	241,493,136	56,593,276

Industries	Number of returns	Deductions not allocable to specific types of income				Taxable foreign income (less loss) before adjustments	Foreign tax credit claimed
		Total	Research and development	Interest	Other		
	(1)	(31)	(32)	(33)	(34)	(36)	(12)
All industries	5,502	110,817,387	13,485,504	42,001,568	54,391,211	241,493,136	56,593,276
Agriculture, forestry, fishing, and hunting	210	* 21,971	* 673	* 10,534	* 10,633	107,736	11,559
Mining	112	1,022,125	* 23,501	482,400	482,337	4,418,975	1,434,081
Utilities	7	* 54,649	0	* 29,501	* 25,026	* 89,888	* 29,961
Construction	235	21,810	* 101	* 890	* 20,493	108,170	21,821
Manufacturing	1,039	46,096,041	10,906,052	15,239,527	19,617,336	154,593,276	37,151,333
Wholesale and retail trade	658	2,686,030	70,576	1,019,125	1,445,641	11,669,584	2,985,951
Transportation and warehousing	68	1,335,443	* 25,432	8,600	1,295,194	2,444,326	197,508
Information	607	6,660,160	2,145,207	704,809	3,753,108	14,580,764	2,764,509
FIRE	965	23,114,114	* 15,804	11,017,958	11,823,907	29,584,426	5,745,227
Services	1,603	29,805,044	298,157	13,488,225	15,917,537	23,895,992	6,251,328

Binding Foreign Tax Credit Limits.

- U.S. taxpayers face binding FTC limits.
- Even after doing various things to avoid excess foreign tax credits, U.S. taxpayers wind up with about 20% of their foreign taxes unused as carryforwards each year (some of which expire unused).
  - 2002: $17.5 b aggregate FTC carryforward out of $57.1 b in foreign taxes available for credit.
  - 2000: $12.4 b FTC carryforward out of $52.5 b in foreign taxes available for credit.
  - 1998: $9.4 b FTC carryforward out of $46.7 b in foreign taxes available for credit.
  - Earlier years exhibit similar patterns.

Carryforward as a Percentage of Foreign Taxes Available for Credit, Even Tax Years 1978-1996



Timing of Taxation: Anti-Deferral Regimes

- In 1961, Kennedy Administration proposed to tax US shareholders on income currently earned by controlled foreign corporations (“CFCs”), except in developing countries
  - US exchange rate was fixed and investment abroad by US companies depleted US gold reserves
- Congress rejected Administration’s proposal as anti-competitive and, in 1962, adopted a more targeted “Subpart F” regime aimed at “passive” and “mobile” income
  - Passive income provisions intended to address “incorporated pocketbook,” i.e., shifting of passive income abroad
  - Active income provisions intended to serve as a “backstop” to the rudimentary arm’s-length pricing rules then in force
  - At the time, no other country had a similar anti-deferral regime

Subpart F Regime

- Subpart F treats certain types of income (“Subpart F income”) earned by controlled foreign corporations (“CFCs”) as distributed pro rata to certain US shareholders for US tax purposes
  - Applies to US persons owning at least 10% of the voting stock of a CFC (“10% shareholders”)
  - A CFC is defined as a foreign corporation that is more than 50% owned, by vote or value, by 10% shareholders
- US shareholder is taxed on pro rata share of Subpart F income whether or not actually distributed by the foreign corporation
  - Corporate shareholders generally may claim an indirect FTC with respect to Subpart F income as if actually distributed
  - Actual distributions made out of such previously taxed Subpart F income are not taxable to the shareholder

Subpart F Income

- Subpart F income includes Foreign Base Company Income and certain other types of income
- Foreign Base Company ("FBC") Income includes:
  - Foreign personal holding company income
  - Foreign base company sales, services, and oil-related income
- Special rules applicable to foreign base company income
  - De minimis rule.—If FBC income is less than $1 million or 5% of CFC income then none of the income is treated as FBC income
  - "De maximis" rule.—If more than 70% of CFC's income is FBC income then all of the CFC's income is treated as FBC income
  - High tax exception.—If CFC receives FBC income that is taxed at a rate more than 90% of the US rate, such income is not treated as subpart F income

Subpart F Income (cont’d)

- Foreign Personal Holding Company (“FPHC”) Income
  - FPHC income consists mainly of passive income, such as: interest, dividends, rents, and royalties as well as certain income from commodities, factoring, foreign currency, and notional principal contract transactions
  - Exceptions and special rules
    - Same country exception
    - Unrelated party active rent and royalty exception
    - Active finance exception (expires after 2009)
    - CFC look-through rule (expires after 2009)

Subpart F Income (cont'd.)

