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COMPARATIVE TAX SYSTEMS

HEARING

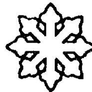
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

SECOND SESSION

JULY 21, 1992



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COMPARATIVE TAX SYSTEMS

TUESDAY, JULY 21, 1992

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:04 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senators Baucus, Bradley, Pryor, Daschle, Danforth, Chafee and Grassley.

[The press release announcing the hearing follows:]

[Press Release No. H-38, July 16, 1992]

SENATOR BENTSEN ANNOUNCES HEARING COMPARING CORPORATE TAX RATES, REPRESENTATIVES FROM GERMANY, JAPAN, GREAT BRITAIN TO TESTIFY

WASHINGTON, DC.—Senator Lloyd Bentsen, Chairman of the Senate Finance Committee, Thursday announced a hearing examining the effect the U.S. tax code has on competitiveness, compared with tax systems in Germany, Japan and the United Kingdom.

The hearing will be at *10 a.m., Tuesday, July 21, 1992* in Room SD-215 of the Dirksen Senate Office Building.

"As we move closer and closer to a world economy, we need to look at how our tax laws affect the ability of American companies to compete in the world marketplace," Senator Bentsen said.

"In addition it is critical to understand how the tax systems of our chief competitors stack up to our own," Bentsen said. "The Finance Committee has not looked at tax competitiveness from this angle yet, and it's time we do."

Witnesses will include these experts on the tax systems of the three countries: Professor Albert Rädler from Munich, Germany; Mr. Yoshio Nakamura, deputy director of the Keidenren, the largest Japanese business association; and John Isaac, former deputy chairman of the Inland Revenue, the United Kingdom's tax collecting agency.

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order. Let me say to our friends and our witnesses who have travelled quite a long distance to be here with us and who have done so at their own expense how appreciative we are of having you.

You will find that the Senate has been on a two-week recess. They are a bit slow getting back to the job. We will have a number of them who will be appearing. We have competing committees also meeting in this first day. So, some of them are going to be in and out in the process. A bit irregular, but that is the way the system works.

Let me, further, state that whether it is baseball or it is business, it is awfully important to know what the competition is doing. That is particularly true in taxes.

Time and time again, as Chairman of this committee, I have heard various interest groups say, but they do more for us in Germany, or Japan, or London, or some other place around the world. We are favored there and we are discriminated against in the United States.

I admit to taking that with a grain of salt when the various interest groups tell me. But, in order to answer some of those questions, we have been able to be favored with what I believe to be excellent authorities on Europe and Japan that can testify before us.

If we are going to compete effectively in this world, we have to know how the tax laws affect the ability of American companies trying to sell goods and services abroad. We need to know how we stack up against the competition.

Now, the preliminary OECD data shows that six of the world's major industrial nations have lower marginal tax rates on new investment than the United States. This is investment, like new plants and equipment. And that, in turn, translates into productivity and income gains.

By examining the tax systems of other countries with our own, we can glean a better idea of works and what does not. Great Britain's Parliament, Japan's Diet, Germany's Bundestag, and our Congress all wrestle to raise the necessary taxes to fund the services people want from their government.

And while the circumstances are different for each country, the task is comparable. Every government must strike that balance between collecting revenue in an even-handed manner, making sure that everyone pays their fair share, and then, in turn, providing an environment that is conducive to economic growth.

We are here today to discuss how these three countries strike that balance and to learn from their experiences with their specific tax policies, especially as to those that bear on that nation's competitiveness.

Specifically, we want to know more about our neighbors and competitors, how they treat savings, for example, under their tax laws; how they tax capital; how they tax research expenses; how they treat corporate earnings and how they tax the foreign income of multi-national corporations.

This hearing will give us an important opportunity for committee members to explore the tax systems of our major trading partners; ask questions about the advantages and disadvantages of different approaches to various issues of income tax.

To start us off, we have these three distinguished experts who have traveled a long distance, and I hope they have been able to get their time clocks adjusted over the weekend.

Dr. Albert Rädler, a Professor from the University of Hamburg and a member of the Ruding Commission, a group charged with developing a harmonized tax law for the European community.

Mr. Yoshio Nakamura, the deputy director of Keidanren, Japan's largest business organization. And if I have mispronounced some of that, forgive me.

And John Isaac, who developed England's corporate tax rules in the 1960's and 1970's and then presided over their administration as Deputy Chairman of Inland Revenue, until his retirement last year.

I thank them for their time and their generosity, and look forward to their testimony. Now they are going to be joined by Alan Auerbach. Dr. Auerbach, of our Joint Committee on Taxation, will answer any questions of the tax laws of the United States as a contrast.

It is critical that we have as much information as possible on the relationship between tax policy and economic growth, and the testimony of these witnesses will be invaluable in that regard. Senator Baucus, do you have any comments?

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you very much, Mr. Chairman. Mr. Chairman, I think this hearing, although it is not well attended yet, is probably one of the more important hearings we are going to have this Congress, and I suspect we will have many more like it in the future as we, as a country, address our competitiveness vis-a-vis other countries.

Our American declining competitive position, I think, can be traced to a number of factors. Certainly our educational system is one; the antagonistic government/business climate another; our low national savings investment rates are still another.

But, in my view, our tax policy also bears some of the responsibility for our country's competitiveness problems. Our tax policy has been seen as a vehicle for raising revenue and for redistributing income. But the role of tax policy in building our country, frankly, has not received a lot of attention.

Our current system of taxation may not be in our best interests. I think we, as Americans, find it very complicated; we do not really want to deal with it in very many ways. But I think we have to deal with it if we are going to progress.

Because, essentially, as the world becomes more and more competitive generally, we can less afford the luxury of not spending as much attention as we should to each of the components in our country which do affect America's competitiveness.

It is like a company; it is like a business. We have to look at all the aspects of the operation if we are going to be truly competitive and we cannot let slide one aspect of our operation. In this case, we cannot let slide our Tax Code as one of the components of competitiveness.

Our current system, I think, too much favors consumption over saving; it favors short-term gains over long-term investment. And if we can change appropriately and responsively the rewards and penalties inherent in this system, that is, to reward patient capital and reward longer-term thinking, I think we will then be taking a significant step forward in achieving greater American competitiveness.

In today's global economy, I think there are two compelling reasons for examining taxation as practiced by our principal trading partners. First, what they do does have a direct effect on our econ-

omy. Taxes do influence international allocation of capital in the flow of goods and services.

And, second, the differences between our system and that of others can be instructive. The Japanese corporations' willingness to ignore next quarter's profits in favor of the long-term is legendary. Perhaps a look at Japan's system of taxing capital gains can help us encourage such behavior in our firms.

It is also time to examine value-added taxes and other consumption taxes more closely. Of course, we must ensure that such a tax does not have a regressive or otherwise unfair impact. But there are good reasons that most other developed nations employ VATs to raise revenue and encourage savings.

Finally, it has recently been alleged that foreign corporations operating in our country are not paying their fair share of taxes by manipulating transfer prices between subsidiaries.

They may be able to park their profits in low-tax nations and avoid U.S. income taxes. If true, this practice does damage the United States, not only through tax revenues lost, but by putting American firms that pay higher taxes at a competitive disadvantage.

I look forward, very much, Mr. Chairman, to this hearing. Unfortunately, I must manage a bill on the Floor dealing with a very mundane subject: the interstate transportation of garbage; a far cry from the subject of today's hearing. I will have to leave fairly shortly, but I will certainly examine the record. I have some questions I will submit for the witnesses to answer. But, thank you, Mr. Chairman, for holding this hearing. It is a very important one. Thank you.

[The questions appear in the appendix.]

The CHAIRMAN. Thank you. Mr. Isaac, if you would proceed, please.

STATEMENT OF JOHN ISAAC, CB, FORMER DEPUTY DIRECTOR, BOARD OF INLAND REVENUE, LONDON, ENGLAND

Mr. ISAAC. Thank you, Mr. Chairman. I hope it will be helpful in this first intervention if I say something very briefly and very superficially about the main features of the U.K. tax system and concentrate, to some extent, on its business aspects rather than the personal aspects, and then hold myself ready to answer in more detail.

In the United Kingdom, income tax is charged on all incomes of individuals. It is charged on a scheduler system so that, in certain respects, the rules differ for different kinds of income, notably: employment, self-employment, investment, or passive incomes.

Taxpayers are entitled to a personal allowance which is indexed for inflation and currently stands at 3,445 pounds; a little more for the elderly, and an additional allowance for married couples.

The first 2,000 pounds of taxable income is charged at 20 percent; the next 21,700 pounds at 25 percent; and everything over 23,700 pounds at 40 percent. The top rate was reduced to its present 40 percent in the budget of 1988.

Out of some 25 million or more taxpayers, some two million may be liable at the reduced rate, 20 percent; 1.5 million at the higher

rate of 40 percent. And it follows that the very great majority of taxpayers are liable at the basic rate of 25 percent.

Since 1990, husbands and wives have been taxed independently. Figures I have given are tax; they do not include Social Security contributions, which are charged separately.

Income from savings is, as a general rule, taxed on normal income tax principles. But, there are significant exceptions to that rule, most notably longstanding tax privileges for pensions and for owner-occupied houses, and, more recently, some more or less modest personal savings.

In the United Kingdom, a capital gains tax is charged on disposals of chargeable assets. Since the 1988 income tax reforms and the reduction of the top rate to 40 percent, gains have broadly been charged at the top slice of income up to 40 percent, but there are three important qualifications to that rule.

First, as part of the 1988 package, the charge is limited to gains accruing since 1982. Second, indexation relief exempts from tax merely nominal gains, arising from a fall in the value of money, as measured by the retail price index.

Third, largely, if not wholly for administrative reasons, the threshold for the tax is set at a relatively high figure of, currently, 5,800 pounds, again, indexed for inflation. Thus, the effective rates of tax on capital gains are significantly lower, in most cases, than the nominal rates.

Again, married couples are taxed independently.

The tax is levied on two main kinds of chargeable assets in roughly equal proportions: stocks and shares, and real property.

CGT, Capital Gains Tax, is not charged on government securities, on certain corporate bonds, on the taxpayer's main home, or on death. Companies are charged to corporation tax on their gains broadly on capital gains tax principle, but, of course, without any personal threshold.

There is a form of roll-over for gains on certain business assets reinvested in the business, and also retirement relief for unincorporated businesses and small family companies.

The corporation tax in the United Kingdom is a partial imputation system. That is, part of the corporation tax paid by the company is imputed to the shareholder and covers his or her liability to income tax on distributed profits. This system was introduced in 1973.

The present structure of the tax rates and tax base date largely from reforms made in 1984. These aimed at a broadening the tax base and a reduction of the tax rate; in some ways reminiscent of the U.S. tax reforms of 1986.

The rate of corporation tax in that reform was reduced from 50 percent, in stages, to 35 percent, and has been reduced, further, to 33 percent. There is no minimum tax in the United States sense.

The 1973 system introduced a reduced rate of corporation tax for small companies which commonly paid little or no dividends and would otherwise have suffered an increase in their tax burden, as a result of the change. The rate is now at 25 percent; the same as the basic rate of income tax. It applies to companies whose profits are less than 250,000 pounds with tapering provisions above that.

In very broad terms, profits for corporation tax are determined on normal accounting principles, but capital expenses are allowed only in accordance with the strict statutory provisions.

In particular, for plant and machinery, depreciation is allowed at 25 percent on a reducing balance basis. By international standards, that is probably fairly close to the rate at which firms actually write off assets in real life; perhaps a little on the generous side, perhaps therefore providing some margin of relief for inflation, at least at the present levels.

Under the United Kingdom imputation system, when a company pays a dividend or other distribution, it pays Advance Corporation Tax, ACT—in United States terms, a compensatory tax—at one-third of the dividend, or 25 percent of the sum of the dividend and tax credit.

ACT can be set off against the company's tax on its profits up to a limit. Above that, the ACT, Advance Corporation Tax, can be carried back or forward to other years. The dividend to the shareholder carries a tax credit, again, at one-third of the dividend or 25 percent of the sum of the two.

The tax credit can be paid in whole or part to an exempt shareholder or someone below the tax threshold. A higher rate tax payer is liable for the excess over 25 percent. It is, therefore, in U.S. terminology, a refundable credit. Part of the credit is payable to certain overseas countries, including the United States, under the terms of double tax agreements.

Double tax relief for overseas taxation is given by the credit method. The United Kingdom has a very wide network of international double tax agreements, and I think take a leading role, with the United States and other partners, in working out arrangements with the familiar dual objective to tackle, by direct action, or by exchange of information, attempts to avoid or evade tax altogether—a point made by Mr. Baucus, I think—and, at the same time, to tackle the kind of double economic taxation or excessive compliance requirements that would leave all business in all countries worse off.

More generally, if I may say so, with respect, Mr. Chairman, my own experience when I was working for the U.K. Government echoed very closely some of your introductory remarks about the need, certainly for the United Kingdom, in an open-world economy, to have regard always to the implications of policy options—not just for domestic objectives, but for the ability of a country to compete in increasingly internationally mobile and open world markets.

Finally, inheritance tax. Inheritance tax is charged on estates passing on death, with tapering provisions on lifetime gifts, more than 3 years, but within 7 years of death, and also on certain other special kinds of gift.

There is a business and agriculture relief at 100 percent, full relief, or 50 percent, depending on the nature and scale of the taxpayer's business or farming interest. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Isaac, you apparently did not understand about a written statement. I am very interested in what you have to say. I am not sure I followed it all, and I would hope you would

that you would reduce some of that to writing for us and let have a copy of it. Would you do that?

Mr. ISAAC. I shall be very happy to do so.

[The prepared statement of Mr. Isaac appears in the append

The CHAIRMAN. Thank you very much. Mr. Nakamura, if you would proceed, please. Mr. Nakamura is the deputy director of the International Economic Affairs Department of the Japan Federation of Economic Organizations. We are pleased to have you, sir.

STATEMENT OF YOSHIO NAKAMURA, DEPUTY DIRECTOR, INTERNATIONAL ECONOMIC AFFAIRS DEPARTMENT, JAPAN FEDERATION OF ECONOMIC ORGANIZATIONS (KEIDANREN), TOKYO, JAPAN

Mr. NAKAMURA. Mr. Chairman, members of the committee, my name is Yoshio Nakamura. I am very happy to appear before you today, and do so willingly in response to your invitation, to explain to you about the tax system of Japan and to answer any questions you may have. I have submitted a detailed written statement which I respectfully ask the committee to include in the record.

Before I begin my testimony, I feel I must explain my office in Tokyo. Keidanren is a private and non-profit economic organization in Japan which represents all branches or economic activities, except the agricultural sector. What we do is create a consensus among the business community and voice corporate interests in the formation of Japan's domestic and international economic policies.

Japan's present tax system owes enormously to Professor Shoup from Columbia University. Indeed, after Professor Shoup's recommendations in 1949, the Japanese tax system has brought about distortions and imbalances in all phases of direct and indirect taxes.

In order to eliminate distortions, imbalances and perception of excess tax burdens, the tax reform was implemented in 1989 to expand tax bases for the whole tax system and to institute a system imposing tax burdens lightly and broadly and a 3 percent consumption tax was introduced.

National corporate income tax in Japan is 37.5 percent on distributed and undistributed profit, plus a prefectural inhabitant's tax of 5.0 percent of corporate taxes, a municipal inhabitant's tax of 12.3 percent of corporate taxes, and an enterprise tax—12 percent on profit, but deductible.

According to Japanese Government calculation, this brings the effective tax rate to about 50 percent of profit. In the United States, this rate is about 40 percent, which is about 10 percent lower than Japan.

Moreover, a 2.5 corporate surtax is currently imposed on the amount of corporate tax. This calculation of effective tax rate is based on certain assumptions. First, that taxable income is computed in a uniform manner, and that no special tax measures exist.

Second, that no tax deduction, such as MACRS (Modified Accelerated Cost Recovery System) apply. Third, that all taxes are paid by corporations on an individual basis as opposed to a consolidated tax payment method.

In Japan, criticism of the special tax measures granted to the corporations has sustained them to a low ratio over corporate tax

revenues, with a result that these provisions currently have little effect on mitigating the tax burden.

Japanese corporations do not realize exception benefits from the method used to compute taxable income. Significantly, special tax measures favoring corporations have been curtailed to lower amounts in recent years and revenue losses attributable to these measures are estimated at only 3.1 percent of total corporate tax revenues.

In total, those special tax measures reduced the Japanese corporate tax rate by about 1.4 percent in 1991, which was 17 percent higher than the United States. Therefore, there is no consensus between the government and business community that tax policy should be used as an instrument of industrial policy. Rather, a heavier tax burden has been applied, partly in order to reduce a large deficit in the budget.

Japan has not established an effective mechanism for imposing compliance in income tax, though the consumption tax has been introduced, because the current consumption tax is based on the accounting records instead of invoices and has some exemptions.

The taxpayers in Japan have strong feelings of burden and pressure from income taxation. To eliminate such feelings of increasing burdens and imbalances in income taxation, a framework of income tax taxation was devised in 1989.

To date, tax rate for these brackets increased by 10 percent from one bracket to the next, up to 50 percent. Accordingly, there are six brackets in total. Finally, central and local taxation combined, the highest marginal tax rate amounts to 65 percent.

Interest income from deposits used to be exempt from tax, but this measure was abolished in 1987 because they posed inequity burdens among income categories. Now interest tax rates from all savings and deposits are subject to withholding income tax at a flat rate of 20 percent.

Dividends receivable are required to be included in ordinary income, with a 20 percent withholding tax, but taxed separately under certain conditions. Tax credit is allowed for dividends. Capital gains from sales of securities are taxed at 26 percent, or at 1 percent on the proceeds from selling securities, but are included in the taxable income on corporate income tax.

These tax measures reduce capital costs for our companies. However, one research shows that the capital costs for the Japanese companies were higher by about 5 percent than those for the U.S. companies from 1980 to 1990. I believe that if the capital costs in Japan would be lower than those in the United States. U.S. companies could raise capital in the Japanese financial market.

Japanese companies have made a great effort to enhance their competitiveness which should be evaluated highly. However, it is true that the Japanese countries have created friction with other countries.

And now the word competitiveness has less positive connotation in Japan. Japanese business leaders review their behaviors. We, at Keidanren, resolved at the 1992 General Meeting to promote economic symbiosis—or Kyosei, in Japanese—with other countries.

Kyosei consists of two Chinese characters. "Kyo" means "together" and "sei" means "to live." The character combined means

"existing together." Through Kyosei, or economic symbiosis, we are attempting to enhance compatibility with foreign economies, while at the same time providing a more equitable distribution to our people. Thank you very much.

[The prepared statement of Mr. Nakamura appears in the appendix.]

The CHAIRMAN. Thank you. Dr. Rädler. Dr. Rädler is a Professor at the University of Hamburg, the Institute for International Tax and Finance. We are pleased to have you. Proceed, sir.

STATEMENT OF ALBERT J. RÄDLER, PH.D., PROFESSOR, UNIVERSITY OF HAMBURG, INSTITUTE FOR INTERNATIONAL TAX AND FINANCE, MUNICH, GERMANY

Dr. RÄDLER. First, just one personal remark. Mr. Chairman, I was 12 years old at the end of the war, and for the next 4 or 5 years I think I survived, thanks to the generosity of the American people by providing us daily school meals. And I would like to thank the American people for that.

The CHAIRMAN. Thank you. You are very generous, sir. Thank you. Looks like you turned out well.

Dr. RÄDLER. Thank you. [Laughter.]

Dr. RÄDLER. Well, I always say I am a war child, you know, because I can have problems with stopping eating. First, I would like to follow-up two remarks you made before, Mr. Chairman. The first concerned the issue of tax burdens of companies and international comparisons.

In one of our first meetings of the Ruding Committee, our Chairman asked each of the eight members to provide a paper in which there was the clear proof that the tax burden in each of the members' countries was the highest. And everybody could provide that, you see.

And the second remark I would like to make was that we very soon found out in our analysis that really there are four important areas which have to be taken into account in comparing tax burdens.

The first one, of course, is tax rates, as we do. But, equally important, there are three others. And this the tax base, the tax system, mainly the relationship between companies and shareholders, and fourthly—and not to forget that—tax enforcements and tax compliance in the respective countries.

Now, coming to my subject, to Germany, the combined corporate tax burden is rather high in Germany. It is approximately 57.5 percent on returned earnings and 46 percent on distributed income, and there is added divided withholding tax. We have no relief for smaller companies.

And the top level for unincorporated German business, which is extremely important—and you have to take that into account whenever you are making international comparisons because I would say two-thirds, even of larger German businesses, is unincorporated.

So, all of the family companies you can say there are not incorporated, but they are partnerships. So, that has to be added in international comparisons. And their tax burden comes up to over 60 percent.

And since those tax rates are substantially higher than yours, it was quite a surprise for me to find out that total tax collection in both countries, coming from taxes on income and profit, compared to GDP in our countries, was the same in 1989 based on OECD statistics. And I tried to find out why that is so; what is the reason that we have this big differential in rates, and on the other hand, the revenue is the same.

And I think some of the reasons of differences can be traced back that there are tax expenditures in Germany, but, on the other hand, I also find there are tax penalties in the United States. And let me just list the main differentials that I found.

The first one will be quite a surprise to you: that Germany does not tax capital gains coming from privately-owned assets. On the other hand, all assets and all capital gains coming from assets which are business assets are fully taxed. And the next point is the declining balance, depreciation based on a maximum of three times straight line.

However, I do not find this regard. This is a form of accelerated depreciation as a tax expenditure because, somehow, I think it compensates for the negative effect of inflation. That came as a great surprise from the calculations which were made from our committee, that the impact of inflation on business is very high, and much higher than we all think it is.

And I just would like to add that nowadays there is substantial tax incentives for investment in East Germany, but that, as you know, is simply necessary to start business activities.

In the tax accounting field, our law is more oriented towards financial accounting. Intangibles such as goodwill, trademarks, customer lists—which, as you know, are a problem right here in this country—can be regularly depreciated. And goodwill, over 15 years, straight line.

Substantial losses in the value of any fixed asset can be taken into account by a write-down to the going concern value. Provisions for contingent liabilities are also accepted when they are obligatory on the German generally accepted accounting principles.

The close relation between tax accounting and financial accounting is, I think, a reason why we do not need a minimum tax. Because nobody in Germany can depreciate an asset for tax purposes if it is not depreciated at the same time on an accumulated basis in his financial statements, and the same is true for any other form of write-offs.

And this is also a problem which we have with our friends in the common market because there are eight countries which more or less follow this continental system, and there are four—including the United Kingdom, Ireland, Denmark, and the Netherlands—who follow, more or less, your system. But there are differences even between the two groups—substantial differences in between.

And in our committee we could not agree on a proposal. We could not find any, you know. So, we just proposed that ways must be found over the next years to bring the two systems together one way or another; probably through increased harmonization of financial accounting rules.

An important point is that, since 1977, there is full integration of German corporate tax for German shareholders, I would like to

add. If you think of your S corporations, which are quite important, but we extend that on a different technique to all kinds of corporations.

Problems here come with the common market because I am fully convinced that the imputation system is not the ideal system for the common market. And in our committee everybody thought that when we have a common currency, then it is also time to at least have a common system or bring the systems together, but we will see what is going to happen there.

Concerning individuals, it seems to me that the German taxpayer can claim more deductions for work-related expenses and also for the education of the children. As a financial measure in the private sector, I feel that ownership of houses and apartment buildings is encouraged by several tax incentives. So, buying buildings is the traditional way for a German professional to save.

Life insurance is generally exempt. Compliance and enforcement of reporting of interest, however, has been very low and there are new developments. Perhaps we will have a chance to discuss them later on.

