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Hearing on

An Examination of U.S. Tax Policy and Its Effect on the International Competitiveness of U.S.-Owned Foreign Operations

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Introduction

My name is Martin B. Tittle. I am a licensed attorney in the state of Michigan, and I am employed as a researcher at the University of Michigan Law School in Ann Arbor. One of my research topics for the past twelve months has been the Foreign Sales Corporation and Extraterritorial Income Exclusion Act cases in the World Trade Organization (WTO) and the U.S. response to those cases. My statement is submitted on my own behalf and not on behalf of any government or private entity.

At the July 15 Senate Finance Committee hearing, Assistant Treasury Secretary Pamela F. Olson stated that it would be worthwhile for the United States to "tak[e] a long-term look at the structure of the Tax Code to see whether or not our worldwide system continues to make sense or whether we would be better off with a territorial system." Senate Committee on Finance, "Treasury's Olson Testifies on Need for New U.S. International Tax Plan," 2003 Worldwide Tax Daily 142-13 para. 383 (July 24, 2003). Worldwide systems tax residents on their worldwide incomes, whereas territorial systems usually do not tax residents on active foreign-source income.

A Third Option: Extending Foreign Tax Credit to VATs

The "either-or" choice presented by Secretary Olson should be broadened to include a third option. We could alter our worldwide system to achieve a territorial result - little or no taxation of offshore business income - without the upheaval of changing to a territorial system. One alteration that would help achieve this result is foreign tax credit for value added taxes (VATs).

VATs are transaction taxes that businesses must pay on in-country sales. They differ from sales taxes in that they have an internal mechanism for giving businesses a credit for the VAT they pay on their purchases. VATs exist in more than 120 countries that cumulatively account for about 70% of the world's population. Liam Ebrill et al., *The Modern VAT* xiv (2001). Therefore, many U.S. companies doing businesses overseas will have paid VAT to one or more foreign governments.

Allowing credit for VATs would tend to eliminate U.S. taxation of foreign-source business income because VAT is a tax on gross sales, while income tax is a tax on net income. For instance, sale of $100 worth of widgets on which the profit margin is 10% would yield a profit of $10 and an income tax of only $3.50, assuming a tax rate of 35%. That same sale, however, would yield $15 of VAT in Luxembourg, where the standard VAT rate is 15%, and $25 in Denmark or Sweden, where the rate is 25%.

Credit for VATs need not be an all-or-nothing proposition; it could be phased in. We could either limit the credit to a percentage of each VAT dollar and allow that percentage to increase over time, or we could offer dollar-for-dollar credit with a cap on the maximum reduction of any single year's tax bill, and gradually raise the cap.

Theoretical Basis for Extending Credit to VATs

Historically, U.S. foreign tax credit has been limited to income-type taxes, but the reason for this limitation remains a mystery. No explanation was included in the 1918 act that introduced the credit, and, surprisingly, none has been enunciated in subsequent legislation.

In 1956, Professor Stanley Surrey speculated that the basis for the limitation might lie in the purported "nonshiftability" of income taxes. Stanley S. Surrey, "Current Issues in the Taxation of Corporate Foreign Investment," 56 Colum. L. Rev. 815, 820-821 (1956). "Shifting" taxes, he explained, were those whose economic incidence was generally assumed to be passed on from the statutory or nominal payor to someone else. Examples included sales, turnover, and excise taxes. Income taxes, on the other hand, were generally assumed to be "nonshiftable," and therefore actually borne, or suffered by the taxpayer.

Five years later, Elisabeth Owens came to same conclusion, saying "the chief determinative factor in deciding whether a tax qualifies for the credit should be whether or not the tax is shifted or passed on by the person paying the tax." Elisabeth Owens, *The Foreign Tax Credit* 83 (1961), *quoted in* Karen Nelson Moore, "The Foreign Tax Credit for Foreign Taxes Paid in Lieu of Income Taxes: An Evaluation of the Rationale and a Reform Proposal," 7 Am. J. Tax Pol'y 207, 217-218 (1988).

Joseph Isenbergh repeated that theory of creditability in 1984, calling it the "only plausible explanation that has ever appeared for limiting the foreign tax credit to income taxes." Joseph Isenbergh, "The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes," 39 Tax L. Rev. 227, 288 (1984).