- Foreign Base Company Sales Income
  - Arises when a CFC sells goods that are both made and sold for use outside its country of incorporation and are either purchased from, or sold to a related party, except if CFC is manufacturer
    - New regulations tighten definition of manufacturing
  - Among other things, creates an incentive to establish separate distributors in every country rather than use a regional distributor
- Foreign Base Company Services Income
  - Arises when CFC performs services outside its country of incorporation for a related person or on behalf of a related person
- Foreign Base Company Oil-related income
- Other types of Subpart F income
  - Subpart F insurance income (sec. 953)
  - Investments in US Property (sec. 956)
  - Bribes and income from proscribed countries

Other Anti-Deferral Regimes

- Personal Holding Company (1934)
- Passive Foreign Investment Company (1986)
  - Overlap with CFC regime eliminated in 1997
- “Excess” passive asset regime (1993-96)

Comparison of Anti-Deferral Rules

Canada, France, Germany, Japan, the Netherlands and UK

- Two general approaches
  - Transaction-based systems (like Subpart F) used in US, Canada and Germany
  - Jurisdiction or entity-based approach used in France, Japan, and UK
  - Exemptions in both systems tend to reduce differences in practice
- Other than the US, countries with transactions-based anti-deferral regimes generally exempt active business income, such as foreign base company sales and service income
- Jurisdiction-based anti-deferral regimes generally tax all income of subsidiaries in low-tax countries, but generally exempt active business income that has some local connection.
- Examples from NFTC 2001 study are illustrative.

Table 4–1a. Summary of Examples

Country	Active financial services income from unrelated parties	Active financial services income from related parties	Engaged in active business-dividend from active business subsidiary in another country	Holding company-dividend from active subsidiary in another country
Canada	Deferred	Deferred	Deferred	Deferred
France	Deferred	Deferred	Deferred	Attributed, but gets 100% participation exemption
Germany	Deferred	Taxed currently	Deferred if holdings are commercially related to its own active business	Taxed currently unless it would have been exempt to parent
Japan	Deferred	Taxed currently	Deferred	Taxed currently
Netherlands	Deferred	Deferred	Deferred	Deferred
United Kingdom	Not taxed currently	Taxed currently	Deferred	Deferred if CFC has a business establishment effectively managed there and 90% of its income is from companies in active business
United States	Taxed currently*	Taxed currently*	Taxed currently	Taxed currently

*Ignores effects of active financial services legislation.

Table 4–1b. Summary of Examples

Country	Engaged in active business-interest from active subsidiary in another country	Holding company-interest from active subsidiary in another country	Active business-royalty payments from subsidiary in another country
Canada	Deferred	Deferred	Deferred
France	Deferred	Taxed currently	Deferred
Germany	Deferred if lent on a short-term basis or if funds are borrowed on foreign capital market and lent on a long-term basis	Deferred if funds are borrowed on foreign capital market and lent on a long-term basis	Deferred if used on R&D and no participation of related parties
Japan	Deferred	Taxed currently	Deferred if its meets non-related party or location criteria
Netherlands	Deferred	Deferred	Deferred
United Kingdom	Deferred	Deferred if CFC has a business establishment effectively managed there and 90% of its income is from companies in active business	Deferred
United States	Taxed currently	Taxed currently	Taxed currently

Table 4–1c. Summary of Examples

Country	Holding company royalty payments from subsidiary in another country	Active oil-related income from unrelated parties buying and selling outside CFC country	Active oil-related income-buying from unrelated parties in another country selling to related parties in another country
Canada	Deferred	Deferred	Deferred
France	Taxed currently	Taxed currently	Taxed currently
Germany	Taxed currently	Deferred	Deferred
Japan	Taxed currently	Deferred	Deferred
Netherlands	Deferred	Deferred	Deferred
United Kingdom	Deferred if CFC has a business establishment effectively managed there and 90% of its income is from companies in active business	Deferred	Taxed currently
United States	Taxed currently	Taxed currently	Taxed currently