I feel that Germany will not be able to continue this combination of high tax rates and incentives oriented to encourage investment and saving, since it is in heavy tax competition primarily with the member states of the European community, such as I just mentioned—34 percent from France and the United Kingdom, 35 percentfrom the Netherlands. The German Government has promised to reform company taxation in the forthcoming years, but we will see what will happen. Thank you.

[The prepared statement of Dr. Rädler appears in the appendix.]

The CHAIRMAN. Mr. Isaac, in your country, as I understood it, you index and you only tax the capital gain on the excess above the indexing.

Mr. ISAAC. Right.

The CHAIRMAN. How has that worked for you, indexing?

Mr. ISAAC. We use the retail price index, that is, the measure of the purchasing power of the pound.

You take the acquisition cost of an asset. Suppose here you had bought an asset in year Y for 100 pounds. You sell it in year Y plus 10 years later for 200 pounds. Over those 10 years, the price level in the United Kingdom has risen by 60 percent. Let us take those three assumptions. Therefore, when you sell the asset, you treat it as if you had bought it for 160 pounds; and your tax gain is 40 pounds. The initial price of 100 pounds is upgraded for the effects of inflation.

The CHAIRMAN. All right.

Mr. ISAAC. Stated like that, it is, dare I say, very simple. In practice, it is a very considerable complication. But that is broadly how it works.

The CHAIRMAN. Let me ask the three of you, and any one of you can answer: What aspects of the U.S. tax system, as you know it, to the degree you know it, do you find the least rational or the most conducive to economic health? Any one of you. Yes.

Dr. RÄDLER. Yes. To me, it is something I could never understand. Also, working for companies as a consultant, I could never understand that when there is a substantial loss on share in a

company, in a subsidiary, that you cannot take that loss before you either sell or liquidate the company.

The CHAIRMAN. I think that is a legitimate criticism. What do you think the best features of the system are?

Dr. RÄDLER. Well, the best system, I think that you always try to tax—at least you try—according to ability to pay. Those are equity aspects which I think are stronger in this country than in other countries.

The CHAIRMAN. All right. Yes, Mr. Nakamura.

Mr. NAKAMURA. I think you depend heavily on income tax.

The CHAIRMAN. On what?

Mr. NAKAMURA. Income tax, like Japan. I think your dependence on income tax is more than 90 percent of total tax revenues. So, in Japan we introduced a consumption tax about 3 years ago. I think consumption tax or value-added tax is neutral to the resource allocation. It is, I think, the best tax in the world.

The CHAIRMAN. Of course, both Nakasone and Takeshita had trouble with that. I recall that very well. All right. Now, we are debating enterprise zones, meaning an area that has serious economic problems, trying to decide whether to put some kind of incentives in there to help. Some of you have done that. Have they been effective, or not?

Mr. ISAAC. We have had a system of enterprise zones by that name in the United Kingdom. They are tending to be on the way out now, partly in response to European community rules, as they represent a potential distortion of trade.

And I think that there is some question, as in so many investment incentives, how far they add to the total amount of investment and how far they, by contrast, essentially change the place or the assets in which the investment takes place.

In other words, if, in the United Kingdom, you have 100 percent depreciation, let us say, very accelerated write-off for investment, that made it quite attractive to build commercial buildings in the London Docklands. It is not clear that the result of that is more offices, more factories were built than would have been built otherwise. The building takes place this side of the road, and not the other side of the road.

The other constraint on these things is that, as some companies are now finding out, a tax allowance is valuable only if you have profits against which to set the tax.

The CHAIRMAN. Well, we may have another round of questioning here. Senator Bradley.

Senator BRADLEY. Thank you very much, Mr. Chairman. Mr. Isaac, I noted that, in Britain, mortgage interest is deductible only on the first 30,000 pounds.

Mr. ISAAC. Yes.

Senator BRADLEY. Which is $57,585.

Mr. ISAAC. Yes.

Senator BRADLEY. So, if someone has mortgage interest in excess of that amount they are not allowed to deduct that excess?

Mr. ISAAC. That is right.

Senator BRADLEY. And what percent of the taxpayers have nondeductible mortgage interest?

Mr. ISAAC. I think, now, a fairly high proportion. I cannot give you a figure. The ceiling has been held at that level for, now, some considerable period of years, deliberately so. And over that time inflation and increase in the price of property has meant that mortgage interest relief has been of decreasing importance in home ownership.

I think the policy thinking behind that reflects a number of factors. One, an anxiety that the tax-privileged status of bricks and mortar, or some institutional investments like pensions, was attracting capital away from productive investment.

Senator BRADLEY. Yes. So, the thought was that the money was flowing into real estate investment as opposed to into plant and equipment?

Mr. ISAAC. Yes, that is one thought. If you get a tax privilege for bricks and mortar.

Senator BRADLEY. So that it was affecting your competitiveness.

Mr. ISAAC. Affecting competitiveness. Yes.

Senator BRADLEY. When did you make that change?

Mr. ISAAC. What has happened over a long period has been that the cap has been held, not increased in line with inflation. So, it has been a steady process over a number of years.

Senator BRADLEY. Well, when did it start, when did you put the cap in?

Mr. ISAAC. I am sorry to say, I would have to check on that.

Senator BRADLEY. What is your guess at what percent of the taxpayers are above the cap?

Mr. ISAAC. My guess would be well over half, perhaps three-quarters, but I would need to check.

Senator BRADLEY. Over half of the taxpayers have a mortgage loan above $57,000?

Mr. ISAAC. My guess would be that, but I would need to check that. I could do so and let you have it.

Senator BRADLEY. If you could.

[The information requested follows:]

Mr. NORM RICHTER,
U.S. Senate,
Committee on Finance,
Washington, DC

24 July 1992

Dear Mr. Richter: May I place on record my appreciation of the courtesy with which we were received by Senator Bentsen and members of the Senate Finance Committee on Tuesday. I think that we were all conscious that we had an enormously wide span of ground to cover. I hope that we were in the event able to be of some help to the Committee.

During the session, I promised to check a couple of points of detailed fact about the "cap" on the tax relief for Mortgage Interest. The "cap" was first imposed in 1974–75 at 25,000 pounds. It was raised to 30,000 pounds in 1983–84; and has been held at that level ever since. It is estimated that the "cap" affects something in the region of 40% of all mortgages, and about 70% of new mortgages.

As I said at the meeting, these are averages, with the practical impact varying widely, in response to differing levels of house prices in different regions.

Over this period other restrictions have been introduced: to withdraw relief from the cost of home improvements (as distinct from new home purchase); in 1988 to confine relief to one "ration" of 30,000 pounds per home (previously 30,000 pounds per person); and most recently, in 1991 to confine relief to the basic rate of 25% (with relief no longer being extended to the higher 40% rate).

I also promised to let the Committee have a note, recording the very brief outline of the UK tax system that I gave orally at the beginning of the session. As I mentioned to you, it was only after my arrival on Monday night, that I learned that written evidence would be acceptable. In the circumstances, I have slightly expanded my oral remarks, to include some relevant details, for which there was no room in the 10 minute timetable for an oral presentation. I hope that the Committee will find that helpful.

Yours Sincerely,

A.J.G. ISSAC

Mr. ISAAC. It is very unevenly spread across the country. In parts of London or the Southeast, you would find it difficult to buy a hen shed for much less than 30,000. In parts of the country further away, then it buys quite a lot of property.

Senator BRADLEY. All right. What about in Germany, Dr. Rädler; how do you treat mortgage interest?

Dr. RÄDLER. Well, that depends, of course. We changed the law a couple of years ago that the value of living in their own home is no longer taxed. And that, of course, makes it more neutral not to allow deduction of costs. But there is exemption for new homes, so people who have new homes get an interest deduction for a number of years on a limited amount.

Senator BRADLEY. Can they deduct their full interest?

Dr. RÄDLER. Up to a certain values. But it gives a cash value, I would say, of about up to 15,000, 20,000 marks a year. This is the price.

Senator BRADLEY. That is the cap?

Dr. RÄDLER. No. That is the tax incentive. The tax expenditure is about that. It is between 10,000 and 20,000 marks a year for people acquiring a new home.

Senator BRADLEY. So, you can deduct up to 20,000 or 30,000.

Dr. RÄDLER. No, no. This is the cash value. You see, that is the tax value they get if they have high income, or relatively high income.

Senator BRADLEY. So, how do they get the subsidy?

Dr. RÄDLER. The government subsidy, you can say, is between 10,000 and 20,000 marks. And that is part of our policy to increase ownership of houses, of homes.

Senator BRADLEY. Yes. But how do they get the subsidy?

Dr. RÄDLER. Through the tax system.

Senator BRADLEY. How?

Dr. RÄDLER. They can deduct the interest.

Senator BRADLEY. All right. Up to 20,000 to 30,000 marks.

Dr. RÄDLER. And they also get a limited deduction for depreciation of the home.

Senator BRADLEY. Depreciation of the home. That is a new one.

Dr. RÄDLER. Yes.

Senator BRADLEY. Mr. Nakamura, what about in Japan?

Mr. NAKAMURA. We have a tax credit for the home, but it is very limited. Only 1 percent is credited until 20 million yen of loans, and 0.5 percent additional 10 million yen of loans.

Senator BRADLEY. So, you have a very limited incentive for home ownership.

Mr. NAKAMURA. Right. Yes.

Senator BRADLEY. What is the rationale behind that?

Mr. NAKAMURA. I think it is a revenue loss, and the government does not want to have a revenue loss.

Senator BRADLEY. You do not want to have the money going into home ownership, you would rather it going into the investment in plant and equipment.

Mr. NAKAMURA. Well, I do not know about that. Do you mean that the government likes to spend more money on equipment and machinery depreciation?

Senator BRADLEY. Yes. I meant, if you have a tax incentive for investing in home ownership——

Mr. NAKAMURA. Right.

Senator BRADLEY [continuing]. Versus a tax incentive for investing in plant and equipment.

Mr. NAKAMURA. That is a special appreciation offer to corporations.

Senator BRADLEY. I see.

The CHAIRMAN. Thank you. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. I want to thank Senator Grassley for letting me go in his place, because I have to leave, unfortunately. I have a brief question that I would ask each of you, if you could respond briefly.

What is the best corporate tax incentive that you think you have as part of your tax system? What tax break—one an objective observer might say was a break—has borne fruit in increased investment, or increased production, or greater capital investment? Maybe you, Mr. Isaac, first. As you look at your tax code.

Mr. ISAAC. I think my answer would be the lower rate of tax. Speaking from my own personal view, U.K. industry benefited greatly from the changes in 1984 when the tax breaks were withdrawn, the rate of tax came down.

Senator CHAFEE. The rate came down.

Mr. ISAAC. The rate came down.

Senator CHAFEE. From what to what?

Mr. ISAAC. Well, it came down from 50 percent, to 35 percent, and, now, 33 percent.

Senator CHAFEE. That is the corporate income tax rate now?

Mr. ISAAC. Yes, the corporate tax came down in a broadly revenue-neutral operation.

Senator CHAFEE. And when Mrs. Thatcher brought it down, or when she recommended that it be brought down, they also did away with the breaks, if you would?

Mr. ISAAC. Yes.

Senator CHAFEE. To get the lower rate.

Mr. ISAAC. That is right.

Senator CHAFEE. Thank you very much. Dr. Rädler, what would you say?

Dr. RÄDLER. I feel the most useful instrument for that purpose to give incentive to growth is fast depreciation, declining balance depreciation, as we have in Germany, three times straight line. I think that helps.

Senator CHAFEE. And your industry would say this is a very beneficial aspect of your code?

Dr. RÄDLER. I would think that they would say so. I am speaking on my own, you know.

Senator CHAFEE. Oh, yes.

Dr. RÄDLER. But I would certainly think so.

Senator CHAFEE. But, I mean, you know what you are talking about, or you would not be here. That is an assumption we make.

Dr. RÄDLER. Yes.

Senator CHAFEE. Mr. Nakamura.

Mr. NAKAMURA. I think that the best effective way is reducing corporate tax. Japan's corporate tax is 37.5 percent. We need it to be reduced.

Senator CHAFEE. Well, have you reduced it from what it was? In other words, did you come down and thus get increased investment, or has it gradually crept upward?

Mr. NAKAMURA. We believe that the Japanese corporate tax is the highest in the world, including the special tax measures. So, real tax burden is very, very heavy on Japanese corporations. So, our interest in the business community is to reduce corporate tax rates, and special tax measures have been abolished very rapidly, very recently.

Senator CHAFEE. Well, Japanese industry seems to be doing pretty well, despite the high rate.

Mr. NAKAMURA. Well, I think competitiveness is determined by other factors. The tax factor is a very important factor, but other factors are also very important in determining the competitiveness, I think.

Senator CHAFEE. You mean non-tax factors.

Mr. NAKAMURA. Non-tax factors.

Senator CHAFEE. Such as people working very hard, and quality, and so forth.

Mr. NAKAMURA. By quantity of capital, and quality of capital, cost of capital, and the quality of labor, quantity of labor and technology.

Senator CHAFEE. I see. Well, is there anything that has been done in your tax code that has proven very beneficial to industry? I am talking solely the tax code now. Incentive for production, incentive for investment. For instance, are dividends deductible?

Mr. NAKAMURA. Eighty percent of intercorporate dividends are deductible.

Senator CHAFEE. How about when you pay them to individual stockholders?

Mr. NAKAMURA. Tax credit is offered to individuals for dividends receivable.

Senator CHAFEE. All right. How about to the corporation?

Mr. NAKAMURA. Eighty percent of the dividends receivable is not included in income, only 20 percent is included.

Senator CHAFEE. All right. Thank you very much. Thank you, Mr. Chairman.

The CHAIRMAN. Yes. Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Chairman. A very interesting hearing. I thank you very much for bringing this topic and these experts before the committee. I would start with the gentleman from Japan.

As I have been able to ascertain, your individual tax rates run from 10–50 percent, and yet broad categories of interest are taxed only at the 20 percent withholding rate: individuals over 65, cer-

tain widows; and the disabled may exclude most interest from all taxations.

Lastly, an individual who receives dividends from a single company aggregating not more than $100,000 a year may elect to be taxed on those dividends at the 20 percent withholding rate.

My question, then, is how long have these savings incentives been in existence, and, more importantly, how effective have they been in spurring national savings?

Mr. NAKAMURA. Well, our tax incentive on savings were abolished in 1987. When we looked at statistics on savings, the savings ratio dropped in 1987 from 16 percent to 14 percent. So, I think an incentive for savings had a real impact on the savings ratio in Japan.

Senator GRASSLEY. So, the trend has been, because of the tax policies, that there has been less savings?

Mr. NAKAMURA. Well, right now we have abolished the tax incentives on savings. But in trend, the Japanese savings ratio has been declining. But in 1986 we used to have tax-exempt savings.

The Japanese savings ratio was at 16 percent. But, after abolition of tax measures on savings, that ratio dropped to 14 percent. So, in that sense, the tax incentive had some effect on the saving ratio.

Senator GRASSLEY. All right. This committee has recently taken action on legislation just in a bill recently voted out of this committee to amortize intangibles. There seems to be some concern about including goodwill in this area, although this committee has included goodwill on a prospective basis.

Goodwill in Japan can apparently be amortized over 5 years. Apparently, Germany allows goodwill to be amortized. Does this foster Japanese and German acquisitions to capture goodwill write-offs, or has it had any negative effect, if any, resulting from the amortization of goodwill in Germany and Japan? I would start with Japan.

Mr. NAKAMURA. Well, in Japan we can amortize intangible assets in a straight line method. In patents, I think the patent is 8 years, and design rights is 7 years. You mentioned 5 years goodwill, but it depends on the intangible asset. But the method of depreciation is straight line method, not the declining balance method.

Senator GRASSLEY. All right. But has it encouraged the acquisition of other corporations so that the goodwill could be written off? Has it had any effects, your present depreciation of goodwill, the writing off of goodwill?

Mr. NAKAMURA. I do not think that amortization of goodwill will have a negative effect on the merger and acquisition.

Senator GRASSLEY. All right. Germany.

Dr. RÄDLER. Well, we have straight line depreciation over 15 years. So far, we do not have any negative effects. I would like to add that, in the case of a clear loss in value, for example, the acquired business has losses for two or 3 years, you can amortize the remaining total value. That is part of this. Write off the lower concern value.

I would like to add that, in our committee in Brussels, we had long discussions on this issue because there are such great differences. For example, the Netherlands four to 5 years, and, in

other countries, like the United Kingdom, you can never amortize that. And I think in the common market you cannot operate under such different tax situations.

Senator GRASSLEY. I would ask Mr. Isaac, in the United Kingdom, in regard to the fact that you can deduct up to 40,000 pounds per year against income for investing in newly-issued common stock of qualified companies. Again, how long has this provision been in effect, and has it been effective in spurring investment?

Mr. ISAAC. This was introduced in the mid-1980's. It was against a background that there was a shortage of risk capital for very small start-up businesses. There was a limit to the amount such businesses could prudently borrow without over-gearing, and it was in a world in which the venture capital industry was, at that time in the United Kingdom, very undeveloped as compared with the United States.

Against that background, the government thought it right to have this very generous tax expenditure where the post-tax return for investment would be very much greater than the pre-tax return. It is a quite strong tax subsidy.

It is a little difficult to quantify the amount of new investment that has been called forth by that relative to the cost of the investment.

The nature of the scheme was changed quite significantly in 1988 when, for the first time, rented accommodation was brought into the business expansion scheme.

At that point, the market saw considerable attraction in getting a tax subsidy for an asset which was reasonably stable and safe in value—bricks and mortar. And a high proportion of investment in business expansion since 1988 has been in bricks and mortar and rented accommodation.

The British Chancellor announced in the 1992 budget that the scheme would be brought to an end in 1993 when the five-year rented accommodation scheme was due to come to an end in any event.

Senator GRASSLEY. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Pryor.

Senator PRYOR. Yes. Thank you, Mr. Chairman. If I might inquire a little bit about the relationship in your three countries between the taxpayer and the tax collector. Is this an adversarial position that the taxpayer has against what would be our Internal Revenue Service? Mr. Isaac, may I ask you that question?

Mr. ISAAC. I think that the number of people who enjoy paying tax in the United Kingdom is limited.

Senator PRYOR. Is limited, did you say? Well, we have that in common.

Mr. ISAAC. Having said that, we certainly seek—and I speak for the board of which I was a member—to avoid an adversarial position. Certainly there are times when both sides need to debate, and there are times when the two sides—the taxpayer and the tax gatherer—disagree.

However, we saw it also very much as part of our function to provide a service to the taxpayer to make it easier for those who want to meet their obligations to do so. And that was part of a bargain between the public service and the public whom we served. The

other element is to encourage, within the law, those who prefer not to pay the right amount of tax to do so.

Senator PRYOR. Dr. Rädler, what about Germany?

Dr. RÄDLER. Well, I think I can follow very much what you said, Mr. Isaac. We have a system of tax audit. Each tax return is audited, looked at, by a tax inspector in the office. And then there are regular field audits. Any companies, I would say, of more than 50 people get an audit every 4 years for the last 4 years.

For the strict system of controls, you also notice the number of tax inspectors, which is substantially higher than all the other countries: Germany has about 100,000 tax inspectors. Compare that, for example, with your numbers.

And I had the pleasure of being a visiting professor in Tokyo, and I made a study at that time that the Japanese have only one-fourth, compared to the number of people, of tax inspectors that we have. And the problems we are getting recently are legal issues because the constitutional court, from time to time, tends to declare certain provisions illegal, so everybody is filing in opposition an appeal to tax assessments, just in order to keep his rights.

Because, you know, if he has not done so and there comes a decision from the constitutional court, he would not get a refund. And only those people benefit who have filed an appeal. So, that really is today's problem. We have far too many cases before the tax court. There are about 80,000—90,000 new cases a year for the tax court, and that brings problems.

Senator PRYOR. We have some of the same problems. Mr. Nakamura, what about in Japan?

Mr. NAKAMURA. As the Chairman mentioned in the introduction, the consumption tax was not popular when we introduced it. But we have some exemptions on the consumption tax. The purpose of the consumption tax, to achieve fair taxation among taxpayers, we applied accounting records instead of invoices, so we still have unfair taxation among the taxpayers.

Senator PRYOR. Are the taxpayers rights in your respective countries clearly spelled out and enunciated?

Mr. ISAAC. I will say, yes, very clearly. I would like to have mentioned, and I will say it now, that we published some years ago and republished last year a Taxpayer's Charter which set out in reasonably plain English the taxpayers' rights and obligations, and avenues of appeal if they felt that they had not received the treatment that they thought they should have done.

Senator PRYOR. Well, Mr. Chairman, my time is up. Thank you very much.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Mr. Chairman, thank you very much. And, gentlemen, thank you all for being here. I would like to ask you generally about the consumption tax, your experience with it, and your views of it. There is increasing concern within the United States that we have moved too far toward rewarding consumption and discouraging savings and investment.

We are the only industrialized country in the world now without some form of consumption tax. So, there is a considerable amount of ferment going on now about the issue of consumption tax. Those who are critics of it have several concrete criticisms.

One criticism is that the consumption tax is an invitation to big government. It is too easy to increase the consumption tax and government gets out of control. Another criticism is that, particularly when it is put in place, it is inflationary. The price of goods must go up very quickly to accommodate the consumption tax.

A third criticism is that the consumption tax is regressive. What is your view of it, what is your advice on it, and how, if at all, would you meet those criticisms? Starting with you, Mr. Isaac, and then Mr. Rädler, and Mr. Nakamura.

Mr. ISAAC. On your last question, it would be impertinent of me to advise the U.S. Senator. I can only share my experience with you and leave you, if I may, to draw your conclusions.

Certainly, in the United Kingdom, we have had consumption taxes of one kind or another for a great many years. And all commentators would be, I think, extremely surprised to see them withdrawn, partly for the reasons you yourself have mentioned, Senator: the balance on taxes on earning and taxes on spending.

Senator DANFORTH. I missed the beginning of the sentence.

Mr. ISAAC. I said that it would surprise all commentators if any action were taken to remove the existing value-added tax or the purchase tax that preceded it. The case for it, I think, rests partly, as I said, on the perception that there should be a balance between taxes on earning and taxes on spending.

Partly for a more general reason that, in my experience, it is unsafe to try to put too much weight on any single source of tax and that a broad-based tax system tends to be more robust, partly, perhaps, because the rates of each tax can then be lower. That is, again, I say, a very important factor, as a tax collector.

So for the argument about regressiveness. The effect in the United Kingdom, of the value-added tax, I think, is mitigated very much because some items are exempt—notably, food and home ownership—which bulk very large in the incomes of the very poor. So, that strongly mitigates the feared regressive effect.

Of the first two, if I may say so, there is some internal conflict between the argument it is too easy to increase and it is inflationary. Those of us who have sat through budget meetings with ministers of finance are well aware of the restraints on increases in taxes which would increase price levels. Thank you, Senator.

Senator DANFORTH. Thank you. Dr. Rädler.

Dr. RÄDLER. In Germany, the value-added tax now brings in about 27 percent of total tax collection nowadays. And it seems, in a way, as some people claim, it is some kind of ultimate money machine for government and we are going in degrees because of EC needs; because of the internal market next year; our rate from 14 percent to 15 percent.

And, contrary to the United Kingdom—and that is a problem within the community—we do not have the exemption for food and other necessities, but have a reduced rate of 7 percent, and, as a compromise, the 7 percent is not increased, which is half of the rate. And compared with our neighboring countries, Germany really has the lowest rates on VAT, except for Luxembourg. France is higher; it is 18.6. Netherlands are 19.5, and the same for Belgium.

Certainly, there is a problem of regressivity, but we try to overcome that by cash grants for children. The problem of inflation cer-

tainly is there. We have noticed that whenever there was an increase of the tax rate of 1 percent, usually there was also additional inflation of 1 percent or so.

Senator DANFORTH. Mr. Nakamura.