The issue of shiftability is not merely a technical one. As Judge Moore has correctly noted, "the goal of achieving tax neutrality between foreign and domestic investment [sometimes called capital export neutrality, or CEN] is satisfied [only] if taxes do not alter the relative rates of return on investments; allowance of a tax credit limited to taxes that are not shifted to others is consistent with that goal, since taxes that can be shifted do not affect the taxpayer's rate of return." Moore, *supra*, at 217 (paraphrasing Owens, *supra*, at 84).

Shiftability and nonshiftability are understood today, not as separate states that are fixed characteristics of different taxes, but as the opposite ends of a continuum across which all taxes move in response to market circumstances. In 1989, Judge Moore reviewed over 40 sources before saying, "The tax policy maker must conclude that a conclusive answer is not available today to the question whether the corporate income tax is shifted or whether it is in fact borne by the corporation and its owners." *Id.* at 222. That question has not been resolved in the years between 1989 and the present. *See, e.g.*, Douglas A. Kahn and Jeffrey S. Lehman, *Corporate Income Taxation* 22-25 (5th ed. 2001) (noting "substantial uncertainty about the incidence of the corporate income tax"); Cheryl D. Block, *Corporate Taxation* 14 (1998) (noting that the extent and direction of corporate tax shifting "is the subject of much debate and the incidence question remains unresolved").

Similarly, Liam Ebrill and his co-authors freely admit in the International Monetary Fund's book *The Modern VAT* that "[t]he effective incidence of a VAT, like that of any other tax,

is determined not by the formal nature of the tax but by market circumstances, including the elasticity of demand for consumption and the nature of competition between suppliers. . . . The real burden of the VAT tax may not fall entirely on consumers but may in part be passed back to suppliers of factors through lower prices received by producers." Ebrill, *supra*, at 15, 76. The VAT that U.S.-based e-tailers are now required to pay under the EU's e-commerce VAT Directive is likely nonshiftable either largely or completely because they face EU competition that can charge lower VAT and no VAT. *See* Martin B. Tittle, "U.S. Foreign Tax Creditability for VAT: Another Arrow in the ETI/E-VAT Quiver," 30 Tax Notes International 809, 813-815 (May 26, 2003).

Judge Moore's solution to the income tax's quasi-shiftable character was to suggest that the foreign tax credit be eliminated as a windfall, and that foreign income taxes be returned to their pre-1918, deductible-only status. Moore, *supra* at 226. However, an equally rational solution would be to continue the credit for income taxes, so as not to disadvantage businesses when income taxes cannot be shifted, and, with appropriate limitations, to expand the credit to VATs and other taxes that, like income taxes, are sometimes nonshiftable. *See* Isenbergh, *supra*, at 294-295 (suggesting expansion of the foreign tax credit to include all foreign taxes and noting that, if the amount of the credit is capped, "the Treasury has little reason to care about [the foreign government's] precise methods [of taxing]").

The fact that the shiftability of both income taxes and VATs varies dynamically in step with market forces is indicative of a broader similarity. Direct taxes like income tax and indirect taxes like VAT are not opposites, but rather are alternate methods for allocating the same tax burdens. For example, it is widely acknowledged that VATs are essentially equivalent to a combination of several direct taxes, including a direct tax on business profits and a direct tax on wages. Ebrill, *supra*, at 18-19, 198.

On the other hand, taxes that, under WTO rules, must be classified as direct are sometimes so similar to VATs that the difference is not substantive. For instance, the flat tax proposed by Congressman Richard Armey and Senator Richard Shelby in 1995 was essentially a flat-rate subtraction VAT in which collection of the tax had been divided between business and individuals. *See* Freedom and Fairness Restoration Act of 1995, H.R. 2060, 104th Cong. (1995); S. 1050, 104th Cong. (1995). That division of collection was not considered significant by knowledgeable observers including University of California, Berkeley economics and law professor Alan J. Auerbach. *See* Michael J. Graetz, "International Aspects of Fundamental Tax Restructuring: Practice Or Principle?," 51 U. Miami L. Rev. 1093, 1098 (1997). It was, however, enough to make the flat tax a direct, and not an indirect tax under existing WTO rules. As such, it could not have been remitted on exports and applied to imports, as VATs are, despite the fact that it was in essence a "broad-based flat rate consumption tax." *Id*. at 1097.

