International Aspects of Recommendations from the President's Advisory Panel on Federal Tax Reform Panel

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Starting Point for Recommendations

- Executive Order
  - Make the tax code simpler, fairer, and more pro-growth
  - Recognize the importance of homeownership and charity
  - Revenue neutrality
  - Distribute tax burden in an “appropriately progressive manner”
  - One option must use the current income tax system

- Other Factors
  - Limited consideration to individual and corporate income taxes
  - Repeal the Alternative Minimum Tax
  - Focus on simplicity
  - Desire to reach consensus
  - Federal Advisory Committee Act

Consideration of Reform Options

- Four “Big Picture” Reform Approaches
  - Reform of current income tax system
  - Progressive consumption tax
  - Partial replacement VAT
  - National retail sales tax

- Two Recommendations
  - Simplified Income Tax Plan
  - Growth and Investment Tax Plan

International Tax

- State of current international tax system
  - “A cumbersome creation of stupefying complexity.”
  - “Is there anybody who really understands these rules? I think the answer is no.”
  - “It's difficult to overstate the crises in the administration of the international tax system of the United States.”
  - “Our current system is deeply, deeply flawed.”

Current Income Tax System

- Encourages wasteful tax planning
- Results in uneven outcomes for firms depending on their planning sophistication and circumstances
- Likely distorts economic decisions to a greater extent and is more complex than a system that simply exempted active foreign business income from U.S. tax
- Despite its complexity, raises relatively little revenue from the foreign income of U.S. MNCs
  - Estimates suggest that exempting active foreign source income could raise revenues
- No consensus from experts on reform options

Panel Approach for International

- Level the playing field among companies
- Encourage growth
  - Lower the corporate tax rate
  - Reduce incentives for wasteful tax planning
  - Make businesses more competitive in their foreign operations
- Simplify the rules
- Require some disclosure of where profits are earned
- Focus on outbound policy
  - Panel did not address inbound policy directly
  - Encourage inbound investment by making U.S. a more attractive location for operations

Reform Alternatives for International Taxation

- Do nothing
- Incremental reform
  - For example, accelerate some provisions of AJCA
- Tax financial accounting income ("book income")
  - Impose worldwide taxation with no deferral
  - Considerations
    - Not attractive as policy option unless corporate rate is substantially lower than current law
    - Substantive policy choices (consolidation, M&A, etc.)
- Dividend exemption (territorial)
  - Ultimately recommended after careful study
  - Panel proposal differs from the JCT option presented earlier this year

Simplified Income Tax Proposal

- Territorial tax regime
  - Income earned abroad by foreign affiliates (subsidiaries and branches) would fall into two categories--
    - "Foreign Business Income" would generally be exempt from U.S. taxation
    - "Mobile Income" would be taxed to U.S. parent on a current basis
  - Foreign tax credit system would serve a more limited function
    - FTC still available to offset foreign tax paid (including withholding taxes) on Mobile Income
    - FTC would be available for withholding taxes on royalties
    - FTC basket rules replaced with a single overall FTC limitation

Simplified Income Tax Proposal

- Territorial tax regime expense allocation rules
  - Business expenses attributable to exempt foreign earnings would not be allowed as a deduction from U.S. taxes
  - Interest expense would be allocated between U.S. and foreign income on a basis that takes into account all debt – both U.S. and foreign (new AJCA rules).
    - Interest expense allocated to foreign income would then be further allocated between exempt and non-exempt foreign income
  - Parent general and administrative (G&A) expenses not directly charged out would be allocated to foreign income pro rata based on worldwide income.
    - G&A expense allocated to foreign income would then be further allocated between exempt and non-exempt foreign income.

Simplified Income Tax Proposal

- Territorial tax regime expense allocation rules (continued)
  - No parent R&D expenses would be allocated against exempt foreign-source income since royalty income generated by those expenses would be fully taxable at U.S. rate.
- Exemption and allocation rules will necessarily put pressure on transfer pricing regime
- Subpart F rules would be required
- Corporate rate lowered to 31.5 percent

Simplified Income Tax Proposal

- Integration
  - Exclude 100 percent of corporate dividends paid out of income subject to U.S. tax
    - Corporations will notify shareholders regarding proportion of dividends that can be excluded based on amount of income subject to tax in the U.S. relative to worldwide earnings in prior year
    - Also required to disclose domestic and worldwide revenues and income reported for financial accounting purposes
  - Exclude 75 percent of capital gains received by individuals on sales of corporate stock in U.S. corporations if held for more than one year
- Corporate residency (JCT option)

Simplified Income Tax Proposal: Concluding Remarks

- The territorial proposal deserves further study
  - Goal was not to draft legislation, but to present Treasury Secretary with a starting point. Many details of the regime yet to be worked out.
  - Plan represents a refinement of prior proposals
- The plan allows policy-makers to focus on important questions regarding taxation of cross-border income in today's global economy
  - For example, should royalties be taxed at a lower rate?
- International taxation represents one of the most difficult areas to address in tax reform

Growth and Investment Tax Plan

- Started with the Progressive Consumption Tax

- Businesses would be taxed on business cash flow at 30%

  Receipts from Sales
  Less: Purchases from Other Businesses
  Less: Wages and Compensation
  Equals: Taxable Business Cash Flow

- Expensing of new investment
  - Ensures that after-tax return is the same as pre-tax return

- Eliminates interest deductibility
  - Allowing both expensing of new investments and an interest deduction would result in a net tax subsidy to new investment

Growth and Investment Tax Plan

- Panel recommended using destination basis
  - Tax base = domestic consumption wherever produced
    - Sales to customers abroad, which are not consumed in the U.S., would be exempt from the tax while purchases from abroad, which are consumed in the U.S., would be included
    - Thus, "border adjustments" necessary to impose a destination basis tax
    - Royalties received from abroad are exempt
  - "Transfer pricing" implication: since base is domestic consumption there is no incentive to over- or under-charge for sales with related parties
  - Destination basis limits tax avoidance opportunities by "closing" the system
    - Using domestic consumption as a base prevents U.S. businesses from structuring transactions with foreigners to avoid U.S. taxes

Growth and Investment Tax Plan

- VATs in place around the world all use destination basis

- GATT/WTO - The historical distinction between indirect and direct taxes has no economic significance
  - Cash-flow tax is economically equivalent to a VAT with a wage subsidy
  - USTR may be required to negotiate with trading partners

- Do border tax adjustments matter?
  - Not when switching between destination and origin based tax (this is well known among economists but not accepted)
  - Switch from an income tax to a consumption tax would have economic implications

Growth and Investment Tax Plan

- Issues associated in implementing a border-adjusted cash-flow tax
  - Refunds (rate, evasion, etc.)
  - Short-term impacts/transition
  - Treaties

- Does scheduler tax on financial income create additional issues?
  - Impact on legality of border adjustments
  - Use of businesses to evade tax on capital - need anti-deferral regime

Value-Added Tax

- International consequences more certain
  - Border adjustable
  - Easier transition
- Refunds of VAT – potential for abuse
- Lower rate reduces some problems
  - 15 percent top individual rate
  - 15 percent corporate rate
  - 17.6 percent tax-exclusive VAT rate