Mr. NAKAMURA. There was a concern when we introduced the consumption tax about the size of government. But we have a strong movement for administrative reform in the government. The business sector always watches the size of the government. And on the inflation, the Japanese consumption tax is a very low rate—it is 3 percent. So, inflation was not a problem when we introduced the consumption tax.

And on regressivity, as income distribution is getting fair, regressiveness of the consumption tax is not a problem. And, also, the consumption tax achieves an effective tax compliance mechanism, so we supported introduction of the consumption tax.

Senator DANFORTH. Thank you, Mr. Chairman. Thank you all.

The CHAIRMAN. Gentlemen, it has been an extraordinarily interesting bit of testimony. I regret the fact that our time schedule is such that we cannot pursue it even more. But thank you very much for your attendance. We are appreciative of your being here.

Our next set of witnesses. Mr. John Wilkins, who is director of Tax Policy Economics for Coopers and Lybrand, Washington, DC, and Mr. Anthony J. Saggese, who is the general tax attorney for Texaco. Mr. Saggese, would you pronounce your name for me?

Mr. SAGGESE. Saggese, Senator.

The CHAIRMAN. Saggese.

Mr. SAGGESE. Saggese. As in Cochise, although it is not Indian. It is Saggese.

The CHAIRMAN. All right. We are pleased to have you. Thank you very much. Mr. Wilkins, if you would proceed, please.

STATEMENT OF JOHN G. WILKINS, DIRECTOR OF TAX POLICY ECONOMICS, COOPERS & LYBRAND, WASHINGTON, DC

Mr. WILKINS. Thank you, Mr. Chairman. As you noted, I am director of Tax Policy Economics at Coopers & Lybrand. Prior to leaving government service at the Treasury Department 2 years ago, I was vice chairman of the Committee on Fiscal Affairs of the OECD. Part of my testimony today draws upon findings of a recent study by that group. I thank the committee for inviting me to share my views.

Countries differ considerably in the tax burden they place on their businesses and on their citizens. This reflects, in part, the role of government, its size, and its scope of activities. There is no one correct answer: Some will select a large role for government, others will opt for a small role.

Among the four countries that are the focus of this hearing, the United States takes the least from its citizens to finance government—30 percent of gross domestic product. This compares favorably with Japan's 30.6 percent; and even more favorably with the tax burdens of the United Kingdom and Germany—which claim more than 36 percent and 38 percent, respectively.

Nations also differ in how they finance government. In analyzing how, we too often focus only on taxes levied by the Federal Government. This, obviously, can paint a misleading picture in inter-

national comparisons. Japan relies most heavily on income taxes and least on consumption taxes, when you look at all levels of government combined.

For every 100 yen they collect in income taxes, the Japanese collect only 22 yen in consumption taxes. What may surprise some is that the United States collects a higher proportion of consumption taxes. For every $100 of income taxes, U.S. tax authorities collect about $32 of consumption taxes. And, again, I am referring to all levels of government. Obviously, these are mostly at the State and not the Federal level.

The CHAIRMAN. Are you talking about all major countries, or are you comparing to Japan when you say that?

Mr. WILKINS. I am comparing just these four countries at the moment. The United Kingdom and Germany each depend on consumption taxes much more than either the United States or Japan, with consumption taxes in each of these countries bringing in about three-fourths as much tax as their income taxes.

Even with no consumption taxes allocated to business taxpayers, 30 percent of all taxes paid in the United States are paid by businesses. In the United Kingdom and Germany, businesses pay a smaller share of the total tax—28 and 25 percent, respectively—while in Japan, business taxes account for more than 39 percent of the total government revenue.

Information like this, Mr. Chairman, is helpful in the kind of broad comparison of tax regimes that you are undertaking today. However, we should also be aware that when it comes down to decisions about where a multi-national is going to invest, how they are going to invest, then they are going to look not at these overall levels of taxes, but particularly at the effective tax rates that you referred to in your opening statement.

The overall weighted effective marginal corporate tax rate on domestic investment in the United States, including deductible State and local taxes is, by one measure, about 13.8 percent, substantially lower than the statutory rate of 38.3 percent. And this 38 percent, again, includes the Federal tax at 34 percent, and average State and local taxes, at 6.5 percent, which is deductible.

However, even with this kind of dramatic drop from the statutory rate down to the effective rate, the United States is only second-lowest of the four countries in both statutory and effective rates. At 10.7 percent, by the measure I am using, Germany has the lowest effective rate, interestingly, and Japan, at 21.9 percent, has the highest effective corporate tax rate of these four countries.

From all of the statistics I have cited, it would appear that Japan ranks near the bottom. After all, they have the highest effective marginal tax rate on corporate income; they rely least on savings rewarding consumption taxes; and, as my written statement explains, they have the fastest-growing overall tax burden. But, at the same time, Japan has outpaced the United States in real growth.

Over the last 20 years, the United States, Germany, and the United Kingdom have all lost out to Japan by as much as 2:1. They, as we know, have the highest savings rate—nearly 20 percent of GDP. Obviously, taxes and corporate taxes are not the whole story.

Subsidies are offered in various countries; sometimes within the tax system, sometimes outside the tax system, as we have heard this morning. In closing, I would like to urge the committee not to lose sight of one U.S. tax program——

The CHAIRMAN. Mr. Wilkins, take more time if you want to.

Mr. WILKINS. The point I would like to make, with a few more seconds, Mr. Chairman, on the non-tax subsidies that go to various countries, according to some OECD statistics for 1988—the last year those particular statistics were available—the United States devoted an amount equal to 0.6 percent of GDP to subsidies of business and industry. Japan was about 50 percent higher than this, according to those statistics. It was about 0.9 percent; still a relatively low number.

In the United Kingdom, the same statistics show that subsidies to business and industry were as high as 1.3 percent of GDP, and in Germany, they were a huge 2.3 percent. And, in fact, that number exceeds the entire German corporate income tax by about 15 percent.

The last point I had started to make was the fact that our treaty program is doing a lot of good for multi-national businesses. As non-tax barriers are being dropped around the world—exchange controls and other direct barriers to investment—taxes have become relatively more important, although they are not the only contribution to impediments to international investment.

Treaties are doing a lot of good, however. They are lowering the effective tax rate that people otherwise would be facing by as much as about 15 percent. We have treaties with all of the other three countries here.

Most of them, however, have broader networks, and I would encourage us to try to expand that treaty network. Not only does it help our businesses compete abroad, but it also boosts the global efficiency of capital by just having a better distribution of capital worldwide. Mr. Chairman, that concludes my written statements. I will obviously be happy to answer any questions later.

[The prepared statement of Mr. Wilkins appears in the appendix.]

The CHAIRMAN. Would you proceed, sir?

STATEMENT OF ANTHONY J. SAGGESE, GENERAL TAX ATTORNEY, TEXACO INCORPORATED, WHITE PLAINS, NY, ACCOMPANIED BY ROBERT A. RAGLAND, CHIEF TAX COUNSEL AND MANAGING DIRECTOR, NATIONAL CHAMBER FOUNDATION, WASHINGTON, DC

Mr. SAGGESE. Mr. Chairman, members of the committee, I am Anthony Saggese, general tax attorney to Texaco, which is headquartered in White Plains, NY. With me today is Robert Ragland, managing director, and chief counsel to the National Chamber Foundation.

I have primary responsibilities for the company's tax matters in major sections of the world, including Western Europe, Eastern Europe, the Commonwealth of Independent States, and China. I am appearing today on behalf of the National Chamber Foundation, the tax and public policy research affiliate of the Chamber of Commerce of the United States.

It should be known that my comments do not necessarily reflect the views of the U.S. Chamber of Commerce, for with the exception of limited in-kind contributions, the National Chamber Foundation is not funded by the Chamber of Commerce. Also, the foundation operates under the direction of its own board of directors.

We appreciate the opportunity to discuss the findings of U.S. International Tax Policy For A Global Economy: a major study evaluating factors affecting U.S. competitiveness in the global marketplace.

The report represents a collaboration of a multi-industry working group, including the extractive industry, electronics, pharmaceuticals, food and grocery products, and financial services. Our data was assembled over 18 months, released to the public in May 1991, and presented to the House Committee on Ways and Means in testimony on July 18, 1991.

The study includes case study examples which were assembled by Price Waterhouse as consultant to the National Chamber Foundation working group. Texaco and other member companies of the National Chamber Foundation working group agreed to provide technical and financial support for this project because we believe that U.S. tax policies are adversely affecting the foreign operation of U.S. companies.

Empirical data contained in our study confirmed our fears and demonstrated the pressing need to reform U.S. tax law, both domestic and foreign, to remove provisions that are confounding efforts to succeed in the highly competitive global marketplace.

All of us are painfully aware that the U.S. economy has not been performing up to its potential. Fewer of us, however, are aware that the foreign activities of U.S. multi-nationals is one of the few happy chapters in our otherwise disappointing economic book.

The Commerce Department notes that "U.S. exports were a vital source of growth in U.S. output and employment over the last half of the 1980's. In fact, the number of jobs supported by merchandise exports reached a record 7.2 million in 1990." Quite clearly, this is an area of public policy that Congress would do well to favor.

In current economic terms, it is unfathomable that lawmakers would burden companies doing business in the world marketplace. Instead of penalizing multi-nationals, U.S. policy should be aggressively promoting foreign investment by U.S. companies.

As shown in our study, this can be accomplished by such actions as: repealing the provisions that are based on the misguided notion that foreign trade exports U.S. jobs; repealing provisions that are unique to U.S. tax law in the international arena; and simplifying the provisions that add compliance costs without adding competitiveness.

We should also consider adopting a package of pro-economic growth incentives to undo decisions made in 1980 to raise the tax rates on capital and capital gains. A recent report issued by the Democratic Policy Committee of the U.S. Senate agrees with our assessment that foreign trade is a key to domestic economic growth.

While we do not agree with all of the policy recommendations contained in their study, we do find merit with the premise that "there is a new competition in the world today—an economic com-

petition. The fate of individuals and nations will no longer be decided by who can win an arms race, by who can produce a better bomber or missile.

The United States is secure in its defense today, and it will remain so for the foreseeable future. The fate of individuals and nations today and into the next century will be decided by which countries can mobilize their national resources to win the global economic competition."

The Finance committee has every right to be concerned with foreign tax issues. The United States is participating in a declining share of an expanding world marketplace. This lamentable status is attributable, in part, to an overwrought and archaic tax system, as applied to taxing foreign operations of U.S. companies, developed after World War II when the United States was the only meaningful economy in the world.

In those days, we could afford to adopt unilateral standards and pressure other industrial and developing nations to follow our lead. Today, we cannot.

U.S. goods and services must compete on a price and quality basis with virtually identical products and services offered by competitor companies headquartered in other countries. Those countries differ in their treatment of foreign income in a number of key ways.

Our study confirms that U.S.-headquartered companies pay more tax on foreign income, and labor under a compliance burden that is measured in terms of complexity and lack of clarity, and work under a capital cost system that is one of the most hostile in the industrial world.

The U.S. International Tax Policy For A Global Economy study contains an extensive discussion of options to modify particular tax rules consistent with the principles of eliminating discrimination against foreign sourced income, achieving greater harmonization with the international tax norms, and reducing the complexity of international tax rules.

We recommend a thorough review of U.S. tax laws affecting the foreign operations of U.S. companies. Some possible options include—this is only a limited list—generally permitting deferral for various types of active business income; restricting foreign tax credit limitations to two primary categories: active business and passive portfolio income; eliminating the separate foreign tax credit limitation for non-controled, Section 902 corporations; reflecting foreign borrowings in the allocation and apportionment of interest expense and allowing U.S. corporations borrowing on their own ability to allocate and apportion its interest on the basis of its assets, and providing a more equitable methodology for the allocation of interest and research expenses.

We would also recommend providing symmetrical treatment of domestic and foreign income and expense, including domestic loss recapture, and reviewing and revising U.S. tax laws to facilitate participation by U.S. taxpayers in international joint ventures. These are further discussed in the studies, Senators, and there are other items, as well. Some of these, I am sure, are not new to you.

I thank you for this opportunity, on behalf of the National Chamber Foundation, to testify today. We have supplied your respective

offices with a copy of the study. Of course, the National Chamber Foundation would be more than happy to supply additional copies to your staff upon request. We thank you for your time, and I am prepared to respond to any questions you may have.

[The prepared statement of Mr. Saggese appears in the appendix.]

The CHAIRMAN. Yes. In listening to your statement, you seem to imply, as I understand you, that the fall of U.S. corporations from the rank of the top 25 in the world, that much of it is because of our tax policy. That is the implication that I am getting. Obviously, there are other very major factors involved.

How would you respond to the rather startling testimony that we had this morning that Japan's tax burden on corporations is 10 percent higher than in the United States, and higher than in most industrialized nations? And they are being extraordinarily successful in what they have been able to do in market penetration around the world. How would you respond to that?

Mr. SAGGESE. Mr. Chairman, I can respond in two ways: First, I believe that we must look at effective tax rates and not the generally applicable corporate tax rate. As we know, there are several ways to raise the tax rate. One, is to raise the rate itself, and another is withdraw deductions or certain types of incentives.

Also, I found the testimony rather interesting, but I was hoping that there would be more of a focus on how foreign governments tax their U.S. based multi-nationals. There is a disparity as to how those individuals who testified here this morning from the United Kingdom, Germany, and Japan, and other countries throughout the world tax their U.S.-based multinationals when they are operating outside of their country.

And I think that is an area that has hampered us here in the United States. Perhaps not what we would call domestic tax policy—and that is what is contained in this study—but, to a great extent, how we tax our U.S.-based multi-nationals operating abroad.

The CHAIRMAN. Well, perhaps we could have pursued that more, but the time limitations prevented it. Mr. Wilkins, you just heard what he stated insofar as what I assume he was talking about, in an effective tax rate, and you spoke to that one. Would you comment, again, insofar as the relationship of the Japanese effective corporate tax rate as related to our own?

Mr. WILKINS. Yes. The effective corporate tax rates for all countries are substantially below the nominal rates that were referred to this morning—50 percent, I think for Japan, 38 percent for the United States. The effective rate is the rate that you would actually pay if you were making an investment.

Now, the National Chamber Foundation study figures are effective rates for companies investing in manufacturing, through Switzerland, I believe, and distributing in Italy, or just the opposite, Italy and Switzerland. The OECD has done something similar trying to get to the same point.

What the OECD did was to try to look at the way companies actually invest. They actually invest 50 percent in machinery, 28 percent in structures, 22 percent in inventories. And how they finance those investments—they finance 55 percent by retained earnings, 10 percent by new equity, 35 percent by borrowing.

All of these have slightly different tax consequences in our country, as well as in other countries, by the way we treat debt, and so forth. That is what goes into the calculation of the effective tax rate, trying to weight these properly and see what the actual rate is going to be at the margin when a company makes an investment. In that respect, the figures I cited had Japan the highest, but far lower than the 50 percent statutory rate.

The CHAIRMAN. Well, I understand that. But I am trying to make a comparison thing between the United States and Japan. That is why I asked you the effective rate for the two.

Mr. WILKINS. The effective rate that we would have in Japan would be about 22 percent, as compared to a rate of about 14 percent on the same kind of basis in the United States, just looking at corporate taxes.

The CHAIRMAN. That is right.

Mr. WILKINS. One of the problems is that we need to look beyond the corporate tax into the individual tax and whether the cost of capital is affected by individual tax rates; my figures are only looking at the corporate tax for the moment.

The CHAIRMAN. Well, I heard the comment about punitive capital costs. But part of that has been influenced, as I understand it, by the extraordinary savings rates in Japan and the fact that they are earning multiples on their stocks.

We were running 75, and 100 times earnings, and they were putting out bonds at 1 percent, with a few little warrants out there on the end. And they were getting interest rates that were like one or 2 percent; far, far more favorable to investment than what we saw in this country.

But that was not necessarily the tax rate that brought that about. And that, incidentally, has changed materially with the change in the stock market in Japan where we are now seeing capital costs much more comparable to ours than with Germany. Senator Grassley.

Senator GRASSLEY. This may be asking the impossible, not in a sense because you are not capable of it, but because maybe we do not have time in regard to my approach to it. But my question is in regard to kind of your simplifying and summarizing the comparative cost of capital, the United States against foreign competition.

My question comes from the general assumption I get from American business people that our cost of capital is higher, and consequently we are economically uncompetitive in the global environment.

Also, from the standpoint that there appears to be conflicting evidence from various studies, both American and foreign, about whether U.S. cost of capital is higher. So, I would like to have each of your respond as best you can to that general assumption.

Mr. WILKINS. I will take it first, because my answer may be more brief. I do not know the answer to that, Senator Grassley. As you pointed out, there are conflicting studies and they are by very reputable economists.

The reason why we might expect costs of capital to be rather equal across countries is that savings by individuals, who are the ultimate source of financing, ought to be rather fluid and be able

to be used. There is no particular reason Japanese savings could not be used to finance American business.

And you can look at the international markets for your basic savings for investments. It turns out that a number of studies suggested that savings are not as fluid as they ought to be, and that, for whatever reason, people may prefer to invest in businesses in their own country.

This will start to bring down the cost of capital because you have a kind of build up of savings. Perhaps that means that people in Japan will be able to demand less as their after-tax return than investors in the United States might demand where there is not as large a savings pool.

Mr. SAGGESE. I agree, Senator Grassley, that the answer depends on which economists you speak to, which capital intensive groups, and what other groups who indicate we have a low cost of capital and give some benefit to the tax rate, and others who say the tax rate does not play a part in it. I think one factor, the topic of this discussion here today, or at least with the National Chamber Foundation testimony is with respect to U.S. taxation of foreign source income. And often that factor does not come into play in economic calculations of the cost of capital. I have heard economists testify and speak at a number of conferences here in town, at the American Council for Capital Formation, or IRET, to that point.

And many times they have no appreciation at all of the foreign tax provisions contained in U.S. tax law. And when they are raised by tax lawyers, such as myself, they either acknowledge cost of capital factors, or want to slide by them.

And I submit for the consideration of the committee; in considering the cost of capital to U.S. companies, that those making these estimates and doing those discussions consider the taxation of U.S.-based multi-nationals, because that affects when money is repatriated, how it is repatriated, where money goes. Not necessarily in our industry—we have to go where the oil is—but for other industries within the United States.

I would say that the U.S. tax provisions as applied to foreign operations should definitely be considered in any of these studies, no matter where they come out.

Senator GRASSLEY. And your point is that they are not being considered today?

Mr. SAGGESE. That is right; to a great extent, sir.

Mr. RAGLAND. Senator, if I may. We tried to take a look at the cost of capital and we estimate that, on equipment purchases——

The CHAIRMAN. Mr. Ragland, who are you?

Mr. RAGLAND. I am Bob Ragland. I am chief tax counsel and managing director for the foundation.

The CHAIRMAN. All right.

Mr. RAGLAND. And we took a look at the cost of capital and we estimate that, for equipment, 85 cents on the dollar is recovered domestically. Prior to 1986, it was roughly 100 cents on the dollar. If, however, a company is in an AMT situation and remains in there for an estimated 5 years, those recovery rates are reduced to 65 cents on the dollar.

Whether it is 65 cents or 85 cents, this is the least advantageous in the industrial world. And the numbers with respect to heavy in-

vestment outside of the United States have dramatically increased in recent years and we think it is because of these numbers.

Senator GRASSLEY. Thank you, Mr. Chairman. I guess maybe just one editorial comment. I did not talk to Senator Bentsen about why this hearing is being held, but I guess to answer the question that we ought to know, or ought to find more about the cost of capital. And that is the purpose of your hearing. Right? So we can have a competitive tax policy.

The CHAIRMAN. That certainly is a major part of it. We are trying to stay world competitive. We have got ourselves an enormous trade deficit. We are trying to see some of those things that affect it, particularly on tax policy. Senator Danforth.

Senator DANFORTH. Mr. Wilkins, one of the interesting points you made was that if you factor in our State and local taxes which are mainly consumption taxes and compare them to the tax system in Japan, that our consumption taxes would actually exceed the Japanese consumption tax. Did you say that?

Mr. WILKINS. As far as the reliance on various sources of revenue, that is correct. In the United States, we would be picking up 14 percent of our total government revenue from consumption taxes, as compared to 11 percent for Japan.

Senator DANFORTH. And how about the United Kingdom and Germany?

Mr. WILKINS. Germany would be 25 percent, and the United Kingdom, 29 percent.

Senator DANFORTH. So, the United Kingdom is 29, Germany is 25.

Mr. WILKINS. And the United States, 14, and Japan, 11. In other words, both Japan and the United States rely much more heavily on income taxes than do either Germany or the United Kingdom of the four countries we are talking about today.

Senator DANFORTH. Well, do you have a conclusion from that? I mean, a lot of people are thinking—I certainly am—more and more about consumption taxes. And, of course, the purpose of it is to try to induce savings and investment and discourage consumption and have a more balanced tax system.

Mr. WILKINS. That is right. That really requires a substitution of a consumption tax for an income tax.

Senator DANFORTH. Right.

Mr. WILKINS. Rather than just an increase on top of what we already have.

Senator DANFORTH. That is right. I mean, I do not think, even if you wanted to, you could not sell it politically that we were just going to have this huge source of revenue.

Mr. WILKINS. That is right. I think there is no question that it would be useful for the competitiveness of this country to have a better balance between consumption taxes and income taxes as the rest of the world seems to have, with, perhaps, the notable exception right now of Japan. They have just introduced their consumption tax and it is still at a low rate. It is possible they will be making more modifications there, too.

The income tax rates are an extremely important component of this whole cost of capital, and I think you will notice that two out of three answers this morning to your question as to what they ad-

mired most or what was best about our system for business—two of them said, low income tax rates are important.

I agree with that. I think low income tax rates are terribly important. So, if the alternative was to raise our corporate tax rates, I would very much favor looking more at consumption taxes and less at income taxes.

Senator DANFORTH. We seem to be changing our tax laws every two or 3 years now. And I had previously believed that we should have a hiatus, that we should try to provide a little bit of stability in our tax laws.

On the other hand, I guess my net view is that right now we have done it wrong and that we really should change it. Do the two of you have any view about whether the time is right for us to have a significant change in our tax system?

Mr. SAGGESE. Senator, I do not know about a significant change. That has different meanings to different people. But there is a saying, if it is not broken, do not fix it, but I am not so sure that that applies to the tax law today. We would like stability in the tax law. I think all corporate America and individuals, would like it as well.

Though, once a law is passed here, a tax law—we are still dealing with many of the things in the 1986 tax laws—are they are unclear as to what they mean by regulations, or regulations to be drafted, and interpretations, and rulings, and discussions back and forth with Treasury and the IRS. So, even if we stopped today, I am sure that that would go on for years and years to come.

In the foreign tax provisions, I think that there is a need for change; there is a need for dramatic change. As you know, there is a hearing going on right now over in the Ways and Means Committee on the Rostenkowski-Gradison bill on simplifying and correcting some of the foreign tax provisions in the U.S. Code, and we applaud the two Congressmen for their acts.

Unfortunately, it is a pay-as-you-go system. They are saying, we are going to fix A, B, and C, but it is going to be a cost in the foreign tax area of X, Y, and Z. And if something needs to be fixed, we do not believe that you should break it somewhere else.

So, I do not know quite what significant in context, means. I think there is a need for change, particularly in the foreign tax area. I agree with you, Senator. I think there should be a serious look at consumption taxes here. I know you have assembled a broad-based group—which I commend you for—of all sectors of corporate America to look at a consumption tax.

