American Exporters Deserve New Tax Credit

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Most American exporters have benefited from the tax break provided by the Extraterritorial Income Exclusion Act (ETI). Now, however, the U.S. is under orders from the World Trade Organization (WTO) to repeal ETI or face up to $4 billion per year in punitive duties on goods sold in the European Union.

Last year, Ways and Means Chairman Bill Thomas proposed 19 offsets to cushion ETI repeal, but they were sharply criticized as benefiting only multinationals. Last month, Reps. Phil Crane and Charlie Rangel proposed an ETI repeal package with a tax break only for domestic companies. I propose a new offset that is compatible with both the Thomas and Crane-Rangel plans and that can benefit both U.S.-based businesses and multinationals. That offsetis a limited tax credit for payment of foreign value added taxes.

The difference between value added taxes (VATs) and U.S. income tax is at the heart of a problem U.S. exporters have faced since the early 1970's. U.S. income tax applies to all income, worldwide, so the prices of U.S. exports have to be set high enough to yield a fair profit after all tax is paid. VAT, however, is rebated on goods that are exported, and that gives foreign exporters an advantage.

The U.S. has used different systems over the years – DISC, FSC, and finally ETI – to lower U.S. exporters' tax bills and offset this advantage, but each has been condemned as an export subsidy. Rebate of VAT is also an export subsidy, according to author Liam Ebrill in the International Monetary Fund's 2001 book *The Modern VAT*. However, according to the rules of the WTO – rules that the U.S. accepted when it became a WTO member in 1994 – giving companies a break on direct taxes, like U.S. income tax, is prohibited, while rebating indirect taxes, like VAT, is okay.

Just as VATs and their refundability have helped foreign exporters in the past, I propose we make them help U.S. exporters now. Some U.S. businesses already pay VAT to foreign governments, either due to the presence of subsidiaries or branches in VAT countries or, in the case of U.S.-based businesses, due to the structure required for certain international transactions. Further, many more U.S. firms will be paying VAT very soon. Starting July 1, the EU's Directive 2002/38/EC (nicknamed the "E-VAT Directive") will require any business delivering software or other digital e-products to an EU consumer over the Internet to pay VAT on that sale. A tax credit for VATs will lower the tax bills of all these firms, and it will not breach our WTO obligations, as DISC, FSC, and ETI did.

Foreign tax credit for VATs makes sense today both from an economic and a tax standpoint. Economically, the distinction between direct, income taxes and indirect VATs has become a distinction without a difference. For example, it is widely acknowledged that VATs are no different from a combination of direct taxes on a business's profits, interest and rent, and wages. On the other hand, taxes that, under WTO rules, must be classified as direct are sometimes VATs in everything but name. The flat tax proposed by Congressman Richard Armey and Senator Richard Shelby in 1995 was essentially a VAT in which collection of the tax had been divided between business and individuals. That division of collection had no economic significance whatsoever, but it was enough to make the flat tax a direct, and not an indirect tax under existing WTO rules.

This economic similarity between VATs and income taxes raises the question why foreign tax credit has always been limited to direct, income-type taxes. Although Congress has never stated a reason, a twentieth-century myth held that indirect taxes were always passed on to a business's customers, and thus were not an expense that could influence its investment decisions. Now, however, we know that both indirect and direct taxes must sometimes be absorbed by businesses, and therefore it is appropriate to extend foreign tax credit to both.

U.S. International Tax Counsel Barbara Angus, in discussing the ETI crisis last November, implored her audience to "[t]hink about where we would want to be if we had the chance to start new!" Considering what we know today about the economic equivalence of income taxes and VATs, and considering the E-VAT Directive's unprecedented and unfair extension of VAT liability to U.S. e-businesses, expanding foreign tax credit to include VATs would be a step in the right direction. Not only would it cushion ETI repeal and give American businesses the double taxation relief they deserve, it would go a long way toward erasing the now-outdated distinction between direct and indirect taxes.

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