Table 4–1d. Summary of Examples

Country	Active sales income—bought from related in another country sold to unrelated in another country	Active sales income—55% bought from unrelated in another country all sold to unrelated in another country	Active business—55% income from unrelated parties in CFC country, 45% service income from related party in another country	Increase in investment in home country
Canada	Deferred	Deferred	Deferred	Deferred
France	Taxed currently	Taxed currently	Deferred	Deferred
Germany	Deferred	Deferred	Deferred unless services provided to party subject to German tax	Deferred
Japan	Deferred	Deferred	Deferred	Deferred
Netherlands	Deferred	Deferred	Deferred	Deferred
United Kingdom	Taxed currently	Deferred	Deferred	Deferred
United States	Taxed currently	45% taxed currently	45% taxed currently	Taxed currently

Subpart F income of U.S. Controlled Foreign Corporations

Year	Subpart F Income	Current Earnings & Profits (less deficit) after Income Taxes
2004	$ 47.8 b	$ 292.9 b
2002	31.4 b	162.1 b
2000	29.4 b	164.4 b
1998	20.2 b	109.1 b
1996	22.9 b	108.6 b
1994	16.3 b	75.2 b
1992	13.2 b	73.0 b
1988	12.1 b	63.1 b

Source: IRS, Statistics of Income

Differences and impact.

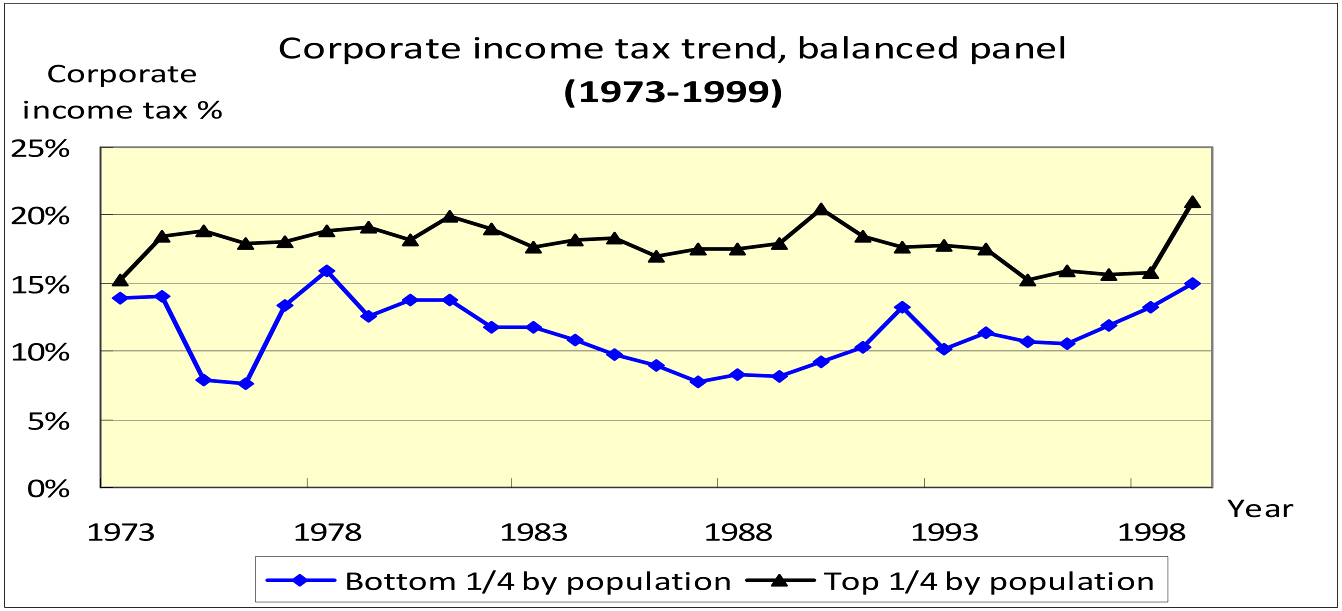
- There are other differences between U.S. and foreign systems of taxing foreign income.
- For example, the U.S. does not offer "tax sparing" credits for investments in developing countries, whereas by the early 1990s the U.K. had "tax sparing agreements with 26 countries, and Japan had "tax sparing" agreements with 15 countries.
- The net impact of all these provisions is that there is a substantial U.S. tax liability associated with outbound investment by U.S. firms.