I cannot take a position on consumption taxes on behalf of the National Chamber Foundation, for, as I am sure you are well aware, corporations are divided on the question; some are strongly opposed, some strongly favor it. However, I am able to make some general observations: First, there is a substantial segment of corporate America that is concerned with trade imbalance and believe that some type of consumption tax would put us on an equal footing, particularly with respect to our exports. I am unable to go much further than that. Again, being from the oil industry, we lack an appreciable surplus of oil in this country to export. But there are other corporations interested in consumption tax for deficit reduction, some even going as far as saying full replacement of the income tax, and some for partial replacement.

So, if you look at different reasons, I think there is a substantial interest in looking at a consumption tax. As for Texaco, we believe it warrants serious consideration. We would want to look at a package; we would want to consider what the revenues are going to be used for.

And, second—and, again, we believe it is secondary and not primary—is how the tax itself would be drafted. As I am sure you are aware of, the tax may be implemended in many ways. We talk of a consumption tax, but then you get into the nitty-gritty of how it would be drafted, and move forward into a complex series of technical concerns.

Senator DANFORTH. Thank you.

The CHAIRMAN. Gentlemen, thank you very much. We appreciate your testimony. It has been very helpful to us.

[The prepared statement of Senator Hatch appears in the appendix.]

[Whereupon, at 11:53 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

[Submitted by Senator Lloyd Bentsen]

[JOINT COMMITTEE PRINT]

COMPARISON OF THE TAX SYSTEMS OF THE UNITED STATES, THE UNITED KINGDOM, GERMANY, AND JAPAN

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON JULY 21, 1992

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

JULY 20, 1992

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JOINT COMMITTEE ON TAXATION

102D CONGRESS, 2D SESSION

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on July 21, 1992, on a comparison of the United States' tax system with the tax systems of certain other countries. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a comparison of the tax systems of the United States, the United Kingdom, Germany, and Japan.

A country's system of taxation is one of governments' main economic policy tools, and it can have a significant impact on its economy. Comparing the United States' tax system to that of other countries may provide insight into one way in which their economies differ and potentially useful ideas about how other countries address the problems associated with raising revenue and promoting economic well-being.

The tax system may affect the economy by influencing people's choices about consumption, saving, labor supply, and investment, as well as by altering the after-tax distribution of income. In general, the ideal system of taxation is one that raises the necessary revenue without greatly distorting individual economic decisions and also fulfills a society's distributional goals.

For the purpose of this pamphlet's analysis, taxes can be broadly grouped into two classes: those that tax the return to capital, and those that do not. Examples of the former include individual income taxes levied on interest and dividend income and on the gains of appreciated assets, wealth taxes, and corporate taxes. Taxes that do not tax capital income include classic consumption taxes like sales taxes and consumption-based value-added taxes, as well as taxes on wage income, like payroll taxes.

Taxes on the return to capital may distort decisions about how much to save and to invest, and hence affect a country's stock of capital and level of wealth. Taxes may affect saving by reducing the return to saving and may affect the size and composition of investment by changing the cost of capital. Because increases in the quantity and quality of the capital stock are important factors fueling economic growth, people often focus on cross-country differences in capital income taxes to rationalize differences in economic growth.

This pamphlet describes the extent to which different countries rely on different taxes to raise revenue and provides some analysis of how their different tax systems affect their rates of investment, saving, and economic growth.

The pamphlet is organized as follows. Part I of the pamphlet presents an overview of the revenue sources of the United States, the

[1] This pamphlet may be cited as follows: *Joint Committee on Taxation, Comparison of the Tax Systems of the United States, the United Kingdom, Germany, and Japan* (JCS-13-92), July 20, 1992.

United Kingdom, Germany, and Japan. Parts II, III, IV, and V provide summary descriptions of the tax systems of the United States, the United Kingdom, Germany, and Japan, respectively. Part VI discusses economic trends in the four countries and provides an analysis of the role of taxes and investment, saving, and the cost of capital.

I. OVERVIEW OF THE TAX SYSTEMS OF THE UNITED STATES, THE UNITED KINGDOM, GERMANY, AND JAPAN

Comparison of tax receipts

The proportion of tax receipts as a share of gross domestic product (GDP) has risen over the past 25 years in all four countries reviewed here (the United States, the United Kingdom, Germany, and Japan), with relatively consistent increases in Germany and Japan (Figure 1). The United States experienced the smallest increase among the four countries over that period; by 1989, it had the smallest share of GDP collected as taxes.

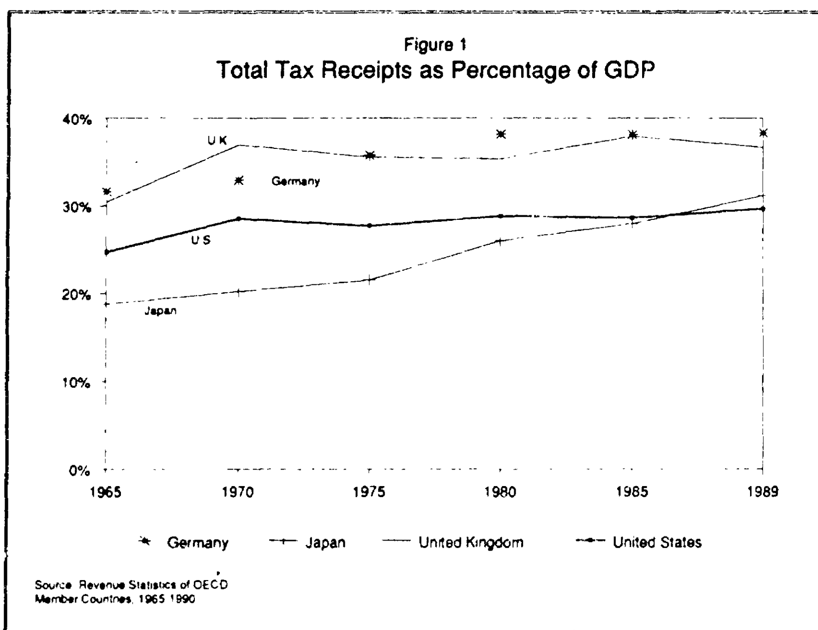


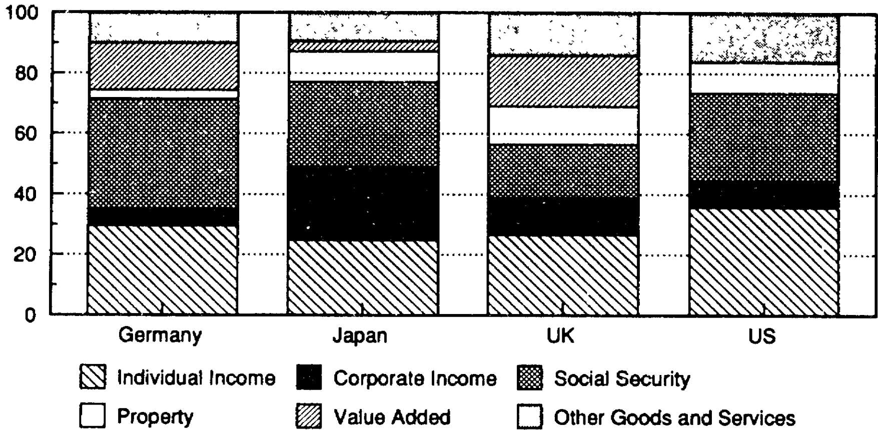
Figure 1
Total Tax Receipts as Percentage of GDP

Composition of tax receipts across countries

The composition of tax receipts varies substantially across the four countries (Figure 2). Of the four countries, the United States relies most heavily on the individual income tax. The corporate income tax yields almost one-quarter of Japanese tax revenue, a proportion nearly twice as large as that in the United Kingdom and much higher than that in Germany and the United States.

Value-added taxes are significant revenue sources in Germany and the United Kingdom. In contrast, the United States does not impose a VAT, and Japan, which imposed a VAT in April 1989, collected only 3.3 percent of its tax revenue through its VAT in that year.

Figure 2
Composition of Total Tax Receipts (1989)



Source: Revenue Statistics of OECD Member Countries, 1965-1990

Table 1 shows the composition of taxes for each of the four countries at regular intervals over the period from 1965 to 1989. A number of trends may be discerned from the data. One is that three of the countries introduced a value-added tax over the period. For each of the three, the VAT appears approximately to have replaced as a source of revenue other taxes on goods and services. Another trend is that social security taxes increased as a share of total tax receipts in Germany, the United States, and, to a lesser degree, Japan. For Germany and the United States, both corporate income taxes and property taxes declined as a share of total taxes over the period reviewed. In the 1980s, the United Kingdom moved to a greater reliance on corporate income taxes.

Table 1

Selected Taxes as a Percent of GDP

Germany	1965	1970	1975	1980	1985	1989
Individual Income Tax	8.2%	8.8%	10.8%	11.3%	10.9%	11.3%
Corporate Income Tax	2.5%	1.9%	1.6%	2.1%	2.3%	2.1%
Social Security Tax	8.5%	10.0%	12.0%	13.1%	13.9%	13.9%
Property Taxes	1.8%	1.6%	1.4%	1.3%	1.2%	1.2%
Value Added Taxes	0.0%	5.6%	5.3%	6.3%	6.0%	5.9%
Other Taxes on Goods & Services	10.4%	4.8%	4.4%	4.0%	3.8%	3.9%
Total Tax Revenue	**31.6%**	**32.9%**	**35.7%**	**38.0%**	**38.0%**	**38.1%**
Japan	**1965**	**1970**	**1975**	**1980**	**1985**	**1989**
Individual Income Tax	4.1%	4.3%	5.1%	6.3%	6.9%	7.7%
Corporate Income Tax	4.2%	5.3%	4.4%	5.7%	5.9%	7.6%
Social Security Tax	4.1%	4.5%	6.2%	7.6%	8.5%	8.7%
Property Taxes	1.5%	1.5%	2.0%	2.1%	2.7%	3.2%
Value Added Taxes	0.0%	0.0%	0.0%	0.0%	0.0%	1.0%
Other Taxes on Goods & Services	4.9%	4.5%	3.7%	4.2%	3.9%	2.9%
Total Tax Revenue	**18.3%**	**19.7%**	**20.9%**	**25.4%**	**27.6%**	**30.6%**
United Kingdom	**1965**	**1970**	**1975**	**1980**	**1985**	**1989**
Individual Income Tax	9.1%	11.6%	13.5%	10.5%	10.1%	9.8%
Corporate Income Tax	2.2%	3.3%	2.4%	2.9%	4.8%	4.5%
Social Security Tax	4.7%	5.1%	6.2%	5.8%	6.7%	6.4%
Property Taxes	4.4%	4.6%	4.5%	4.2%	4.5%	4.6%
Value Added Taxes	0.0%	0.0%	3.1%	5.1%	6.0%	6.2%
Other Taxes on Goods & Services	10.0%	10.6%	5.9%	5.2%	5.9%	5.2%
Total Tax Revenue	**30.4%**	**36.9%**	**35.5%**	**35.3%**	**37.9%**	**36.5%**
United States	**1965**	**1970**	**1975**	**1980**	**1985**	**1989**
Individual Income Tax	7.5%	10.0%	9.1%	10.6%	10.2%	10.6%
Corporate Income Tax	3.9%	3.6%	3.0%	2.9%	2.0%	2.5%
Social Security Tax	4.1%	5.5%	6.8%	7.6%	8.4%	8.7%
Property Taxes	3.8%	3.9%	3.7%	2.9%	2.9%	3.1%
Value Added Taxes	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Other Taxes on Goods & Services	5.4%	5.5%	5.1%	4.8%	5.1%	4.8%
Total Tax Revenue	**25.9%**	**29.2%**	**29.0%**	**29.5%**	**29.2%**	**30.1%**

Source: *Revenue Statistics of OECD Member Countries, 1965-1990*

For both Figure 2 and Table 1, the categorization of the types of taxes are made according to procedures developed by the Organization for Economic Co-operation and Development (OECD). The OECD attempts to make its classifications so that the data are comparable across countries. The classification of taxes into income taxes, property taxes, and goods and services taxes are generally governed by the base on which the tax is levied. Throughout Part I, the data represent combined tax receipts of all levels of government (Federal, State, and local) within a given country. The following definitions are employed by the OECD:

Income taxes—Taxes levied on the net income or profits of individuals and enterprises. These include social security contributions based on net income after deductions and exemptions for personal circumstances. When social security contributions are based on eligible earnings, payroll, or number of employees without deductions or exemptions for personal circumstances, the taxes are considered social security taxes (see below). For countries employing a credit imputation method for integrating individual and corporate income taxes (e.g., the U.K. advance corporation tax discussed in Part III.B.2.), the full amount of any credit is treated as a reduction in individual income taxes whether the credit reduces individual

income tax liability or is paid as a cash refund. (Tax credits for corporations with respect to dividends paid to other corporations are deducted from the corporate income tax category.)

Social security taxes—All compulsory contributions that are paid to institutions of general government and are earmarked for the provision of social security benefits; are levied as a function of earnings, payroll, or the number of employees; and are made by insured persons or their employers. Social security benefits include unemployment insurance benefits and supplements; accident, injury and sickness benefits; old-age, disability and survivors pensions; family allowances; and reimbursements for medical and hospital expenses or for provision of hospital or medical services.

Property taxes—Recurrent and non-recurrent taxes on the use, ownership or transfer of property. These include taxes on immovable property or net wealth, taxes on the change of ownership of property through inheritance or gift, and taxes on financial and capital transactions. It does not include taxes on capital gains resulting from property sales.

Value-added taxes—All general consumption taxes charged on value-added, irrespective of the method of deduction or the stages at which the taxes are levied. But general sales taxes are included in the category below.

Other taxes on goods and services—All taxes and duties levied on the rendering of services and on the production, extraction, sale, transfer, leasing, or delivery of goods other than value-added taxes. This category includes multi-stage cumulative taxes (such as turnover taxes), general sales taxes (whether levied at manufacturing, wholesale, or retail level), specific excise taxes, import and export taxes, use taxes, and taxes on extractive processes.

II. DESCRIPTION OF UNITED STATES TAX SYSTEM

A. Overview

The U.S. Federal Government imposes and collects individual and corporate income taxes, social security taxes, excise taxes, estate and gift taxes, and customs duties and fees.

In addition, U.S. State and local governments independently impose and collect their own separate taxes. These governments often impose one or more of their own property and sales taxes and taxes of the types imposed by the Federal Government (other than customs duties). For the year 1990, approximately 49 percent of State tax receipts were from sales and gross receipts taxes; 32 percent were from individual income taxes and 7 percent were from corporate income taxes.[2]

B. Federal Income Taxation

1. Individual income tax

Tax rates

Citizens of the United States and aliens resident in the United States are subject to the U.S. individual income tax on their taxable incomes. For 1992, the individual income tax rate schedules are as follows:

Table 2.—Federal Individual Income Tax Rates for 1992

If taxable income is	Then income tax equals
Single individuals	
$0–$21,450	15 percent of taxable income.
$21,450–$51,900	$3,217.50, plus 28% of the amount over $21,450.
Over $51,900	$11,743.50, plus 31% of the amount over $51,900.
Heads of households	
$0–$28,750	15 percent of taxable income.
$28,750–$74,150	$4,312.50, plus 28% of the amount over $28,750.
Over $74,150	$17,024.50, plus 31% of the amount over $74,150.

[2] Prentice Hall, *All States Tax Guide*, para. 210-A, 1992.

Table 2.—Federal Individual Income Tax Rates for 1992—Continued

If taxable income is	Then income tax equals
Married individuals filing joint returns	
$0–$35,800	15 percent of taxable income.
$35,800–$86,500	$5,370, plus 28% of the amount over $35,800.
Over $86,500	$19,566, plus 31% of the amount over $86,500.
Married individuals filing separate returns	
$0–$17,900	15 percent of taxable income.
$17,900–$43,250	$2,685, plus 28% of the amount over $17,900.
Over $43,250	$9,783, plus 31% of the amount over $43,250.

The individual income tax brackets are indexed for inflation.

In addition, a refundable earned income tax credit is available to taxpayers who reside with a qualifying child and have earned income below a specified amount. For qualifying individuals, the credit acts like a negative income tax. Other nonrefundable tax credits are allowed to individuals for certain business expenditures (described in more detail in Item 2, below), certain child care expenditures, the elderly, and the disabled.

Tax base

For U.S. individual taxpayers, taxable income is determined by reducing gross income by certain allowable deductions to arrive at adjusted gross income ("AGI") and then reducing AGI by other allowable deductions and exemptions. Gross income generally means income from whatever source derived, including (but not limited to): compensation for services, gross profit derived from trade or business activity (discussed in more detail in Part 2 below), gains from dealings in property, interest (other than interest from certain indebtedness issued by State and local governments), rents, royalties, dividends, alimony and separate maintenance payments, annuities, income from life insurance and endowment contracts (other than certain death benefits), pensions, income from the discharge of indebtedness, distributive shares of partnership gross income, income from an interest in a trust or estate, and income in respect of a decedent. Gross income may be reduced by expenses properly allocable to rents, royalties, and trade or business income. Deductions generally are not allowed for losses from trades or businesses in which taxpayers do not actively participate.

In order to determine AGI, gross income is reduced by certain contributions to certain qualified retirement plans, certain tax and health-insurance expenses of self-employed individuals, penalties on early withdrawal of savings, and alimony payments. In order to

determine taxable income, an individual may reduce AGI by personal exemptions and either the standard or itemized deductions. For 1992, the amount of the personal exemption is $2,300 and is allowed for the taxpayer, the taxpayer's spouse and each dependent. This exemption amount is adjusted for inflation and is phased out for taxpayers with incomes over certain thresholds. For 1992, the amount of the standard deduction is $3,600 for single individuals; $5,250 for heads of households; and $6,000 for married individuals filing jointly. Additional standard deductions are allowed for the elderly and the blind. An individual may deduct the amount of the individual's itemized deductions if it exceeds the amount of the applicable standard deduction. The itemized deductions are medical and dental expenses in excess of 7.5 percent of AGI; State and local income, real estate, and certain personal property taxes; home mortgage and investment interest expense; contributions to certain charitable organizations; casualty and theft losses in excess of 10 percent of AGI (and in excess of $100 per loss); moving expenses; and certain miscellaneous expenses in excess of 2 percent of AGI. The total amount of itemized deductions allowed to be deducted also is subject to limitation and is phased out for taxpayers with incomes over certain thresholds.

Savings incentives

Tax incentives are provided with respect to various retirement savings plans. Trusts established pursuant to qualified retirement plans generally are not subject to income tax, thus allowing earnings on amounts contributed to such trusts to accumulate tax-free. A contribution to a qualified trust by an employer on the behalf of its employees generally is deductible by the employer and not includible in the gross income of the employees until distributed from the trust.[3] In some instances, employees and self-employed individuals also may establish or make contributions to qualified plans on a tax-deductible basis. A plan beneficiary generally is not taxable with respect to qualified plan benefits until such benefits are distributed to the beneficiary. Various limitations and restrictions apply with respect to who may be a beneficiary under a qualified plan, how plan benefits vest, how much may be contributed to a plan, when and how benefits are distributed to the beneficiary, and how distributed benefits are taxed.

In addition, several income tax provisions provide incentives for owner-occupied housing. Individual taxpayers are allowed to deduct home mortgage interest (but not other consumer interest, unless related to a home equity loan) expense and real estate taxes. An individual may defer the recognition of gain on the disposition of a principal residence if a residence of comparable or greater value is acquired within a specified period. An individual age 55 or older may permanently exclude recognition of up to $125,000 of gain on the disposition of a principal residence. Moreover, the imputed

[3] For fiscal years 1993 through 1997, the estimated 5-year cost to the U.S. Treasury from foregone individual income taxes due to: (1) the net exclusion of pension contributions and earnings is $306.4 billion; (2) the exclusion of pension contributions and earnings for Individual Retirement Accounts is $38.3 billion; and (3) Keough (self-employed individual) plans is $15.4 billion. See, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1993–1997* (JCS-8-92) April 24, 1992, p. 17 (hereinafter, *Federal Tax Expenditures*).

rental value of owner-occupied housing is not included in the gross income of the owner. Further, special tax benefits are provided for certain bonds used to provide home mortgage financing and for thrift institutions that hold a certain amount of home mortgage-related assets.[4]

Capital gains

The rate of Federal income tax on the net capital gains of an individual taxpayer may not exceed 28 percent. Net capital gains generally are the excess of (1) the net gains (over losses) on the sale or exchange of capital assets held more than one year over (2) the net losses (over gains) on the sale or exchange of capital assets held not more than one year. An individual may not deduct more than $3,000 of capital losses in excess of capital gains for any taxable year; any remaining unused loss may be carried over to another taxable year. In addition, losses on the sale of personal use property generally are not deductible. Capital assets generally mean property held by the taxpayer except property held by the taxpayer primarily for sale to customers, certain property used in a trade or business, certain property created by the taxpayer, accounts receivable, and certain publications of the U.S. Government. Thus, assets held by an individual for investment purposes (such as stocks and bonds) generally are treated as capital assets.

Capital gains and losses generally are recognized upon the sale or exchange of a capital asset. However, no gain or loss is recognized upon the transfer of an asset at death and the recipient of the property generally takes a fair market value basis in the asset, thus eliminating any capital gain that may have accrued during the life of the transferring decedent.

Minimum taxes

An individual is subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular income tax owed. The tax is imposed at a flat rate of 24 percent on alternative minimum taxable income in excess of an exemption amount.[5]

Alternative minimum taxable income is the taxpayer's taxable income increased by the taxpayer's tax preferences and adjusted by determining the tax treatment of certain items in a manner which negates the deferral of income resulting from the regular tax treatment of those items. Among the preferences and adjustments applicable to the individual alternative minimum tax are accelerated depreciation on certain property used in a trade or business, circulation and research and experimental expenditures, certain expenses and allowances related to oil and gas and mining explora-

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[4] For fiscal years 1993 through 1997, the estimated 5-year cost to the U.S. Treasury from foregone individual income taxes due to: (1) the deductibility of home mortgage interest is $257.5 billion; (2) the deductibility of property taxes is $76.3 billion; (3) the deferral of capital gains on the sale of principal residences is $75.1 billion; and (4) the exclusion of capital gains on the sale of principal residences by persons age 55 and over is $24.5 billion. See Joint Committee on Taxation, *Federal Tax Expenditures*, p. 13.

[5] The exemption amount is $40,000 in the case of joint returns and surviving spouses, $30,000, in the case of a single individual, and $20,000 in the case of a married individual that files a separate return. The exemption amount is phased out for individuals above certain income thresholds.

tion and development, certain tax-exempt interest income, and contributions of certain appreciated property to charities. In addition, personal exemptions, the standard deduction, and most itemized deductions are not allowed to reduce alternative minimum taxable income.

Where an individual pays the alternative minimum tax, a portion of the amount of the tax paid may be allowed as a credit against the regular tax of the individual in future years.

2. Income taxation of corporations and other persons carrying on business

Tax rates

Corporations organized under the laws of any of the fifty States (and the District of Columbia) and foreign corporations operating in the United States are subject to the U.S. corporate income tax on their taxable incomes.[6] The corporate income tax rate schedule is as follows:

Table 3.—Federal Corporate Income Tax Rates

If taxable income is:	*Then the income tax rate is:*
$0–$50,000	15 percent of such income
$50,001–$75,000	25 percent of such income
Over $75,000	34 percent of such income

The availability of the graduated rates described above is phased out such that most corporate taxable income is subject to a flat tax rate of 34 percent.

In addition, taxes at a rate of 28 percent may be imposed upon the accumulated earnings or personal holding company income of a corporation. The accumulated earnings tax may be imposed if a corporation retains earnings in excess of reasonable business needs. The personal holding company tax may be imposed upon the excessive passive income of a closely held corporation. The accumulated earnings tax and the personal holding company tax are designed to support the imposition of two levels (corporate and shareholder) of tax on corporate earnings.

Income of a business carried on as a sole proprietorship or a partnership of individuals is taxed at the individual income tax rates described in Part II.B.1., above.