In the face of this virtual equivalence, it is no wonder that House Ways and Means Committee Chairman William M. Thomas, R-California, has said that the distinction between direct and indirect taxes is, "in today's world, . . . a distinction without a difference." Chuck Gnaedinger and Natalia Radziejewska, "U.S. Lawmakers Still Divided Over FSC-ETI Remedy," 2003 Worldwide Tax Daily 31-1 (Feb. 14, 2003).

Senators Max Baucus, D-Montana, and Charles E. Grassley, R-Iowa, have voiced similar sentiments. *See* Chuck Gnaedinger and Natalia Radziejewska, "Baucus Deems WTO Dispute Settlement System 'Kangaroo Court' Against U.S.", 2002 Worldwide Tax Daily 188-*1* (Sept. 27, 2002) (quoting Senator Baucus as saying, "The [WTO] appellate body's FSC decisions make an unworkable distinction between countries that rely primarily on direct taxes . . . and countries that rely primarily on indirect taxes. . . . Although the appellate body acknowledged countries' sovereign right to set their own tax systems, they interpret WTO rules in a way that heavily favors one particular system."); Chuck Gnaedinger and Natalia Radziejewska, "White House Urges U.S. Senate Finance Committee To Repeal ETI Act," 2002 Worldwide Tax Daily 147-5 (July 31, 2002) (quoting Senator Grassley as saying, with respect to the distinction between direct and indirect taxes, "How can we justify allowing this distinction to continue?").

Recognition of both the economic parity between income taxes and VATs and their equivalence in meeting the foreign tax credit criterion of nonshiftability strongly suggests that both income taxes and VATs should be creditable. Alternate bases for extending credit to VATs could include the competitive needs of U.S. businesses, *see* Glenn E. Coven, "International Comity and the Foreign Tax Credit: Crediting Nonconforming Taxes," 4 Fla. Tax Rev. 83, 86 (1999), or the fact that VAT is the "principal tax" of various foreign countries. *See* Surrey, *supra*, at 820 (noting the need, in 1954, to exclude sales and turnover taxes from the "principal tax" proposal). The nonshiftability criterion has the advantage of being a classic theory and thus does not require "breaking new ground" to validate VAT creditability.

Proposed Standards for VAT Creditability

The standards for creditability of VATs may need to be slightly more stringent than the standards for income taxes. The three criteria for income tax creditability are: (1) the tax must be due from the taxpayer (the "technical taxpayer" rule), (2) there must be proof of payment, and (3) the tax must not have been refunded. *See* I.R.C. 1.901-2(f) (the "technical taxpayer" rule); 1.905-2 (taxpayer must present proof of payment); 1.905-3T (refund of a foreign tax constitutes a change in foreign tax liability).

The first and third of these should be applied to VATs without change. With respect to the second, however, the "gross-up" rule allows foreign tax credit for taxes paid by others as long as the taxpayer claiming credit was liable for the tax. See I.R.C. 1.901-2(f)(1)-(2). If that rule were applied to VAT creditability, then in theory everyone with an invoice showing a charge for VAT might claim a tax credit. Allowing credits on this basis would undermine the rationale for extending credit in the first place - to prevent double taxation from discouraging business activity abroad - because people who make a single purchase abroad are not necessarily attempting to engage in business activity there, even if the purchase is for business purposes.

It would be possible to bar such claims on the ground that the taxpayer could not demonstrate that the tax shown on the invoice had actually been paid by the party issuing the invoice (that is, that it had not been partially or totally offset by deductions). Alternatively, it could be argued that the claimant was not the "technical taxpayer." That argument would be more tenuous because, according to the EU's Sixth Directive, all taxable persons must pay VAT, and the term "taxable persons" includes everyone "who independently carries out in any place"

any of the economic activities of "producers, traders, and persons supplying services." That category includes even those who, as members of special classes, are exempted from payment, and therefore, it might also include casual purchasers. Therefore, unless there is a clear advantage in keeping the criteria for income tax and VAT creditability identical and addressing this issue in an exception, VAT creditability should require that the taxpayer demonstrate direct payment of VAT to the foreign government. That proof could be a VAT return and payment authorization, or, if no VAT return has been or will be filed, it could be the receipt issued to the taxpayer or its representative by customs when VAT was paid at the time of importation into the VAT jurisdiction. Either way, those with no more than an invoice showing a charge for VAT should not be able to claim the credit.