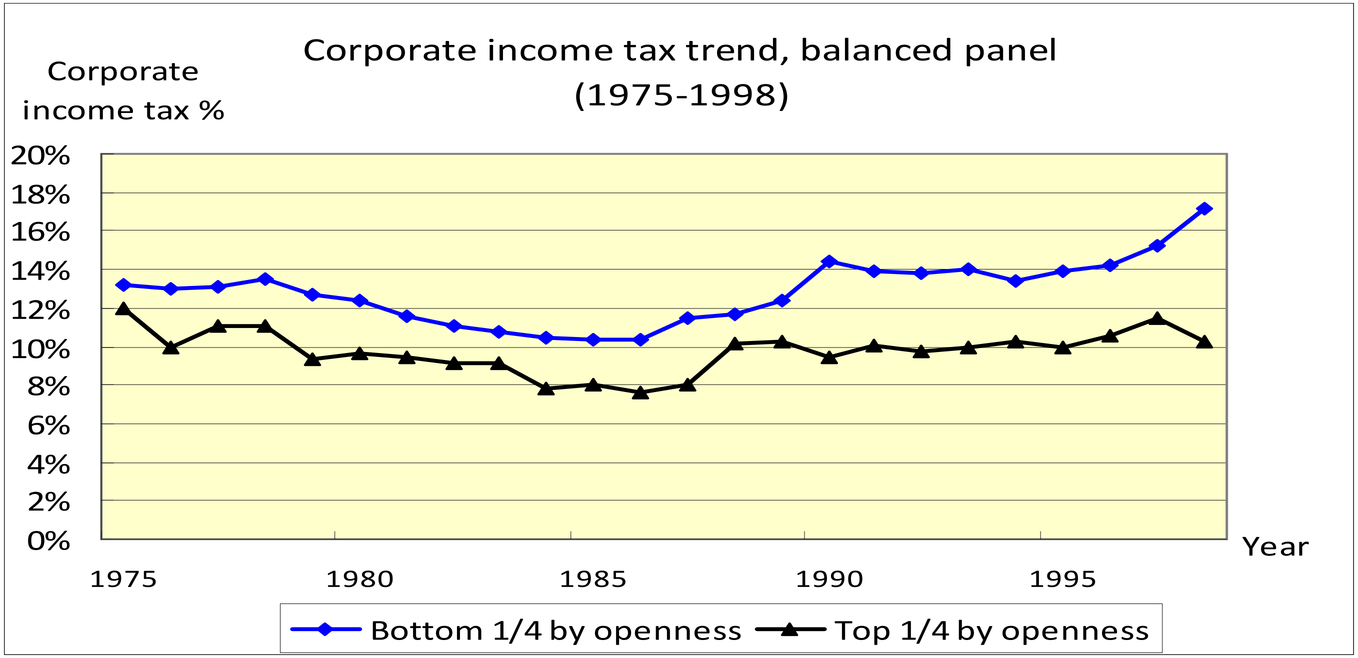
How large is the U.S. tax burden?

- It is a mistake to look only at tax collections, since that does not incorporate the costs that taxpayers incur in avoiding business decisions that would trigger higher taxes.
- Desai and Hines (2004) estimate the net U.S. burden on outbound foreign investment, including the costs of avoidance, at roughly $50b per year.
- Others disagree.

What are the implications of unusually heavy taxation of foreign income?

- High levels of taxation distort business production activities, and thereby reduce the productivity of factors – primarily labor – located in the United States.
- Much of this takes place by distorting the ownership of capital assets, discouraging American ownership in favor of foreign ownership.
- What is the likely direction of policy?
- For that we can look at countries that have long been globalized: small and open economies.


Corporate income tax trend, balanced panel
(1973-1999)
Corporate income tax %
25%
20%
15%
10%
5%
0%
1973
1978
1983
1988
1993
1998
Year
Bottom 1/4 by population
Top 1/4 by population


Corporate income tax trend, balanced panel
(1975-1998)
Corporate income tax %
20%
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
1975
1980
1985
1990
1995
Year
Bottom 1/4 by openness
Top 1/4 by openness

American policy.