Tax base

The taxable income of a corporation or other business generally is comprised of gross income, less allowable deductions. Gross income generally is income from whatever sources, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued

[6] In addition, many State and local governments impose income taxes on corporate income derived in the State or local jurisdiction. See the Appendix for a compilation of State income tax rates.

by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Allowable deductions include ordinary and necessary business expenditures, such as salaries, wages, contributions to profit-sharing and pension plans and other employee benefit programs, repairs, bad debts, taxes (other than Federal income taxes), contributions to charitable organizations (subject to an income limitation), advertising, interest expense, certain losses, selling expenses, and other expenses. Expenditures that benefit future accounting periods (such as the purchase of plant and equipment) generally are capitalized and recovered over time through depreciation, amortization or depletion allowances. A net operating loss incurred in one taxable year may be carried back 3 years or carried forward 15 years and allowed as a deduction in such year. Deductions are not allowed for dividends paid by a corporation to shareholders, expenses associated with earning tax-exempt income,[7] certain entertainment expenditures, contributions to political parties, a portion of the interest on certain high-yield debt obligations that resemble equity, and fines, bribes and other expenditures not in the public interest. Deductions are also allowed for certain amounts despite the lack of an underlying expenditure. For example, a deduction is allowed for all or a portion of the amount of dividends received by a corporation from another corporation; a depletion deduction is allowed for a percentage of the amount of income received from oil, gas, or mineral operations; and a bad debt deduction is allowed in an amount equal to a percentage of the income of certain qualified financial institutions.

There is no special rate of tax on the net capital gains of a corporation. A corporation may not deduct the amount of capital losses in excess of capital gains for any taxable year. Disallowed capital losses may be carried back three years and carried forward five years.

Tax-incentives

Tax incentives are provided with respect to various investments by businesses, including corporations. These incentives include allowing credits against the income tax liability of a business, allowing expenditures that benefit more than one accounting period to be deducted ("expensed") when incurred rather than capitalized, and allowing capitalized costs to be recovered more rapidly than the decline in economic value of the underlying asset would indicate. Investment tax incentives often are not allowed for purposes of computing the alternative minimum tax liability (described in the following section) of the taxpayer.

Among the tax credits granted to businesses are credits for producing fuels from nonconventional sources, the investment tax credit (applicable to investment in certain reforestation, renewable energy property, and the rehabilitation of certain real property), the targeted jobs credit (applicable to the hiring of certain disadvantaged individuals), the alcohols fuels credit (applicable to production of certain alcohol fuels), the research credit (applicable to

[7] For example, the carrying costs of tax-exempt State and local obligations and the premiums on life insurance policies are not deductible.

the incremental investment in certain research and experimental activities), the low-income housing credit (applicable to the investment in certain low-income housing projects), the enhanced oil recovery credit (applicable to the recovery of certain difficult-to-extract oil reserves), and the disabled access credit (applicable to the investment in certain property by small businesses). The credits generally are determined based on a percentage of the cost associated with the underlying activity and generally are subject to certain limitations.

Businesses are allowed to deduct, rather than capitalize, certain expenditures that benefit more than one accounting period. For example, in lieu of depreciation, small businesses are allowed to expense and deduct up to $10,000 of the cost of certain depreciable property placed in service in a taxable year. In addition, taxpayers are allowed to deduct costs associated with research and experimental activity, regardless of whether such activity leads to the creation or further development of a product or asset. Likewise, current deductions are allowed to oil and gas producers, timber growers, mining companies, and farmers for certain costs that are capital in nature.

Taxpayers are allowed depreciation deductions for the capitalized cost of property placed in service and used in a trade or business. The depreciation deductions generally are computed based on methods and lives that recover the cost of the property more rapidly than had the deductions been based on the economic depreciation of the property.[8]

Taxpayers engaged in the development and production of natural resources are allowed depletion deductions. Under cost depletion, taxpayers are allowed to deduct a percentage of the cost of the interests in natural resources, based on the ratio of the amount of the natural resource recovered in the year to the estimated total amount of the natural resources available. Alternatively, taxpayers may be allowed to use the percentage depletion method if it yields a greater deduction. Under percentage depletion, the depletion deduction is computed as a percentage of the amount of gross income received from oil, gas, or mineral operations. The use of the percentage depletion method allows taxpayers cumulative deductions in excess of the cost of the underlying natural resource property.

Minimum taxes

A corporation is subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax owed. The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of a $40,000 exemption amount.[9] Alternative minimum taxable income is the corporation's taxable income increased by the corporation's tax preferences and adjusted by determining the tax treatment of certain items in a manner which negates the

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[8] For fiscal years 1993 through 1997, the estimated 5-year cost to the U.S Treasury from foregone business income taxes due to the benefits of accelerated depreciation (over deemed economic depreciation) is $144.4 billion. See *Federal Tax Expenditures*, pp. 13, 14.

[9] The exemption amount is phased out for corporations above certain income thresholds, and is completely phased out for corporations with alternative minimum taxable income of $310,000 or more.

deferral of income resulting from the regular tax treatment of those items.

Among the preferences and adjustments applicable to the corporate alternative minimum tax are accelerated depreciation on certain property, certain expenses and allowances related to oil and gas and mining exploration and development, certain preferences allowed with respect to shipbuilding, certain tax-exempt interest income, and contributions of certain appreciated property to charities. In addition, corporate alternative minimum taxable income is increased by 75 percent by the amount that the corporation's "adjusted current earnings" exceeds the corporation's alternative minimum taxable income (determined without regard to this adjustment). Adjusted current earnings generally are determined with reference to the rules that apply in determining a corporation's earnings and profits.

Where a corporation pays the alternative minimum tax, the amount of the tax paid is allowed as a credit against the regular tax in future years.

Treatment of corporate organizations, combinations, distributions, and liquidations

The taxation of a corporation generally is separate and distinct from the taxation of its shareholders.[10] A distribution by a corporation to one of its shareholders generally is taxable as a dividend to the shareholder to the extent of the corporation's current or accumulated earnings and profits. Thus, the amount of a corporate dividend generally is taxed twice; once when the income is earned by the corporation and again when the dividend is distributed to the shareholder. Conversely, amounts paid as interest to the debtholders of a corporation generally are subject to only one level of tax (at the recipient level) since the corporation generally is allowed a deduction for the amount of interest expense paid or accrued.

A distribution in excess of the earnings and profits of a corporation generally is a tax-free return of capital to the shareholder to the extent of the shareholder's adjusted basis (generally, cost) in the stock of the corporation; and is a capital gain if in excess of basis. A distribution of property other than cash generally is treated as a taxable sale of such property by the corporation and is taken into account by the shareholder at the property's fair market value. A distribution of stock of the corporation generally is not a taxable event to either the corporation or the shareholder.

The formation of a corporation generally is not a taxable event for either the new corporation or its shareholders. Likewise, a corporate reorganization generally is not a taxable event for either the corporation or its shareholders so long as certain control and continuity tests are met. Reorganizations generally include the merger or consolidation of two or more corporations, the acquisition by one corporation of the stock or property of another corporation through the issuance of voting stock of the acquiring corpora-

[10] For a more detailed discussion of the U.S. income tax treatment of corporations and their shareholders, see Joint Committee on Taxation, *Federal Income Tax Aspects of Corporate Financial Structures* (JCS-1-89), January 18, 1989.

tion, the transfer by one corporation of the stock or assets of another controlled corporation to the shareholders of the transferring corporation, a recapitalization of a corporation, the change in the identity, form, or place of organization of a corporation, or the transfer of the assets of a corporation pursuant to certain bankruptcy proceedings.

Amounts received by a shareholder in complete liquidation of a corporation generally are treated as full payment in exchange for the shareholder's stock. A liquidating corporation recognizes gain or loss on the distributed property as if such property were sold to the distributee for its fair market value. However, if a corporation liquidates a subsidiary corporation of which it has 80 percent or more control, no gain or loss is recognized to either the distributor or the distributing corporation.

Domestic corporations that are affiliated through 80 percent or more corporate ownership may elect to file a consolidated return, in lieu of filing separate returns. Corporations filing a consolidated return generally are treated as a single corporation, allowing the losses (and credits) of some corporations to offset the income (and otherwise applicable tax) of other affiliated corporations.

Noncorporate forms of business enterprise

Proprietorships and partnerships.—Sole proprietorships are not taxed separately, but rather the net income is taxed to the owner as individual income. A trade or business in the United States may be conducted in a form other than that of a sole proprietorship or a corporation. For example, business may be conducted as a partnership. For U.S. income tax purposes, a partnership generally is not subject to tax, but the activity of the partnership is attributed to its partners who are subject to tax on their respective shares of partnership income. For U.S. income tax purposes, certain publicly traded partnerships are treated as corporations.

S corporations.—Certain qualified small business corporations (known as S corporations) and their shareholders may elect to be treated in a manner similar to partnerships and their partners. A qualified small business corporation generally is a domestic corporation which does not have (1) more than 35 shareholders, (2) as a shareholder a person (other than an estate or certain trust) that is not an individual, (3) a nonresident alien as a shareholder, or (4) more than one class of stock.

Estates and trusts.—An estate or trust generally is a separate taxable entity for U.S. income tax purposes. The amount of income distributed from the estate or trust generally is deductible by the estate or trust, and is taxable to the recipient beneficiary. For 1992, the tax rates applicable to estates and trusts are as follows:

Table 4.—Federal Estate and Trust Income Tax Rates

If taxable income is:	*Then income tax equals:*
$0-$3,600	15 percent of taxable income.
$3,601-$10,000	$540 plus 28% of the amount over $3,600.
Over $10,900	$2,584 plus 31% of the amount over $10,900.

Other entities.—In addition, special tax rules apply to investment vehicles such as regulated investment companies, real estate investment trusts, real estate mortgage investment conduits, and common trust funds. The application of these rules generally allow or mandate a single level of income tax on the earnings from such investment vehicles. Other special tax rules apply to cooperatives, mutual companies, and other specialized entities.

3. Foreign aspects of U.S. tax law [11]

In general

The United States exerts jurisdiction to tax, subject to the allowance of a foreign tax credit, the worldwide income of U.S. citizens, residents, and corporations ("U.S. persons").[12] By contrast, the United States taxes nonresident aliens and foreign corporations only on income with a sufficient nexus to the United States.

The Internal Revenue Code generally provides two criteria for asserting jurisdiction to tax the income of nonresident aliens and foreign corporations (collectively, foreign persons), and a third criterion is found in treaties. Under the Code, certain gross income of a foreign person is subject to a 30-percent U.S. tax, without regard to deductions, if it is derived from U.S. sources as determined by statute. In addition, the United States asserts jurisdiction to tax on a net basis, in the same manner and at the same rates as the income of U.S. persons, the U.S. and foreign source income of foreign persons that is effectively connected with a U.S. business. Under treaties, the 30-percent gross basis tax is sometimes eliminated or reduced. In addition, most U.S. income tax treaties provide that the business profits of an enterprise carried on by a resident of the treaty partner are not taxable by the United States unless the enterprise carries on a business through a permanent establishment situated in the United States.

U.S. taxation of income earned through foreign corporations

U.S. persons that conduct foreign operations through a foreign corporation generally pay no U.S. tax on the income from those operations until the foreign corporation repatriates or is deemed to have repatriated its earnings to the United States.[13] The income

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[11] For a detailed discussion of U.S. taxation of foreign investment by U.S. citizens, residents, and corporations, see Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States,* Part Two (JCS-6-91), May 30, 1991.

For a detailed discussion of the U.S. tax rules affecting investment in the United States by foreign persons, see Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990.

[12] As two exceptions to this principle however, possession (e.g., Puerto Rico) source income of U.S. corporations may be exempt from U.S. tax under the possession tax credit, and 15 percent of income from exports may be exempt from U.S tax through use of the Foreign Sales Corporation tax regime.

[13] The foreign corporation itself generally will not pay U.S. tax unless it has income effectively connected with a trade or business carried on in the United States, or has certain generally passive types of U.S. source income.

appears on the U.S. owner's tax return for the year that the repatriation or deemed repatriation occurs, and the United States imposes tax on it then, subject to allowance of a foreign tax credit.

Several existing regimes provide exceptions to the general rule under which U.S. tax on income earned indirectly through a foreign corporation is deferred. The primary anti-deferral regime involves rules applicable to controlled foreign corporations and their shareholders, discussed below. Anti-deferral regimes not discussed in this pamphlet include, among others, foreign personal holding company rules, passive foreign investment company rules, and rules applicable to foreign investment companies.

The controlled foreign corporation (or "subpart F") rules generally apply to any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least ten percent of the stock (measured by vote only). Deferral of U.S. tax on undistributed income of a controlled foreign corporation is not available for certain kinds of income (sometimes referred to as "subpart F income"). When a controlled foreign corporation earns subpart F income, the United States generally taxes the corporation's 10-percent U.S. shareholders currently on their respective pro rata shares of such income, as if the income had been repatriated to them. Earnings and profits of a controlled foreign corporation that are so included in the incomes of the U.S. shareholders are not taxed again when such earnings are actually distributed to the U.S. shareholders.

Subpart F income typically is income that is relatively movable from one taxing jurisdiction to another and that is subject to low rates of foreign tax.[14] Subpart F income primarily consists of foreign base company income and insurance income.[15] Foreign base company income includes five categories of income (reduced by allocable deductions): foreign personal holding company income,[16] income attributable to related party purchases and sales routed through the income recipient's country if that country is neither the origin nor the destination of the goods, income from services performed outside the country of the corporation's incorporation for or on behalf of related persons, income attributable to the international operation of ships and aircraft, and certain income attributable the non-extraction activities of international oil and gas firms.

Foreign tax credit

A credit against U.S. tax on foreign source income may be elected for foreign taxes, including foreign state and local income taxes that would, if imposed by a domestic state or locality, be deductible (but not creditable) for U.S. federal income tax purposes. Alterna-

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[14] Generally, subpart F income does not include income which incurs foreign tax at an effective rate which is at least 90 percent of the highest U.S. marginal tax rate applicable to U.S. corporations.

[15] Subpart F insurance income includes any income attributable to the issuing (or reinsuring) of any insurance or annuity contract in connection with risks in a country (for example, the United States) other than that in which the insurer is created or organized.

[16] Foreign personal holding company income generally consists of interest, dividends, annuities, passive rents and royalties, and net gains from sales of certain types of property.

tively, foreign taxes may be deducted. In addition, an indirect foreign tax credit is allowed to a U.S. corporation for foreign taxes paid by certain first-, second-, or third-tier foreign subsidiary corporations, and deemed paid by the U.S. corporation upon a dividend received by, or certain other income inclusions (e.g., subpart F income inclusions) of, the U.S. corporation relating to earnings of the foreign subsidiary.

An overall limitation on the foreign tax credit applies so that the total amount of the credit may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income bears to the taxpayer's worldwide taxable income for the taxable year.[17] In addition, the foreign tax credit limitation is calculated separately for various categories of income generally referred to as "separate limitation categories" or "separate baskets." [18] That is, the total amount of the credit for foreign taxes *on income in each category* may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income *in that category* bears to the taxpayer's worldwide taxable income for the taxable year. Taxes in excess of the limitation can be carried back two years and forward five years.

Because the United States has relatively low corporate income tax rates compared to some other countries, general limitation foreign source income is effectively exempt, in some cases, from U.S. income tax. Where an active foreign subsidiary of a U.S. corporation generates general limitation income, and repatriates it through dividends, interest, and royalties, "look-through" rules cause all such income to be subject to the general limitation. Thus, all such repatriations may be exempted from U.S. tax under the foreign tax credit.

Source rules

In general

Rules determining the source of income are important because the United States acknowledges that foreign countries have the first right to tax foreign income, but the United States generally imposes its full tax on U.S. income. The mechanism by which these goals are carried out in the case of U.S. persons is the foreign tax credit limitation; and the source rules primarily are important for U.S. persons insofar as these rules determine the amounts of their foreign tax credit limitations by determining the extent to which taxable income is from foreign sources.[19] Taxable income from foreign sources is computed by (1) determining the items of gross income that are from foreign sources, and then (2) subtracting from foreign source gross income the portion of the taxpayer's deductions that are allocable thereto.

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[17] As an additional limitation, the foreign tax credit may not offset more than 90 percent of a taxpayer's pre-credit alternative minimum tax.

[18] The separate limitation categories generally segregate classes of income that typically are subject to either relatively high or relatively low effective rates of foreign tax. For example, a separate limitation is applied to passive income if taxed by foreign jurisdictions at rates lower than the highest applicable U.S. marginal tax rate.

[19] With respect to foreign persons, the source rules primarily are important in determining the income over which the United States asserts tax jurisdiction.

Source of gross income

U.S. source gross income includes, generally, income from U.S. activities carried out in the United States, rents and royalties paid for the use of property in the United States, dividends paid by U.S. corporations, and interest paid by U.S. persons. Foreign source gross income includes, generally, income from foreign activities, rents and royalties paid for the use of property outside the United States, and dividends and interest paid by persons other than those described in the preceding sentence. International transportation income may have a divided source.

Income from sales of personal property and foreign exchange gains generally are sourced on the basis of the residence of the person earning the income. Income deemed to be from the sale (rather than the production) of inventory property, however, generally is sourced according to the place where title to the property passes to the buyer.

Allocation and apportionment of deductions

In general, deductions must be properly allocated and apportioned between domestic and foreign source gross income, respectively. Deductions which cannot definitely be allocated to some item or class of gross income generally are prorated among all classes of gross income.

The apportionment of interest expense generally is based on the approach that money is fungible, so that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid.[20] Interest expense must be allocated on the basis of assets (either tax basis or fair market value) instead of gross income.[21]

Transfer pricing

In the case of a multinational enterprise that includes both a U.S. and a foreign corporation, the United States may tax all of the income of the U.S. corporation under common control, but only so much of the income of the foreign corporation as satisfies the relevant rules for determining a U.S. nexus. The determination of the amount of income that properly is the income of the U.S. member of a multinational enterprise, and the amount that properly is the income of a foreign member of the same multinational enterprise, is thus critical to determining the amount the United States may tax as well as the amount other countries may tax. Due to the variance in tax rates (and tax systems) among countries, and possibly for other reasons, a multinational enterprise may have an incentive to shift income, deductions, or tax credits among commonly

[20] Consistent with this approach, interest expense is apportioned under a so-called "one taxpayer" rule. That is, for interest allocation purposes, all members of an affiliated group of corporations as defined for this purpose (which excludes foreign corporations) generally are treated as a single corporation.

[21] Even though the expenses, assets, and income of foreign members of a controlled group of corporations generally are ignored for expense allocation purposes, stock in such foreign corporations held by affiliated group members is considered an asset for purposes of apportioning interest expense.

controlled entities to the entity in the most favorable tax jurisdiction in order to arrive at a reduced overall tax burden.

Under the Code, the Secretary of the Treasury is granted broad authority to allocate tax items between any commonly controlled parties in order to prevent evasion of taxes or clearly to reflect income. Regulations have adopted the concept of the arm's length standard as the method of determining whether reallocations are appropriate. This standard attempts to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length.

C. Social Security Taxes

Social security benefits are financed primarily by payroll taxes on covered wages.[22] As part of the Federal Insurance Contributions Act (FICA), a tax is imposed on employers and employees measured by the amount of the wages paid to the employees. The tax is comprised of two parts: the old age, survivors, and disability insurance (OASDI) tax and the Medicare hospital insurance (HI) tax. Under FICA, in addition to other taxes, an employer is subject to an OASDI payroll tax equal to 6.2 percent of the covered wages (up to $55,500 in 1992) paid to each of its employees. An employee is subject to a like amount of tax, which is withheld from his or her wages by the employer and remitted to the Government. Employers are subject to the HI payroll tax in an amount equal to 1.45 percent of the covered wages (up to $130,200 for 1992) paid to each employee. Self-employed individuals are subject to a tax that parallels both the employer and employee portion of the OASDI payroll tax. In addition, employers are subject to a Federal unemployment insurance payroll tax equal to 6.2 percent of the total wages of each employee (up to $7,000). Employers are allowed a credit for a percentage of State unemployment taxes. Federal unemployment insurance payroll taxes are used to fund programs maintained by the States for the benefit of unemployed workers.

D. Federal Consumption Taxes

The U.S. tax system imposes excise taxes on selected goods and services, but does not contain a broad-based consumption tax such as a value-added tax or national sales tax.[23]

Among the goods and services subject to U.S. excise taxes are various fuels used by certain vehicles or vessels or stored in certain facilities, alcoholic beverages, tobacco products, certain highway vehicles, air and ship transportation, certain environmentally hazardous activities and products (e.g., hazardous substances, fuels stored in underground tanks, ozone depleting chemicals), telephone communications, vehicles lacking in fuel efficiency, cargo loaded or unloaded at U.S. ports, sport fishing equipment, bows and arrows, firearms, luxury items (specifically, with respect to certain passen-

[22] For purposes of this pamphlet, the term "social security benefits" is used, consistently with the usage in the OECD data, to refer to certain benefits provided outside the Federal Social Security Act (e.g., unemployment compensation), as well as within it.

[23] Most States and many State political subdivisions impose sales taxes on retail sales.

ger vehicles, boats, aircraft, jewelry and furs),[24] coal, certain vaccines, foreign insurance policies, and wagering.[25]

Revenues generated from some of the U.S. excise taxes are dedicated to trust funds, to be used for specific purposes.

E. Federal Taxation of Wealth

The United States does not impose general wealth taxes but does impose estate and gift taxes. The estate and gift taxes are unified so that a single graduated rate schedule is applied to an individual's cumulative taxable gifts and bequests. A unified credit equivalent to a $600,000 exemption is allowed; thus, estate and gift taxes are not imposed until cumulative transfers are greater than $600,000. For 1992, after the application of the unified credit, the U.S. estate and gift rates effectively begin at 37 percent on taxable transfers over $600,000 and reaches 55 percent for taxable transfers in excess of $3,000,000. For transfers occurring after 1992, these rates are scheduled to decline to 50 percent for transfers in excess of $2,500,000.[26]

The gift tax is imposed on the donor and is based on the fair market value of the property transferred. Annual gifts of $10,000 or less per donor per donee generally are not subject to tax.

The estate tax is imposed on the estate of the decedent and generally is based on the fair market value of the property passing at death. Bequests to the surviving spouse of the decedent and to charities reduce the taxable amount of the estate. A generation-skipping transfer tax, that is essentially equivalent to the estate tax, is imposed on certain transfers to younger generations.

A credit is allowed against the Federal estate tax for a portion of State death taxes.

F. State and Local Taxes

States and local governments impose a variety of taxes, and they may cover many of the same subjects as the Federal taxes—e.g., income,[27] estates and gifts, excises, or wage-based premiums for unemployment compensation. In addition, States and localities impose sales taxes,[28] and generate a significant amount of revenue from real and personal property taxes. Further, States and local governments often impose taxes on specific industries operating within the taxing jurisdiction (such as public utilities, hotels, motels, restaurants, and insurance companies). In the area of income taxation, States generally impose their tax on a base that resembles the Federal income tax base, but is limited territorially.

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[24] H.R. 11 (Revenue Act of 1992) as passed by the House of Representatives on July 2, 1992, and H.R. 3040 (Tax Extension Act of 1992) as reported by the Senate Finance Committee on June 19, 1992, would repeal the luxury excise tax on boats, aircraft, jewelry and furs, and would index the base of the tax on automobiles.

[25] See Joint Committee on Taxation, *Schedule of Present Federal Excise Taxes (as of January 1, 1992)* (JCS-7-92), March 27, 1992, for more details on current Federal excise taxes.

[26] H.R. 11 (Revenue Act of 1992), as passed by the House of Representatives, would postpone the scheduled rate reduction until after 1997.

[27] See the Appendix for a compilation of State income tax rates.

[28] For 1990, the State sales tax rates of those States imposing sales or gross receipts taxes generally were 3 to 7 percent of the retail value of goods or services sold. Prentice Hall, *All States Tax Guide*, para. 250, 1992.

A more detailed description of the separate State and local tax laws is beyond the scope of this pamphlet.

III. DESCRIPTION OF UNITED KINGDOM TAX SYSTEM [29]

A. Overview

Not unlike the U.S. tax system, the U.K. tax system includes income-based taxes, transaction-based taxes, taxes based on property values, social security contributions, and other taxes. Income taxes in the United Kingdom include income and capital gains taxes on individuals, a corporate income tax, and a special tax imposed on persons engaged in the extraction of oil and gas from sources within the United Kingdom. Unlike the U.S. tax system, the U.K. tax system has partially integrated the corporate and individual income taxes.

Transaction-based taxes in the United Kingdom are comprised of a national value added tax, customs and excise duties on certain goods and products, a stamp duty (although the scope of this duty has been significantly reduced in recent years), and a wealth transfer tax. Other taxes levied include national insurance contributions to fund the national social security system and taxes imposed by local governments, including property taxes and a community charge.

Business operations in the United Kingdom generally are conducted under one of the following organizational structures: corporations, partnerships, or sole proprietorships. As is the case under U.S. tax law, U.K. tax law generally treats a partnership as a conduit. That is, the partners of the partnership are subject to income tax on their respective shares of the income derived by the partnership.

B. Income Taxation

1. Individual income tax

In general

The United Kingdom has two separate mechanisms for taxing the income of individuals—an income tax and a capital gains tax. As a general matter, U.K. resident individuals are subject to income tax and capital gains tax on worldwide income and gains respectively.[30] The foreign source income of individuals who are resident in the United Kingdom but domiciled abroad is not subject to current income or capital gains tax in the United Kingdom.

[29] The following discussion of the United Kingdom tax system has been compiled from secondary sources including Price Waterhouse, *Doing Business in the United Kingdom*, (1991); Darlington & Sandison, *Business Operations in the United Kingdom—Taxation*, (BNA Tax Management Foreign Income Portfolio No. 68-8th); Kay & King, *The British Tax System*, (1990); Coopers & Lybrand International Tax Network, *1992 International Tax Summaries: A Guide for Planning and Decisions*, (ed. D. Wright 1992).

[30] Taxes imposed by the United Kingdom on income or gains derived from foreign sources may be reduced by means of a foreign tax credit.

Rather, tax is imposed upon remittance of the income to the United Kingdom.

Non-U.K. resident individuals are subject to U.K. income tax only on income arising from U.K. sources. Capital gains of such persons incur U.K. tax only in the case of the disposal of assets situated in the United Kingdom that are connected with a trade or business carried on there by the individual.[31]

Tax rates

The U.K. individual income tax has a graduated rate structure similar to that of the U.S. individual income tax. Since 1988, the basic U.K. income tax rate has been 25 percent.[32] A higher marginal tax rate of 40 percent applies to taxable income in excess of 23,700 pounds sterling ($45,492).[33]

Prior to 1985, an individual's investment income was subject to an additional income tax of 15 percent to the extent that it exceeded 6,250 pounds ($11,997). This levy generally has been repealed, but a similar surcharge of ten percent still applies to the income of certain trusts.

Income subject to tax

As a general rule, all income of a U.K. resident individual (other than capital gains, which are subject to a separate tax) is subject to the U.K. individual income tax. As such, all remuneration related to employment, including employer-provided benefits, generally is taxable. Employees (other than directors) who earn less than 8,500 pounds per year ($16,315), however, are not subject to tax on certain benefits. In addition, certain employee benefits are granted special treatment under the U.K. tax system. For example, contributions by an employer on behalf of an employee to a qualified pension plan are not taxed to the employee. Amounts paid by the plan to the employee are taxed, however. Moreover, contributions by employers to certain employee stock ownership plans are tax-exempt to the employees if the stock is held in trust for at least five years. The conveyance of stock options to employees under a qualified plan also is exempt from U.K. income tax, as is the issue of stock upon the exercise of such an option. Gains realized by employees on the disposition of such stock are subject to the capital gains tax.

For individual income tax purposes, different kinds of income are taxed under five (formerly six) different schedules (e.g., income from land located in the United Kingdom is computed under one

[31] As of 1989, U.K. law also imposes capital gains tax on a nonresident individual's unrealized gains attributable to the removal from the United Kingdom of assets connected with a business formerly operated there by the individual.

[32] The 25-percent basic rate reflects a gradual rate reduction over the past decade. The basic rate from 1979 to 1986 was 30 percent. The rate was reduced to 29 percent for 1986, and was further reduced to 27 percent for 1987.

[33] For the convenience of the reader, references to foreign currency amounts in this pamphlet are accompanied by U.S. dollar amounts. The dollar amount does not purport to be an exact equivalent, but merely the foreign currency amount multiplied by a recent exchange rate—in the case of pounds sterling, the rate of 1.9195 U.S. dollars to the pound, applicable on July 14, 1992, as reported by the *New York Times* of July 15, 1992. Internal differences between the U.S. and foreign economies as to, for example, consumer purchasing power and the distribution of income may cause the dollar amounts shown to deviate from a true economic equivalent to the corresponding foreign currency amounts, assuming that the foreign economic system were to use U.S. dollars instead of its own currency.

schedule while income from a trade or business is computed under another). The tax is computed in different ways for income under the different schedules.

Deductions allowable against income

Expenses of an individual which are wholly, exclusively, and necessarily related to business conducted by that person generally are deductible for income tax purposes. Although the U.K. tax system allows individuals certain nonbusiness-related deductions and personal exemptions, the extent of these is not as great as the scope of itemized deductions permitted for U.S. individual income tax purposes. For example, under U.K. law, there is no general allowance of deductions for payments of interest, casualty losses, medical expenses or charitable contributions.

An individual is permitted to claim deductions for interest payments on the first 30,000 pounds ($57,585) of a mortgage loan attributable to the person's principal residence. Most other interest payments are not deductible, however.

A payment under a charitable deed of covenant is deductible in computing taxable income, but other charitable donations by individuals of less than 600 pounds ($1,152) generally are not deductible. In certain cases, however, employees may agree to have annual deductions from their wages of up to 600 pounds transferred by their employer to specified charities under a qualified payroll deduction plan. These charitable donations are deductible in computing the employee's U.K. income tax. In addition, a deduction is allowed for an individual's single contribution to a charity in an amount of money ranging between 600 ($1,152) and 5 million pounds ($9,597,500), if the contribution satisfies certain conditions.

Every U.K. resident individual is entitled to a personal allowance (or exemption). There are no specific allowances for dependents of the taxpayer, however. For 1991-1992, the amount of the personal allowance is 3,295 pounds ($6,325).[34] In addition to the standard personal allowance, each married person is permitted to claim a married couple's allowance of 1,720 pounds ($3,301) on his or her tax return.[35] Additional personal allowances are granted for persons over 65 years of age whose incomes do not exceed specified levels, and for blind persons.

Tax credits

As a general rule, only two types of tax credits are available to individual taxpayers in the United Kingdom. First, U.K. resident individuals are allowed a credit corresponding to the advance corporation tax (discussed in detail below) paid by a U.K. corporation with respect to dividend distributions made by the company to the individual. This credit only covers the individual's basic rate (25 percent) income tax liability with respect to the dividend. Thus, the individual would be liable for the additional tax liability if the dividend were subject to tax at the higher rate (40 percent).

[34] The personal allowance amount is adjusted annually to account for inflation.
[35] There currently is no provision of U.K. law that allows married persons to file tax returns jointly.

Second, individuals are permitted to claim credit against U.K. income tax on foreign source income to the extent they incurred foreign tax on that income, subject to certain limitations.

Investment incentives

Business expansion scheme

The Business Expansion Scheme (BES) provides income tax advantages to individuals who invest in newly issued common stock of qualifying companies.[36] A company generally may not issue shares qualifying for BES benefits in excess of a subscription price of 750,000 pounds ($1,439,625) in any 12-month period. The purpose of the BES, which was enacted in 1983, is to provide additional sources of equity capital to companies whose securities are not publicly traded.

In general, the BES permits qualifying individuals to deduct up to 40,000 pounds ($76,780) per year against income subject to the higher rate of tax for investments in newly issued common stock of qualifying companies. In order to qualify for the deduction, the stock purchased generally may not have any preference vis-a-vis outstanding existing shares. In addition, the investing individual must have no connection to the company (i.e., he or she must not be an employee, partner, director, or controlling shareholder) at the time of the investment or during the succeeding five-year period.

Personal equity plan

U.K. resident individuals may invest up to 6,000 pounds ($11,517) per taxable year in a personal equity plan (PEP).[37] Under the PEP rules, investments by the plan are limited to investments in shares of companies quoted on the U.K. stock market and in certain unit and investment trusts. As a general rule, capital gains arising from the disposition of plan assets are exempt from capital gains tax. An investor's share of losses incurred by the plan may not be used to offset any gains realized by the investor outside the plan. Dividends on plan investments are exempt from U.K. income tax to the extent they are reinvested by the plan.

Tax-exempt special savings account

Beginning in 1991, an individual may open a tax-exempt special savings account (TESSA). In order to qualify for special tax benefits, the individual may deposit no more than 3,000 pounds ($5,759) in the first 12 months that the account exists, and no more than 1,800 pounds ($3,455) in each of the four succeeding twelve-month periods. Total deposits into the account may not exceed 9,000 pounds ($17,276). If these conditions are satisfied, income earned in the account is exempt from income tax during the five-year period.

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[36] Qualifying companies under the BES are corporations registered, managed and controlled, and mainly doing business, in the United Kingdom. Investments in companies engaged in certain lines of business, such as providing financial, legal, or accounting services, do not qualify for BES benefits.

[37] Generally, a PEP consists of funds contributed by numerous investors and must be managed by a person authorized to carry on an investment business.

Capital gains tax

Capital gains tax was introduced in the United Kingdom in 1965. Having previously implemented a system of indexation of asset bases, the capital gains tax is now only assessed on net gains attributable to periods after April 1982. The bases of assets held at that time were adjusted to fair market value, and since that time have been increased to take account of monthly movements in the retail price index. There is no corresponding indexation of liabilities.

The capital gains tax is determined on a taxable year basis and generally is levied on the total amount of taxable gains less allowable losses arising in the year. The first 5,500 pounds ($10,557) of an individual's net gains in a year, however, are exempt from tax. No deduction is permitted for capital losses in excess of capital gains. Any unused capital losses may be carried over for offset against capital gains arising in future years. The amount of an individual's capital gains is added to his or her taxable income for income tax purposes and is subject to the income tax rates applied on the sum of includible capital gains plus other income. Thus, in the case of an individual who pays the higher rate (40 percent) of income tax on his or her taxable income for a taxable year, any net capital gains (above the 5,500 pound exemption amount) realized in that year will also be taxed at the higher rate.

Certain asset dispositions are not subject to the capital gains tax. For example, gains resulting from the disposition of a taxpayer's principal residence are tax exempt. Also exempt from tax are gains attributable to the disposition of tangible personal property if the sales price does not exceed 6,000 pounds ($11,517).

2. Corporate income tax

In general

Companies that are considered residents of the United Kingdom for income tax purposes are subject to U.K. corporation tax on worldwide income and gains.[38] By contrast, non-U.K. resident companies are subject to U.K. corporation tax only on income and gains connected with trade or business operations carried on in the United Kingdom through a branch or agency.

Tax rates

For U.K. corporate tax purposes, taxable years generally are from April 1 through March 31. The general corporate tax rate for 1991 (i.e., the taxable year ended March 31, 1992) is 33 percent. This represents a reduction in the general rate that has applied for previous years.[39]

[38] A corporation may be considered a U.K. resident for either of two reasons. First, any company that is incorporated under U.K. law is a resident of the United Kingdom and subject to U.K. corporate tax on its global income. Second, a company incorporated outside of the United Kingdom may still be treated as a U.K. resident if it is managed and controlled in the United Kingdom.

[39] For the 10-year period 1973 to 1982, the general corporate tax rate was 52 percent. The rate was reduced to 50 percent for 1983, 45 percent for 1984, 40 percent for 1985, and 35 percent for the 1986 through 1989 tax years. For 1990, the applicable rate was 34 percent.

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Lower rates are applicable to corporations in certain circumstances. For example, the small company rate applies to U.K. resident companies (and nonresident companies under an applicable tax treaty) whose profits do not exceed 250,000 pounds ($479,875). Currently, the small company rate is 25 percent. Taxable income between 250,000 pounds ($479,875) and 1,250,000 pounds ($2,399,375) is subject to tax at an effective rate of 35 percent, thereby phasing out the benefits of the small company rate.

Capital gains

Unlike the U.K. taxes on individuals, there is no separate tax on capital gains realized by corporations. Rather, net capital gains of corporations incur corporation tax at the same rate as applies to their other income.[40] As discussed above, U.K. law allows taxpayers to increase the bases of their assets to account for the effects of inflation that has occurred since 1982.

Certain exceptions apply to the taxation of corporate capital gains that allow for deferral or exemption of gains realized. For example, asset transfers between related companies (generally 75-percent common ownership) are not subject to tax.[41] In addition, U.K. law embodies a concept allowing for deferral of gains on like-kind exchanges similar to the U.S. like-kind exchange rules.

Determination of taxable income

The calculation of a company's taxable income for a taxable year generally follows the calculation of its profits for U.K. financial accounting purposes. However, certain adjustments to book income are required in arriving at taxable income. Generally, taxable income must be computed under the accrual method of accounting and items must be treated consistently from period to period.[42] The company's accounting records should present an overall picture that is not in any way misleading and the company should disclose information that is material to a proper understanding of those records.

Adjustments that are required to be made to financial income include adjustments for depreciation, certain liabilities that have accrued for financial accounting purposes but are not yet accruable for tax purposes, and business entertainment expenses.

For corporate income tax purposes, different kinds of income are taxed under the schedular concept discussed above applicable to the individual income tax. The tax is computed in different ways for income under the different schedules.

Inventory valuation [43]

Inventory generally is required to be accounted for at the lower of cost and net realizable value under any of the following accounting methods: unit cost, average cost, FIFO, LIFO, base cost, or discounted selling price. Costs directly associated with the production

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[40] Prior to 1987, corporate capital gains were taxed at a flat rate of 30 percent.

[41] In this case, the recipient company takes a carryover basis in the asset for tax purposes.

[42] Non-business income, such as interest, generally is subject to tax when received rather than when accrued.

[43] The following inventory valuation rules are also applicable to partnerships and sole proprietorships.

of inventory, including interest, must be capitalized into the basis of the inventory. Moreover, production overhead, but not other indirect costs, must be so capitalized.

Deductions

Generally, in computing taxable business profits, expenses must be wholly and exclusively incurred for the purposes of the business in order to be deductible. Certain expenses are expressly deductible by statute. These include, among others, interest on amounts borrowed for business purposes from a bank actively engaged in business in the United Kingdom, research and development costs, contributions to qualified employee pension plans, certain business start-up costs, and, subject to an overall limit, charitable contributions.

Capital expenditures [44]

The U.K. tax system does not allow a deduction for depreciation. However, under a concept similar to depreciation, capital allowances are granted for the costs of purchasing certain fixed assets for use in business. Capital allowances generally are not available for the cost of goodwill, trademarks, land, or non-industrial buildings such as offices, retail outlets, etc. Following are some of the classes of fixed assets for which capital allowances are permitted.

Machinery and plant.—Prior to 1984, a *first year allowance* of 100 percent (i.e., a current deduction for the full cost) was granted for the costs of most kinds of machinery or plant incurred after 1970. First year allowances generally were repealed in 1984. In their place, a system of *writing down allowances* was established. Under this system, expenditures on machinery and plant generally qualify for an annual writing down allowance of 25 percent of remaining basis less disposal value. (This is similar to the declining-balance method of depreciation.). For example, assume a taxpayer purchases qualifying equipment for 1,000 pounds. In year one, the writing down allowance is 250 pounds, resulting in a remaining basis of 750 pounds.[45] In year two, a writing down allowance equal to 25 percent of remaining basis, or 187.50 pounds, is permitted. This process continues until the taxpayer disposes of the asset.

Industrial buildings and structures.—Capital expenditures related to the construction, repair, or improvement of an industrial building or structure qualifies for an annual writing down allowance of four percent of the expenditure. In addition, 100-percent initial allowances are allowed for costs of certain structures located in enterprise zones (see discussion of enterprise zones below).

Mines and oil wells.—Generally, a writing down allowance of 25 percent on a declining balance basis is granted for certain capital costs related to mineral exploration and extraction activities. Costs attributable to the abandonment of a mineral property may be written off in the year of abandonment.

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[44] The following rules regarding the treatment of capital expenditures are also applicable to partnerships and sole proprietorships.

[45] This assumes the asset has no disposal value.

Scientific research.—100-percent capital allowances (i.e., immediate deductions) are allowed for research-related capital costs (other than the cost of land) related to a trade or business.

Interest expense

Short interest (i.e., interest on loans with maturities of less than one year) and U.K. bank interest generally are deductible in computing trading income. Other types of deductible interest are treated as charges on income (i.e., they are deducted from total income), which generally entails less favorable tax treatment (e.g., limitations on loss sharing).

Non-deductible items

As a general matter, any expenditure that is incurred other than wholly and exclusively for business purposes is not deductible. Other expenditures for which deductions are not allowed include capital expenditures (see discussion of capital allowances above), provisions for bad debt reserves (except for banks), provisions for other reserves against anticipated future losses, interest on underpayments of U.K. income tax, costs related to tax appeals, and foreign taxes (unless no foreign tax credit is claimed).

Group relief

United Kingdom tax laws treat every company as an independent taxable entity. That is, no consolidated group tax treatment is available. Certain other types of relief are provided to commonly controlled companies, however. For these purposes, a controlled group generally consists of two or more resident companies where one owns directly or indirectly 75 percent or more of the stock of the other or others, and all the members of the group are effectively 51-percent owned by the group's parent company. In addition, a U.K. company is considered owned by a consortium if at least 75 percent of its stock is held by other U.K. resident companies of which none individually owns less than 5 percent.

The most important group-relief provision available under U.K. law permits trading (i.e., business) losses to be surrendered by one group company to another member of the controlled group.[46] This produces a result similar to what occurs when a controlled group of U.S. companies files a consolidated U.S. income tax return. As mentioned previously, capital assets generally can be transferred between group members without realization of gain or loss. U.K. law also includes some provisions allowing the reorganization of U.K. companies to be accomplished without incurring full taxation.

[46] Actually, a trading loss may be utilized in any one of the following ways: (1) It may be set against the company's total non-trading profits generated in the same accounting period; (2) If the trading loss exceeds other taxable income for the taxable year, the excess generally may be carried back and offset against any profits of the taxpayer for its previous three taxable years; (3) Losses unused under (1) or (2) may be carried forward indefinitely to be used as an offset against the taxpayer's future trading profits from the same line of business; or (4) It may be surrendered to another group company and used to offset the other company's taxable income for the same taxable year.

Imputation system

In general

The U.K. tax system allows for the imputation of a portion of corporate taxation to individual shareholders receiving corporate dividends. Under this system, U.K. resident companies generally are subject to corporate tax on their distributed and undistributed income. U.K. resident shareholders, on the other hand, receive a credit against some or all of their individual income tax liability on dividends from U.K. corporations. Excess imputation credits are refundable. Dividends received by one U.K. resident company from another U.K. resident company are exempt from corporation tax.

Advance corporation tax (ACT)

As a general rule, the payment of a dividend by a U.K. resident corporation subjects the corporation to a requirement to make an advance payment of corporation tax. The ACT is not a withholding tax on the shareholder's dividend. Rather, it constitutes an additional amount required to be paid by a distributing corporation. The payment of ACT is treated as an advance payment of the company's corporate tax liability for the taxable year of the dividend payment.[47] Thus, the company may take credit for the ACT payment on its corporate tax return for that year. In addition, the amount of shareholder credit that is granted is equal to the amount of the ACT payment. The rate of ACT is established so that it will be equal to individual income tax at the basic rate on the cash amount of the dividend plus the credit. Currently, the basic rate of individual income tax is 25 percent. Thus, the rate of ACT is 25/75 of the cash dividend amount. The shareholder's imputation credit does not cover individual income taxed at the higher rate.

For example, assume a U.K. corporation has taxable income of 1,000 pounds for a taxable year. Further assume it pays a dividend of 120 pounds to its sole shareholder, a U.K. resident individual. As a result of the dividend, the corporation must pay ACT of 40 pounds (25/75 x 120 pounds). For the taxable year, the corporation has an income tax liability of 333 pounds (assuming the corporate tax rate is 33 percent), against which it may claim a credit of 40 pounds for the ACT already paid. The individual shareholder recognizes income of 160 pounds (the dividend of 120 pounds grossed up to include the 40 pounds of ACT credit available to the individual). If this amount of income were subject to U.K. tax at the lower individual income tax rate of 25 percent, the individual's pre-credit tax liability would be 40 pounds. This liability would be fully covered by the imputation credit. On the other hand, if the 160 pounds of taxable income were subject to tax at the higher rate of 40 percent, the pre-credit tax would be 48 pounds. In this case, the shareholder would have to pay a residual tax of 8 pounds.

As a general rule, credit for corporate tax may be claimed only by U.K. resident individual shareholders. However, the United

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[47] If the ACT paid exceeds the company's tax liability for the year, the surplus may either be carried back or forward and set off against its corporate tax liabilities for other accounting periods, or surrendered to a related company.

Kingdom has negotiated a number of double tax treaties, including its tax treaty with the United States, under which part of the ACT credit is allowed to residents of the other country.

Investment incentives

Under present U.K. tax law, certain incentives are granted to taxpayers investing in Northern Ireland or in certain designated enterprise zones. For corporations investing in Northern Ireland, refunds of up to 80 percent of corporation tax are available.

In the 1980s, 26 Enterprize Zones were designated at various locations in the United Kingdom. The purpose of the Enterprise Zone designation is to encourage investment within the designated localities by granting certain favorable tax treatment to persons making such investments within a 10-year period. Extension of the Enterprise Zone legislation has been under review by the U.K. Government.

Under the Enterprise Zone program, businesses located in designated areas are exempt from local property taxes. Moreover, for U.K. income tax purposes, 100-percent capital allowances are allowed for the cost of all buildings (but not plant and machinery) located in an Enterprise Zone. Also, in some Enterprise Zones, loans with favorable terms may be available from Enterprise Agencies.

3. Treatment of foreign income

Foreign tax credit

As stated previously, the worldwide income and gains of U.K. resident individuals and corporations generally are subject to current U.K. tax.[48] In order to prevent an item of non-U.K. source income from being taxed by the source country and again by the United Kingdom, U.K. tax law provides a foreign tax credit (i.e., a credit against U.K. tax on that income to the extent of foreign taxes incurred on that income).

Certain limitations are placed on the ability of taxpayers to utilize foreign tax credits. For instance, the foreign tax credit allowable with respect to a specific item of income is limited to the amount of U.K. income tax (or capital gains tax, if appropriate) attributable to that income, less applicable deductions. In computing foreign source taxable income for purposes of applying this foreign tax credit limitation, however, any deductions from the taxpayer's total profits are allocated to particular items of income in the manner most beneficial to the taxpayer.

The foreign tax credit is available only on a source-by-source (i.e., country-by-country) basis. Thus, excess foreign taxes attributable to one source generally may not offset the residual U.K. tax on untaxed or low-taxed foreign income from a different source. However, taxpayers are able to achieve some degree of averaging of foreign taxes through the use of so-called "mixing" corporations.