- The United States has a relatively small public sector, accounting for about 26% of GDP, significantly lower than the 36% OECD average. (2004 figures)
- U.S. personal income taxes account for a much higher fraction (35%) of total U.S. taxes than is true of the OECD average (25%).
- The U.S. gets 8.7% of its tax revenue from corporate taxes (v. 9.6% for the OECD average) [2004 data].
- Taxes on goods and services are much lower for the U.S. (18% of revenue) than for the OECD (32%).
- The top U.S. personal income tax rate of 41% is typical of OECD countries, though the U.S. corporate income tax rate of 39% is the highest in the OECD, well above the 30% average.
- The United States still has a large country tax policy.

Table 1.6: Consumption Taxes among OECD Countries

Country	Taxes on Goods and Services*: Percentage of GDP	Taxes on Goods and Services*: Percentage of Total Taxation	Taxes on General Consumption*: Percentage of GDP	Taxes on General Consumption*: Percentage of Total Taxation	Value-Added Taxation**: Standard VAT Rate
	Percent				
Australia	8.6	27.8	4.1	13.4	10.0
Austria	12.0	28.4	7.9	18.9	20.0
Belgium	11.5	25.3	7.3	16.1	21.0
Canada	8.5	25.4	5.0	15.0	7.0
Czech Republic	11.8	31.3	7.2	19.2	19.0
Denmark	16.2	32.2	10.0	19.9	25.0
Finland	13.8	31.3	8.7	19.8	22.0
France	11.2	25.3	7.8	17.1	19.6
Germany	10.1	29.0	6.3	18.0	16.0
Greece	9.4	34.6	6.0	22.2	19.0
Hungary	14.8	39.7	10.5	28.1	20.0
Iceland	16.7	40.4	11.5	27.7	24.5
Ireland	11.6	37.8	7.7	25.1	21.0
Italy	10.8	26.4	6.0	14.6	20.0
Japan	5.3	19.4	2.6	9.5	5.0
Korea	8.8	34.3	4.5	17.5	10.0
Luxembourg	11.1	28.8	6.2	16.1	15.0
Mexico	11.3	56.7	3.8	19.1	15.0
Netherlands	12.4	31.7	7.6	19.5	19.0
New Zealand	12.1	32.1	9.0	23.8	12.5
Norway	12.2	27.9	7.9	18.1	25.0
Poland	12.6	36.7	7.7	22.5	22.0
Portugal	13.6	39.3	8.3	23.8	21.0
Slovak Republic	12.5	39.7	7.9	25.1	19.0
Spain	10.0	28.0	6.2	17.5	16.0
Sweden	13.2	26.1	9.4	18.5	25.0
Switzerland	7.0	23.6	4.0	13.4	7.6
Turkey	15.9	49.3	7.1	21.8	18.0
United Kingdom	11.1	30.3	6.8	18.6	17.5
United States	4.8	17.4	2.2	8.0	0.0
Unweighted Average	11.4	31.9	6.9	18.9	17.1

*Figures are for 2005.

**Figures are for 2006.

Source: OECD, *Revenue Statistics* (2007) and OECD Tax Database, www.oecd.org

Tax policies around the world.

- The tax policy challenges facing the United States due to globalization have confronted small open economies for many years; in that sense, large countries are now catching up with them.
- Globalization is a process that makes every country small, which is why it is interesting to consider the tax policies that small countries use.
- The evidence indicates that governments of countries with small open economies have relied relatively little on personal income taxes and corporate income taxes, instead using trade taxes and taxes on sales of goods and services. Small countries typically do not tax active foreign business income.
- The difficulty and distortions of using income taxes has driven much of the world in the direction of expenditure taxation.

Analysis.

- The statistical evidence supports what is apparent from the charts.
  - In 1999, 10% greater national population is associated with 1% less reliance on corporate and personal income taxes, controlling for economic conditions.
  - Similar conclusions appear in changes over time, as populations rise and fall relative to each other.
- Some of this pattern reflects the growing popularity of VATs.
- As the world relies increasingly on expenditure taxation rather than income taxation, countries such as the United States will face intensifying pressures to move its tax policy in that direction.

Interpretations.

- Globalization increases the costs of using corporate income taxes and personal income taxes.
  - Tax base erosion.
  - Economic distortions due to changed behavior.
- Small countries have responded to these costs by relying less on income taxes and more on taxes that are expenditure based (such as VATs).
  - Expenditures are typically less internationally mobile than is income production.
  - Expenditure taxation offers fewer ready avoidance opportunities.
  - Use of VATs in place of income taxes raises important issues of equity.
- Future tax policies of large countries may more closely resemble those of small countries today, posing significant policy challenges.