Finally, there is no allowance for a carryback or carryforward of unused foreign tax credits. In cases where credits would go unused,

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[48] However, if the earnings of a foreign branch cannot be remitted to the United Kingdom as a result of foreign restrictions, deferral of payment of U.K. tax on that income is allowed.

taxpayers may elect to forego the foreign tax credit and instead claim a deduction for foreign taxes.

U.K. law also provides for an indirect foreign tax credit in the case of certain dividend income earned by a U.K. resident company. Where the dividend is from a non-resident company, the foreign tax credit applies to any tax directly withheld from the dividend, as well as to a portion of the foreign taxes incurred by the payor corporation with respect to the profits so distributed. In order to qualify for the indirect foreign tax credit, the U.K. company (or its parent company) must directly or indirectly own at least ten percent of the foreign company's voting stock.

Income earned through foreign subsidiaries

Income earned by non-U.K. subsidiaries (except to the extent they are connected to business operations in the United Kingdom) is not subject to U.K. tax until it is repatriated in the form of dividends. In 1984, special legislation covering controlled foreign companies (CFCs) was introduced. This legislation eliminated the deferral of U.K. tax on certain earnings of foreign subsidiaries.[49] It mainly applies to operations located in tax haven countries.

Under these anti-deferral rules, a controlled foreign corporation is a company that (1) is resident outside the United Kingdom for U.K. tax purposes, (2) is controlled by U.K. residents, and (3) is subject to a lower level of taxation in its home country.[50] If a CFC meets these criteria, certain exceptions may still apply to allow it to retain the benefits of deferral. For example, the CFC may pay a dividend to U.K. resident shareholders during the taxable year equal to at least one-half of its distributable net profits. Another exception applies if the CFC is engaged in real commercial operations with unrelated parties throughout the taxable year. Still another exception applies if the taxpayer can show that obtaining the benefits of deferral was not one of the main reasons for the CFC's existence during the taxable year. Additional exceptions apply to certain publicly traded companies and to companies that earn de minimis amounts of income.

Investments in offshore funds

The legislation enacted in 1984 also contained anti-deferral provisions concerning taxation of investments in certain "offshore funds" (e.g., unit trusts and investment companies located outside the United Kingdom). A U.K. investor subject to these provisions who disposes of a material interest in a qualifying offshore fund is subject to U.K. income tax (rather than capital gains tax) on any gain attributable to the disposition.

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[49] The loss of deferral is accomplished by the Inland Revenue Department's treatment of the relevant earnings of the CFC as having been deemed distributed to its U.K.-resident corporate shareholders, who are in turn subject to U.K. tax on the deemed distributions. Individual shareholders are not subject to the anti-deferral regime.

[50] For this purpose, a company is treated as being subject to a lower level of taxation in its home country if its effective tax rate for the taxable year is less than one half of the applicable U.K. effective tax rate.

Incentives for outbound investment

Generally, the internal tax laws of the United Kingdom provide no tax incentives for outbound investment other than the allowance of deferral on certain earnings of foreign subsidiaries. However, in certain cases where foreign countries have provided "tax sparing" relief to encourage inbound investment, the United Kingdom has agreed in tax treaties with those countries to allow a credit against U.K. tax for the foreign tax so spared.

C. Consumption Tax (Value-Added Tax)

Like the other members of the European Communities (the "EC"), the United Kingdom imposes a consumption-based, value-added tax (VAT) on most goods and services supplied by taxable businesses in the United Kingdom. The VAT liability for any period is determined under the credit-invoice method, pursuant to which (1) the amount of taxable sales is multiplied by the applicable VAT rate (which generally equals 17.5 percent) and (2) a credit is allowed for the amount of VAT paid with respect to most taxable purchases as shown on required invoices. If the credit for the amount of VAT paid with respect to taxable purchases exceeds the amount of taxable sales multiplied by the applicable VAT rate, the excess is refundable to the taxpayer.

The U.K. VAT is based on the destination principle. Under this principle, imports are subject to tax at the applicable VAT rate while exports are zero rated, which means that businesses are not subject to VAT on exports but are allowed a credit for the amount of VAT paid on taxable purchases that are attributable to exports. In addition to exports, the United Kingdom provides a zero rate for: (1) most food for human consumption; (2) non-business users of water, fuel, and power; (3) new residential buildings; (4) passenger transportation; (5) children's clothing; (6) prescription drugs and medicines; and (7) books and newspapers.

The United Kingdom also provides an exemption from the VAT for: (1) the sale and leasing of land and buildings (other than newly constructed buildings); (2) insurance; (3) banking and financial services; (4) certain health services; and (5) education. For an exempt good or service (unlike for zero-rated good or service), no credit is allowed for VAT paid on taxable supplies. For this reason, under the U.K. VAT, a seller of land or used commercial buildings or a lessor of commercial or residential buildings may elect to waive the VAT exemption, in which case a credit is allowed to the seller or lessor for the VAT paid on taxable supplies.

A business that provides goods and services in the United Kingdom in excess of a specified amount (for 1991, 23,600 pounds ($45,300) per year) is required to register with the United Kingdom agency responsible for administering the VAT. A taxable business is generally required to file a VAT return on a quarterly basis. In the case of a business with excess VAT credits (which generally occurs in the case of a business that is engaged in the provision of zero-rated goods or services), a return may be filed on a monthly basis.

D. Taxation of Wealth

The United Kingdom levies an inheritance tax on certain asset transfers during a person's lifetime or at death.[51] The U.K. inheritance tax operates in a fashion similar to the U.S. estate and gift taxes. For individuals who are domiciled in the United Kingdom, the inheritance tax applies to all of their assets whether physically located inside or outside of the United Kingdom.[52] For other individuals, the tax applies only to property actually situated in the United Kingdom.

The rate of inheritance tax is 40 percent. The tax is levied on the decedent's estate to the extent that its value exceeds 140,000 pounds ($268,730).[53] Transfers of assets between spouses who are both domiciled in the United Kingdom are exempt from the inheritance tax. If only one spouse is U.K. domiciled, cumulative asset transfers up to 55,000 pounds ($105,572) in value are tax exempt. In addition, gifts of up to 250 pounds ($480) per person per year and gifts not in excess of 3,000 pounds ($5,758) in total per year are exempt from the inheritance tax.

E. Other Taxes

Social security

All employed persons, as well as their employers, pay contributions to the national insurance system. Employees are entitled to receive retirement, medical, and unemployment benefits. Self-employed persons are also responsible for social security contributions, but they are entitled to benefits on a more restricted basis. Individuals are required to make contributions to the system based on their level of earnings. Persons earning less than 52 pounds ($100) per week are required to pay only two percent of earnings; persons making in excess of that amount must pay nine percent on the excess up to 390 pounds per week ($749). The highest rate of social security tax on employers is 10.4 percent. There is no upper limit (i.e., wage cap) on an employer's contributions.

Excise taxes

The United Kingdom imposes specific excise taxes on certain goods, wherever produced, including most alcoholic beverages, tobacco products, and oil and refined petroleum products. Excise taxes are also imposed on certain legalized gambling activities.

Stamp duties

Originally established in 1891, stamp duties continue to be levied today on certain types of transactions, for instance property sales

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[51] With respect to transfers of assets during a person's lifetime, the tax applies only with respect to those transfers that are made within seven years before the transferor's death.

[52] As a general rule, a person is treated as domiciled in the country which that person considers his or her permanent home. Moreover, for purposes of the inheritance tax, an individual is treated as U.K. domiciled if the individual has been a U.K resident for income tax purposes for at least 17 out of the previous 20 taxable years.

[53] Because it generally is impossible to identify whether a gift made during the donor's lifetime is made within seven years of that person's death, inheritance tax is not levied at the time of the gift. If it turns out that the transfer is subject to inheritance tax, the tax is levied at death under the applicable rates prevailing at the time of death.

and leases.[54] Stamp duties are duties on written documents such as contracts for sales of goods. It is the document itself, and not underlying transaction, that establishes liability for the stamp duty. Such documents are required by law to be stamped, and liability for the duty arises upon stamping of the document. If a document is not duly stamped, it is inadmissible as evidence in a U.K. court of law.

Petroleum revenue tax

The Petroleum Revenue Tax (PRT) is imposed on oil and gas extraction profits attributable to oil and gas production within the United Kingdom and its continental shelf. The PRT has a unique set of rules for determining taxable profits. For example, taxpayers generally are permitted to deduct all expenditures incurred in exploring for and extracting oil or gas, even if they are capital in nature. No deduction is permitted, however, for the costs of land, buildings, or interest.[55] The rate of PRT is 75 percent. The tax is levied prior to, and is deductible for purposes of, the corporate income tax.

Local taxes

Local taxing authorities in the United Kingdom do not impose income taxes. Rather, the cost of services provided to local residents by these authorities generally are funded by property taxes or "rates"—based on the annual rental value of business properties—and a community charge or "poll tax"—a per person levy on adults residing within the jurisdiction.[56]

Car tax

A car tax is imposed at a rate of 10 percent on the wholesale value of cars produced in or imported into the United Kingdom.

[54] In recent years, the stamp duty has been repealed with respect to several categories of transactions. In addition, the stamp duties on corporate stock and other securities (and the 0.5-percent stamp duty reserve tax on certain stock transactions) are to be repealed sometime in 1992.

[55] In order to compensate for the loss of interest deductions, the amount deductible for certain capital expenditures are increased by 35 percent.

[56] The poll tax is not imposed in Northern Ireland. Instead, property taxes continue to be levied on both business and non-business properties (including residences).

IV. DESCRIPTION OF GERMAN TAX SYSTEM [57]

A. Overview

Germany has three levels of government: federal, state (Laender), and municipal, which share the collection responsibilities and ultimate receipts from major elements of the German tax system. There are approximately 40 different federal, state, and municipal taxes. Revenues received by the state and municipal governments are often collected pursuant to federal legislation; revenues received by the federal government may be collected through state tax authorities. The receipts under four major federal tax laws, the individual income tax, the value-added tax (VAT), the corporate income tax, and the trade tax, are apportioned in several ways and ultimately shared to one extent or another among multiple levels of government.

Individual income tax rates range between 19 and 53 percent. For the last half of 1991 and the first half of 1992, an additional surcharge of 7.5 percent of assessed income tax applies. The standard VAT rate is 14 percent, and is scheduled to rise to 15 percent in 1993; basic food and certain other items are taxed at 7 percent. Corporate income tax generally is 50 percent on retained earnings, and 36 percent upon distribution of the earnings. The 36-percent tax borne by the distributing corporation is fully creditable against income tax liability of the distributee. The rate of trade tax is determined by applying a municipal multiplier (adopted by each municipality) to a basic amount equal to 5 percent of trade profits and (generally) 0.2 percent of trade capital. Typical municipal multipliers range between 200 and 400 percent.

Other taxes include revenues from fiscal monopolies, customs duties, and insurance taxes received by the federal government. Revenues from the wealth tax, the inheritance tax, and the real estate transfer tax are received by the states. Revenues from a real estate, or land, tax is received by municipalities. Various excise tax revenues may be shared or collected and used separately at all

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[57] The following discussion of German tax has been compiled from secondary English-language sources and, in one case, from an English translation of parts of one German tax statute. Sources include the following: *German Tax & Business Law Guide (CCH Europe)*, of which the German law firm of Droste Killius Triebel is general editor; Price Waterhouse, *Doing Business in Germany* (reflecting material assembled June 30, 1991); H. Ault & A. Raedler, *The German Corporation Tax Law with 1980 Amendments* (1980); J. Killius, *Business Operations in West Germany*, (BNA Tax Management Portfolio No. 174-5th); H. Gumpel, J. Rudden, K. Ramin, & P. Gumpel, *Taxation in the Federal Republic of Germany (CCH-Harvard Law School World Tax Series)* (2d ed. 1991); Dengel, "Federal Republic of Germany," in *Comparative Tax Systems: Europe, Canada, and Japan* (ed. J. Pechman 1987); Coopers & Lybrand International Tax Network, *1992 International Tax Summaries: A Guide for Planning and Decisions* (ed. D. Wright 1992); M. King & D. Fullerton, eds., *The Taxation of Income from Capital: A Comparative Study of the United States, the United Kingdom, Sweden, and West Germany* (1984); and periodical literature cited below.

levels of government. A church tax is collected from members of certain religious organizations, on behalf of the organizations.

Germany also has a comprehensive social security system covering health insurance, sick pay, old-age benefits, unemployment benefits, and workmen's compensation. The system is funded by employer and employee contributions generally totaling over 30 percent of compensation up to monthly limits.

Rules applicable to taxes in general (e.g., administrative and procedural details of the tax system, definition of residence) are contained in the General Tax Code (*Abgabenordnung,* or "AO"). Other statutes, some of which are mentioned below, determine the substance of the tax liabilities imposed.

B. Income Taxation

1. Individual income tax

Individual income tax is governed by the Income Tax Act (*Einkommensteuergesetz,* or "EStG").

Tax rates

Under internal German law, a resident of Germany is subject to "unlimited" German income tax liability—that is, generally, tax on worldwide income (alternative treatment of foreign source income in certain circumstances is discussed below). Net taxable income in excess of DM 5,616 ($3,786) (for joint returns, DM 11,232 ($7,572)) is taxed at rates beginning under 19 percent, rising to 53 percent for taxable income over DM 120,041 ($80,931) (for joint returns, DM 240,082 ($161,863)).[58] Prior to 1991, the maximum individual income tax rate was for a number of years constant at 56 percent. From July 1, 1991 through June 30, 1992, in cases where tax is collected by withholding, there is a surcharge of 7.5 percent of assessed tax, levied in connection with financing the cost of German unification (the so-called "solidarity surcharge"). On a taxable year basis, the rates for 1991 and 1992 are increased by 3.75 percent of the otherwise applicable tax.

Certain capital gains are untaxed or taxed at half the regular income tax rate, as described below.

Tax base

The tax rates are imposed on the total net income from the following categories: (1) income from a trade or business; (2) income from performing independent personal services; (3) income from performing services as an employee or worker; (4) income from investments; (5) income from agriculture or forestry; (6) income from the rental of property and royalties for the right to use intangible property; and (7) certain miscellaneous items of income.

(1) *Business income.*—Net income from business is computed by reference to the income and expenses of a sole proprietorship, or, where the taxpayer is a partner in a partnership carrying on a business, the taxpayer's share of the partnership income. Business

[58] All currency conversions in this section are made at a rate of $0.6742 per Deutschemark. This was the rate prevailing on July 14, 1992, as reported in the *New York Times* of July 15, 1992.

income also includes gains from the sale of an unincorporated business, the sale of a partner's interest in a business partnership, and sale of stock in a corporation in which the taxpayer held an interest in excess of 25 percent for more than six months. Such gains are taxed at half the regular rate. (Similar rules apply to the sale of a professional practice, gain from which is nominally in a separate category of income from business income, but whose tax treatment bears similarities to the treatment of business income.)

As discussed below in connection with corporate income tax, tax accounting under German law is closely tied to financial accounting. The financial statements generally control for tax purposes (and vice versa) absent a specific rule to the contrary. The following are some features of the computation of income:

Deferred compensation liabilities may be deducted by additions to unfunded pension reserves, by contributions to funded pension plans or relief funds (which are themselves tax-exempt), or the purchase of insurance.

Inventories are valued at the lower of cost or net realizable value. For manufactured goods, costs include direct manufacturing costs and directly attributable administrative and financing costs. Costs may be allocated to specific items of inventory on a direct basis, average basis, or by LIFO or FIFO if they are shown to be appropriate.

Tax depreciation, amortization, and depletion generally conform to depreciation for financial reporting purposes. Regular depreciation allowances may be taken on the straight-line method, three times straight-line on a declining balance, subject to a maximum in any one year of 30 percent, or a production method (i.e., a method based on output and utilization). Acquired goodwill can be depreciated over 15 years on a straight-line method. Goodwill acquired in a fiscal year beginning before 1987 is treated as if acquired in the first fiscal year beginning after 1986. Buildings completed after 1924 may be depreciated on a straight-line basis over a 50 year life, or a shorter life if one can be shown. If the construction permit was applied for after March 1985, depreciation in some cases may be over a 25 year life as follows: 10 percent per year for the first four years, 5 percent during the next three years, and 2.5 percent for the next 18 years. The cost of mineral deposits or other natural resources which the taxpayer exploits can be deducted on the straight-line basis or in proportion to the exhaustion of the deposit. The tax authorities publish guidelines as to useful lives of various types of property, which may be deviated from where a more appropriate life can be shown.

Prior to unification, accelerated depreciation was allowed for investments in "Land Berlin" (Berlin (West)) and areas along the eastern border of the territories in which the tax laws of the Federal Republic of Germany were in force. Use of accelerated depreciation and other special tax benefits in these areas is generally terminated by December 31, 1994. However, accelerated depreciation is in force for all of Berlin and the territories of the former German Democratic Republic (GDR). In general, it applies to up to 50 percent of the cost of eligible property incurred from 1991 to 1994, and is taken in addition to regular depreciation in the year of acquisition or production and the following four years. Because of

the conformity between book and tax accounting, use of accelerated depreciation for tax purposes generally must be accompanied by the same depreciation method for financial accounting purposes.

Special accelerated depreciation is also available for investments in small business, ships and aircraft, pollution reduction, and certain buildings, among other things.

The trade tax, excise taxes, property taxes, and transfer taxes, along with additions to tax and interest, are deductible.

(2) *Income from employment.*—Compensation is taxed when earned, except that pension income generally is taxed generally when received. Expenses related to employment that may be deducted include commuting expenses, job-hunting expenses, and expenses for work clothes. Alternatively, the taxpayer can take a standard employment-related deduction of DM 2,000 ($1,348) per year.

(3) *Rental income and owner-occupied housing.*—There is no tax on imputed income from an owner-occupied residence. Mortgage interest is only deductible against income from the property. There is a credit, however, allowed for the first eight years after construction or acquisition of a residence, starting at 2.5 percent of cost (up to a maximum cost of DM 330,000 ($222,486)) and going down to 1.5 percent.

(4) *Capital investment income.*—Unlike the United States, Germany collects the ordinary income tax on dividends through withholding at 25 percent. Under the imputation system, dividends from German resident companies are grossed up by 9/16, and carry a 36-percent credit for the corporate tax (in addition to the credit for the withholding tax) that may be used by the shareholder against his income tax liability, or refunded to the shareholder if the credit exceeds his liability. (See discussion of integration in Part B.3., below.)

Short-term (sometimes referred to as "speculative") capital gains from the sale of investment securities (gains where the holding period is 6 months or less) or of real estate (gains where the holding period is 2 years or less) are taxed at ordinary rates, although a net short-term gain of under DM 1,000 ($674) during the year is exempt from tax. Other capital gains on securities and real estate investments (other than gains that are business income, as described above) are exempt from income tax.

Currently, interest on certain debts with equity features is subject to 25-percent withholding. Under pending legislation, interest income generally would be subject to 30-percent withholding beginning in 1993.[59]

From items of investment income, the taxpayer may deduct certain investment expenses or, in the alternative, claim a standard deduction of DM 100 ($67) (DM 200 ($134) for a joint return) and a general deduction of DM 600 ($404) (DM 1,200 ($809) for a joint return). The general allowance would be raised ten-fold under the pending legislation regarding interest withholding.

(5) *Computation of combined individual tax base.*—Income and loss from the above-mentioned categories generally is combined. In

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[59] Minor, "German Parliament Committee Compromises on New Interest Withholding Tax Bill," 5 *Tax Notes Int'l* 63 (July 13, 1992).

addition, so-called "special expenses" (*Sonderausgaben*) can be deducted from the sum. These include the full amount of church tax and income tax return preparation expense. Premiums for insurance, social security contributions, and payments to building and loan associations are deductible up to a ceiling dependent on family status. Contributions to charities, political parties, and certain other groups are deductible up to various limits. Political contributions, for example, are deductible up to DM 60,000 ($40,452) (DM 120,000 ($80,904) for a joint return) per year. The cost of education of a child over age 17 is deductible up to DM 2,400 ($1,618). For children not living at home, the deduction is DM 4,200 ($2,831) (DM 1,800 ($1,213) if the child is under age 18). A deduction of DM 1,512 ($1,019) (DM 3,024 ($2,038) for a joint return) is also allowed for each dependent. Residents of the territory of the former GDR are entitled to a special allowance of DM 600 ($404). Deductions for personal expenses in certain cases of hardship are permitted, if the expenses exceed a given percentage of income. Hardship allowances also apply to handicapped persons or those who have to be cared for.

2. Corporate income tax

The income of an entity taxed as a corporation is taxed in accordance with the provisions of the Corporation Tax Act (*Koerperschaftsteuergesetz,* or "KStG"). However, the provisions of the Income Tax Act that govern the business income of individuals (described above) generally govern corporate income taxation, unless a different rule is prescribed in the Corporation Tax Act. Various government-related entities, charitable organizations, professional, union, or political organizations, and pension or other employee benefit funds are exempt in whole or in part from tax.

Tax rate

Under a form of integrated corporate tax that was introduced into German law in 1977, a German resident entity that is taxed as a corporation (for example, an *Aktiengesellschaft* ("AG") or a *Gesellschaft mit beschraenkter Haftung* ("GmbH")) is subject to a "split rate" on its income. Currently, the tax rate on retained earnings (or "statutory burden") generally is 50 percent. From 1977 to 1990 the corresponding rate was 56 percent. The corporate-level tax on distributed earnings (or "distribution burden") is 36 percent. (As described more fully in Part B.3., below, a German dividend recipient can receive a (refundable) tax credit for the amount of the distribution burden.)

Under the German tax system, the taxable profits of a German permanent establishment of a foreign corporation are taxable at a flat rate, rather than under the split rate system. Currently, the flat rate is 46 percent.

Corporations are also subject to the 3.75-percent income tax surcharge from 1991 and 1992. Corporations do not receive a reduced rate on income from capital gains.

Tax base

German corporations are required by law to publish various financial statements that must, as noted above in connection with

individual income tax, be used as the basis for their income tax accounting, absent a specific rule to the contrary. In view of the credits carried by dividends paid by German corporations, there is no domestic exclusion of dividend income of a German corporation. However, because that credit is given to the extent of 36 percent of every (grossed-up) dividend received by an unlimited German taxpayer, there are additional corporate rules to ensure that the 36-percent tax is actually paid, if not at the time the income of the corporation was earned (due to an exemption, for example), then no later than the time when the dividend is paid. (These rules are described in Part B.3., below.)

Because of the integration system, it is possible for a taxpayer with a loss to obtain a refund of tax paid by its subsidiary corporation on the latter's income. In addition, a corporation can elect to share its loss with its shareholder if the two taxpayers are part of an *Organschaft*—that is, a group of taxpayers between which there is sufficient nexus between the subsidiary and the stockholder as to ownership (generally over 50 percent of the voting stock must be owned by the shareholder), business (for example, the shareholder must be engaged in business), and management (the shareholder must exercise some control over management of the subsidiary). Loss sharing in this situation is allowed if a profit and loss sharing agreement is entered into, for a period no less than 5 years, under which the shareholder is treated as owning the income and loss of the subsidiary. Neither of the above methods for consolidation of income and loss in related entities requires the shareholder to be a corporation, but in each case, the subsidiary must be a corporation.

3. Integration of individual and corporate income tax

At present, Germany imposes a 25-percent withholding tax on dividends. The dividend tax is fully refundable to resident shareholders (persons subject to unlimited tax liability in Germany).

In addition to the refundable 25-percent withholding tax, Germany provides "integration," or relief from the taxation of corporate earnings at both the corporate and individual shareholder levels, through two other features of its tax treatment of dividends. First, as described above, Germany imposes a "split rate" on corporate income; under this system, earnings distributed by German resident companies as dividends are often subject to a lower corporate income tax rate than are retained earnings. Second, German resident shareholders that are unlimited taxpayers receive an imputation credit for the corporate-level distribution burden. The credit is applied against the shareholder's German income tax liability or, if the credit exceeds the liability, the excess is refunded to the shareholder. There are no refunds to German resident entities that are tax-exempt (e.g., pension plans).

Under the German imputation system, German resident shareholders generally receive a "gross-up" of their dividend, and a corresponding equal imputation tax credit, equal to a percentage of the dividend. The credit and gross-up are currently 56.25 percent (9/16, or 36/64) of the dividend, or 36 percent of the grossed up dividend. (For simplicity, use of the terms "dividend" and "grossed up dividend" here ignores the 25-percent withholding mechanism

under German law.) The grossed up dividend represents the pre-tax corporate profits distributed to the shareholder.

For example, assume that a German corporation with a single German shareholder earns 100 before corporate tax. The statutory burden is 50. Assume that the remaining 50 is distributed. This results in a decrease of 14 in the corporate tax burden if the full 14 is also distributed. Assume that this is the case. The shareholder has received a cash dividend of 64 (ignoring withholding taxes). This dividend must be grossed up by 56.25 percent (9/16, or 36/64) in computing the shareholder's taxable income. The gross up here equals 36, or 36/64ths of 64. The shareholder's income associated with the dividend therefore equals 100, or 64 plus 36. (This is also the amount of the corporation's pre-corporation tax income.) Because the amount of the gross-up is also a tax credit to the shareholder, this 100 of shareholder income carries a credit of 36, which equals the corporate tax paid and not previously refunded to the corporation. The income tax imposed on these earnings will thus be whatever tax is imposed on the 100 at the individual level, minus 36. This, in turn, may be approximately the same income tax that would have been imposed had the 100 been earned directly by the shareholder. The credit, when considered together with the split rate system, alleviates the double income taxation of distributed profits earned by German companies.

For practical reasons, the credit is allowed under German law for dividends treated as having been derived from corporate profits on which the payor corporation did not, at the time those profits were earned, pay at least the distribution burden, i.e., the lower of the two corporate rates. In such cases, an increased corporation tax will be imposed in the period of distribution to compensate for the amount of the shareholder credit in excess of the corporate tax previously paid. If dividends are treated as having been derived from profits on which the payor corporation paid the statutory burden, then the corporation is entitled to a refund of the difference between the two rates.

An ordering rule determines what tax burden is deemed to have been borne by particular distributed earnings. Equity (*Eigenkapital* or "EK") is divided into classes. Distributions are treated as coming out of these classes generally in the following order: Fully taxed profits are referred to as EK 50 (taxed since 1990 at the 50-percent rate) or EK 56 (taxed between 1977 and 1990 at 56 percent). Their distribution results in a tax refund to the corporation. Next are profits treated as taxed at 36 percent (EK 36). Their distribution results in no refund to the corporation and no additional corporate tax. Profits treated as untaxed are classified in one of several categories: post-1976 foreign source exempt income (EK 01); other post-1976 exempt earnings (EK 02); and pre-1977 equity available for distribution (EK 03). Their distribution requires the corporation to pay additional corporate income tax of 36 percent. Finally, post-1976 contributions to capital are referred to as EK 04. Distributions of EK 04 are not subject to additional corporate tax.

Under this system, a German parent corporation that receives a dividend from a German subsidiary corporation out of the latter's EK 50 typically incurs a tax liability of 50 percent (assuming no loss sharing agreement applies in the case of an *Organschaft*) and a

credit of 36 percent. At the same time, the subsidiary earns a refund of 14 percent. Thus, while there is no dividends received deduction, there generally is no systematic double corporate-level taxation, and no reduction in overall corporate income tax liability.

As shown in Figures 1 and 2 and Table 1 in Part I (Overview of the Tax Systems of the United States, the United Kingdom, Germany, and Japan) above, the ratio of corporation income tax to individual income tax was lower in 1989 for Germany than for Japan, the United Kingdom, or even the United States. As noted in Part I of this pamphlet, the data treat taxes that give rise to imputation credits as corporate taxes, rather than individual taxes. Because of the shareholder level credit for these taxes, however, they could alternatively be viewed as individual income taxes, at least in the year when the credit is taken. (For example, presumably the data treat the 25-percent withholding tax on dividends as an individual income tax and not a corporate income tax.) Under this assumption, the ratio of German individual income taxes to corporate income taxes could be viewed as being greater than is reflected in the figures and tables mentioned above.[60]

4. Adjustments to transactions between related domestic entities

When the tax authorities believe that a transaction between corporation and shareholder does not meet an arm's-length standard (as in the case of excessive compensation of a shareholder), the transaction can be recast as a constructive or hidden distribution of corporate profit.

5. Investment/savings incentives

There is no investment tax credit in German income tax law. As explained above, relative to U.S. law, German tax is reduced in some ways on income of individuals from savings—e.g., through the capital gains exemption, corporate-individual income tax integration, the standard investment income deduction, and the deductions for social security contributions, insurance, and building and loan payments. On the other hand, the top German income tax rates are 22 percentage points higher than the top U.S. rates. Preferential treatment is given to business income and capital and to personal income in the former GDR through accelerated depreciation, the exemption from the trade tax on capital and the net assets tax, and the additional DM 600 ($404) personal allowance. Outside the tax system, investment subsidies and grants between 8 and 23 percent may be available in some cases for investments in the former GDR.[61] In addition, special accelerated depreciation is available in certain cases beyond the former GDR, and investment grants are available in specific activities outside the GDR, for example, in research. There is no minimum tax (but accelerated depreciation for tax purposes must be reflected in financial statements as well).

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[60] The same assumption may apply, to a lesser extent, to the data concerning U.K. corporate and individual income tax.

[61] See generally Bauer & Sonnemann, *Investment incentives in East Germany—Computer Aided Benefit Analysis*, 1992 Intertax 218; Oho, *Tax incentives for investments in East-Germany ('Neue Bundesleander')*, 1991 Intertax 509.

6. Treatment of foreign income

In general

Disregarding treaties, an unlimited taxpayer (i.e., a German resident) generally owes German tax on worldwide income. Foreign income of an active foreign corporation controlled by one or more German taxpayers generally is not taxed in Germany unless repatriated to Germany.

German tax law contains some rules that might be analogized to U.S. anti-deferral rules. Similar to subpart F under the Internal Revenue Code, provisions of the Foreign Transaction Tax Act (*Aussensteuergesetz,* or "AStG") cause the German resident shareholders to be treated as if they received income that a controlled foreign corporation earns generally from sources other than active operations. However, these rules do not alter the corporate-level exemption provided under treaties, described below.

In order to be subject to this regime, the foreign corporation must be majority-owned by German residents. Furthermore, its non-active income must be taxed abroad at less than a 30-percent rate. The rate is determined, for this purpose, taking various factors into account, including both the nominal foreign rate and German tax principles. The tax authorities publish lists of countries treated as having rates below 30 percent. Active operations include agriculture, forestry, manufacturing, mineral extraction, ordinary commercial banking and insurance. Sales, service, and rental operations can be active or not depending on whether the operation avoids base company characterizations analogous to corresponding U.S. foreign base company income definitions. Similarly, dividends may or may not comprise income from an active operation, depending on the nature of the payer and its relation to the controlled foreign corporation.

As in the case of the passive foreign investment company (PFIC), foreign investment company (FIC), and foreign personal holding company (FPHC) rules of the Internal Revenue Code, German law also provides for inclusions of income with respect to holdings by German residents in certain foreign mutual funds or other passive investment vehicles. In a case where a German resident taxpayer holds at least a 10-percent share in the foreign corporation, these rules may cause current income inclusions despite the otherwise applicable treaty exemption of foreign source income.

Relief from double taxation

A taxpayer may obtain relief from double taxation of foreign income through a credit for foreign income taxes it incurs. For this purpose, foreign income can be business income attributable to a foreign permanent establishment. By contrast to U.S. law, business income from sales of property is not classified as foreign on the basis of, for example, the place where title to the property passes to the buyer. Other types of income (e.g., income from investment or employment abroad) may also be treated as foreign source income. Alternatively, foreign income taxes may be deducted.

The credit is limited on a per-country basis—that is, there is no cross-crediting of high foreign taxes against German tax on income from another, lower-tax, country. (Cross-crediting is also limited

due to the treaty exemptions from German tax on certain foreign source income, as described below.) On the other hand, there is no reduction of the limitation for one country by losses in another country. Thus, a loss in one country would not reduce the creditable portion of the taxes imposed by another country. A taxpayer can elect separately on a country-by-country basis whether to take the credit or the deduction. For a country and a year for which the credit is taken, foreign tax in excess of the foreign tax credit limitation cannot be carried forward or back or deducted.

In 1991, the German Supreme Tax Court held that foreign income taxes are further limited by the ratio of the foreign income tax base to the German income tax base. Thus, where a foreign country imposes tax on a gross basis, while Germany imposes tax on the same income after allowance of deductions, the amount of the foreign tax that can be credited would be cut back by the ratio that the deductions bear to the gross income. The tax administration stated in February 1992 that it disagreed with the position of the Court.[62]

German tax on dividends from a foreign corporation to a German resident corporation that owns 10 percent or more of the stock of the foreign corporation can be offset by a credit for foreign income tax paid by the foreign corporation. There is also available against German tax on a dividend from such a foreign corporation a credit for taxes paid by a second-tier foreign subsidiary where the second-tier subsidiary paid a dividend to the first-tier subsidiary in the same year as the dividend from the latter to the German resident. Indirect foreign tax credits below the second tier are not allowed.

Dividends from a developing country subsidiary, as defined under the Developing Countries Tax Act (*Entwicklungslaender-Steuergesetz,* or "EntwlStG"), may be exempt from German tax via a deemed indirect foreign tax credit equal to the German tax which would be payable absent a foreign tax credit (cf. Internal Revenue Code section 936). Argentina, China, Greece, India, Mexico, Portugal, and Spain are some of the countries included in this category.

In lieu of the foreign tax credit, state tax ministries are authorized to partly or completely forgive the tax on foreign source income, or determine the tax at a flat rate, assuming that the federal authorities approve and the adjustment is in the interest of Germany's national economy or the application of the regular rules raise substantial difficulties in a particular case.

Certain income from operation of German-registered, German-flag merchant ships in international transportation is taxed at half the statutory rate.

Treaty exemptions from German tax on foreign income

Under treaties, foreign source income may be exempt from German tax. Approximately 60 tax treaties are in force. These exemptions apply to business income of a foreign permanent establishment, and dividends received by a German corporation from a foreign corporation owned at least 10 or 25 percent by the German

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[62] See Killius & Rieger, "International Aspects of Income Tax," in *German Tax & Business Law Guide (CCH Europe)* para. 140-820 (1992).

corporation. For example, under the U.S.-German income tax treaty, there is excluded from the German tax base of a German resident any item of U.S. source income that, according to the treaty, may be taxed in the United States. In the case of dividends, the exemption applies only to U.S. source dividends paid to a German company directly owning 10 percent or more of the voting shares of the payer. In general, the treaty also prevents the United States from taxing U.S. source interest and royalties paid to German residents.

Thus, assume for example that a German company owns all the stock of a U.S. corporation from which it receives dividends, interest, and royalties. The dividends are exempt from German tax (and carry no direct or indirect foreign tax credits onto the German company's German tax return). The royalties and interest, on the other hand, are taxable by Germany, and there are no U.S. withholding taxes to credit against the German tax. Thus, such U.S. source income may well bear a full 50 percent income tax in Germany. By contrast, were the parent a U.S. company and the subsidiary German, there might be no U.S. tax imposed on the dividends, interest, or royalties after application of the direct and indirect German tax credits carried by the dividend against the U.S. tax on these items of income.

Treatment of foreign taxes under integration

For purposes of the integration system, foreign earnings not taxed by Germany generally are treated as untaxed, without regard to the amount of foreign tax imposed. Thus, payment by a German corporation of a dividend deemed to have been made out of foreign earnings will cause the German corporation to pay the 36-percent distribution burden. In a case where such foreign earnings are distributed to a foreign shareholder, the shareholder may be entitled to apply for a refund of the distribution burden, subject to the same withholding tax (e.g., the statutory 25-percent withholding) that applies on the distribution itself.

Allocation of profits among related taxpayers

The Foreign Transactions Tax Act permits the tax authorities to reallocate income if there has been a deviation from arm's length terms in an international business transaction between related persons. Persons are treated as related if there exists actual common control or one holds at least 25 percent of the interests in the other. Guidelines, not totally dissimilar from the U.S. Treasury Department regulations under section 482 of the Internal Revenue Code, for the application of this law have been promulgated administratively. These guidelines do not address the issue of thin capitalization. Recently, moreover, beliefs have been expressed that German tax courts have cast doubt on the validity of a 1987 Finance Ministry statement which was intended to deal with the issue of thin capitalization.[63]

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[63] See generally Borstell, *German Federal Supreme Tax Court on Shareholder Debt Financing*, 1992 Intertax 61; Killius & Rieger, "International Aspects of Income Tax," in *German Tax & Business Law Guide* (CCH-Europe) para. 142-050; Rubinstein, *World Tax Scene*, 1992 Intertax 303, 306.

7. Treatment of foreign taxpayers

A person other than a German resident is subject to limited tax liability—e.g., tax only on German source income—in Germany. Disregarding treaties, this includes the business income attributable to a German permanent establishment, income from providing services in Germany, dividends from a German resident corporation, certain types of interest that involve the right to participate in profits, rents from German situs property, royalties for uses by a German permanent establishment or for uses of rights registered in Germany, gains from the sale of German real estate and from the sale of German corporation stock by substantial shareholders. Final tax is in some cases imposed by withholding on a gross basis (25 percent in the case of dividends, royalties, personal property rents, and interest from certain types of debt with equity features, or 46 percent in the case of interest on certain loans secured by German immovable property) or by normal assessment in the case of other income. However, income of a German permanent establishment of a foreign corporation is taxed at a flat 46-percent rate, rather than the split rates of 50 and 36 percent.

Treaties can restrict the application of these taxes, in some cases reducing tax to zero. For example, treaties often contain a narrower definition of permanent establishment than internal German law. Treaties may reduce or eliminate the tax on royalties, rents, or interest. Treaties do not eliminate the German tax on dividends paid by German corporations to foreign persons. Moreover, neither internal law nor treaties permit foreign shareholders of German corporations to receive the full German tax credit (or German refund) available to resident shareholders under the German integration system. Because of the split rate system, however, the final German *corporate* tax on German corporate earnings distributed to nonresidents is 36 percent, regardless of whether the nonresident recipient is an individual or corporation, and regardless of the recipient's local tax burden. By contrast, German corporate earnings distributed to a German corporation bear a 50 percent tax.

The European Economic Community parent-subsidiary directive of 1990 will require Germany to eliminate its tax on certain dividends paid by German resident corporations to substantial shareholders resident in other member countries of the European Communities (the "EC").[64] However, while the directive requires most EC countries to eliminate the tax by January 1, 1992, it gives Germany the right to impose a 5-percent tax until mid-1996.[65] Given its split rate system, this permits Germany to compensate in part for the fact that the full German statutory corporate tax burden is not imposed on earnings that are distributed to foreign corporations and not to individuals.

C. Trade Tax

The trade tax *(Gewerbesteuer)* is a combined income and capital tax that generally is confined to income from German business operations, excluding independent personal services. The income por-

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[64] 90/435/EEC.
[65] *Id.* at art. 5, para. 3.

tion of the tax is imposed on the German business establishment's income base for income tax purposes, with some differences. For example, one-half of the interest incurred for long-term debts is not deductible. One-half of rent paid to those not liable for the trade tax is not deductible. Direct investment dividends are excluded from income. Loss carryovers are treated differently than they are under the income tax, and may not be carried back. Real property income may be excluded or a percentage of the assessed value of German real property can be deducted.

The capital portion of the tax is based on the assessed value of the business, with adjustments that correspond somewhat to the adjustments in the income tax base. Thus, for example, the capital tax base is increased by one-half the principal amount of certain long-term debts, and decreased by the value of certain direct stock investments and real estate investments. Currently the capital portion of the trade tax does not apply in the territories of the former GDR.

The trade tax, which is paid to the municipalities, is computed by multiplying a base amount times a municipal multiplier. The base amount is 5 percent of the trade tax income base plus a fraction (generally 0.2 percent) of the trade tax capital base. The final tax can be 3 or 4 times the base amount. Thus, for example, the trade tax on income may be as high as 20 percent.

In Figures 1 and 2 and table 1 in Part I (Overview of the Tax Systems of the United States, the United Kingdom, Germany, and Japan) above, the income portion of the trade tax is included in the categories "individual income tax" and "corporate income tax" to the extent that it is imposed on the income of individuals and corporations, respectively. The capital portion of the trade tax is included in the category "property tax." Considered separately, trade tax *(Gewerbesteuer)* receipts in 1989 were DM 36.7 billion ($24.7 billion), as compared to DM 34.2 billion ($23.1 billion) collected under the corporation tax *(Koerperschaftsteuer).*[66]

D. Value-Added Tax (VAT)

A consumption-based, value-added tax (VAT) has been imposed in Germany since 1968. The German VAT, which was enacted in connection with Germany becoming a member of the EC, replaced a turnover tax that applied to each taxpayer in a multi-stage production or distribution process with no credit or other allowance for tax paid by another taxpayer earlier in the process.

Most goods and services provided by taxable businesses in Germany are subject to tax at the standard VAT rate of 14 percent (the standard VAT rate is scheduled to increase to 15 percent in 1993). A reduced VAT rate of 7 percent applies to the sale of basic food items, books, newspapers, and antiques. Unlike many other countries that are members of the EC, Germany does not impose a higher VAT rate on luxury goods.

The German VAT utilizes the credit-invoice method to determine the amount of VAT due. Under the credit-invoice method, the VAT

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[66] *Statistisches Jahrbuch* 1990, as reported in Price Waterhouse, *Doing Business in Germany* 115 (1991).

liability for any period equals (1) the amount of taxable sales multiplied by the applicable VAT rate, reduced by (2) a credit for the amount of VAT paid with respect to taxable purchases as shown on required invoices. If the credit for the amount of VAT paid with respect to taxable purchases exceeds the amount of taxable sales multiplied by the applicable VAT rate, the excess is refundable to the taxpayer.

Under the German VAT, imports are subject to tax at the applicable VAT rate. Exports and services rendered in connection with the export of goods (for example, transportation, storage, and certain agency charges) are zero rated. Consequently, businesses are not subject to VAT on exports and related services, but are allowed a credit for the amount of VAT paid on taxable purchases that are attributable to exports and related services.

Germany provides an exemption from the VAT for: (1) most transactions by banks and insurance companies; (2) the sale of land and buildings; and (3) the rental of land and buildings. Unlike a zero-rated good or supply, a credit for VAT paid on taxable supplies is not allowed if the good or service to which the supply relates is exempt from the VAT.

A business that has sales of not more than DM 25,000 ($16,855) for the preceding taxable year and expects sales of not more than DM 100,000 ($67,420) for the current taxable year may elect to be exempt from the German VAT. A taxable business generally is required to file a VAT return on a monthly basis.

E. Wealth and Wealth Transfer Taxes

The wealth tax *(Vermoegensteuer)* is an annual tax on taxable net assets of individuals and corporations. Assessed asset values of real property may be less than fair market value, and deductions are allowed in the case of an individual of DM 70,000 ($47,194) per family member, or in the case of corporation, DM 125,000 ($84,275). For individuals, the tax rate is 0.5 percent of the base; for corporations, 0.45 percent. The tax currently does not apply in the former territories of the GDR.

There is also an inheritance and gift tax *(Erbschaftsteuer und Schenkungsteuer)*. The rates and exclusions that apply to particular transfers depend upon the closeness of relationship between the donor and donee, and may depend on the nationality or residence of the donor or donee. At the most tax-favored end of the rate scales (which applies on transfers to spouses and direct descendants), the top rate is 35 percent; at the least favored end (which applies, for example, on transfers to cousins), the corresponding rate is 70 percent. Except in certain cases involving nonresidents, transfer to a spouse is exempt up to at least DM 250,000 ($168,550); to cousins, up to DM 3,000 ($2,022). Revenue from this tax and the net assets tax goes to the states.

F. Social Security

Germany has a comprehensive social security system covering health insurance, sick pay, old-age benefits, unemployment benefits, and workmen's compensation. It generally covers all persons other than the self-employed (or manager/owners of closely held

companies) mandatorily. (Participation in the health insurance program, however, generally is only mandatory up to a certain income level.) The system also may cover self-employed artists, treating their publishers, producers etc. as their employers. Contribution rates change at least annually. Premiums for health insurance and sick pay as of the beginning of 1992 were approximately 14 percent of compensation up to a periodic limit (DM 61,200 ($41,261) per year or DM 5,100 ($3,438) per month in the former Federal Republic of Germany (FRG)), generally shared equally by the employer and employee. Corresponding premiums for old-age benefits were 17.7 percent up to DM 81,600 ($55,014) per year or DM 6,800 ($4,584) per month. Contributions for unemployment benefits were 3.15 percent for the employees and the same for the employer up to DM 6,800 ($4,584) per month in the former FRG. Contributions for workmen's compensation vary by industry, and contributions for all benefits under artist's insurance are based on various percentages of royalties.

G. Other Taxes

Perhaps the most significant taxes not described above are numerous excise taxes, including those on mineral oil, tobacco, and alcoholic beverages. Insurance premiums are subject to a 7-percent excise tax.

Sales of real property are taxed at 2 percent of purchase price. Revenue from this tax goes to the states. Other taxes dedicated to the states include a motor vehicles tax, a beer tax, and a tax on gambling casinos.

The land tax is an annual tax on assessed value of real property. Its rate varies among the municipalities, which are the recipients of the revenue from this tax.

Prior to 1992, Germany had a tax on capital contributions to a German corporation, and a tax on drafts and bills of exchange. Prior to 1991, there was transfer tax of 0.25 percent of the value of transferred stock or securities of a GmbH. These taxes are no longer in effect.

V. DESCRIPTION OF JAPANESE TAX SYSTEM [67]

A. Overview

Taxes are imposed in Japan on income, payroll, consumption, inheritances and gifts, real and personal property, and certain transactions and products. The income tax system of Japan follows a pattern similar to the income tax systems of Western countries, including the United States (and, as is true of Western systems, the Japanese income tax system has its own unique characteristics). Domestic taxpayers, including domestic corporations and resident alien individuals, are subject to income taxation on their worldwide incomes. Corporate income is subject to taxation generally at a flat rate, while individuals are subject to graduated rates of tax on their incomes (including distributed corporate earnings). Japan's corporate income tax and its individual income tax generate the bulk of tax revenues at the national level. Other national-level taxes include a new consumption tax (value-added tax), inheritance and gift taxes, a securities transfer excise tax, and certain other excise taxes. Income and property taxes are also imposed at subnational levels of government in Japan.

B. Income Taxation

1. Individual income tax

Tax rates

Japan's national individual income tax is imposed at marginal rates that reach a maximum of 50 percent on incomes that exceed 20 million yen ($160,000). The following table shows the marginal tax rates that apply to varying levels of taxable income.

Table 5.—Marginal Individual Income Tax Rates in Japan (1992)

Marginal rate	Taxable income (yen)	Dollar equivalent[67].
10 percent	0–2,999,999	$0–24,000
20 percent	3,000,000–5,999,999	24,000–48,000
30 percent	6,000,000–9,999,999	48,000–80,000

[67] The following discussion of Japanese tax has been compiled from English-language secondary sources, including the following: T.A. Barthold & T. Ito, "Bequest Taxes and Accumulation of Household Wealth: U.S.-Japan Comparison" (1991), forthcoming in *The Political Economy of Tax Reforms and Their Implications for Interdependence*, (T. Ito & A.O. Krueger, eds.) (1992) Price Waterhouse, *Doing Business in Japan*, (updated March 31, 1991); H. Ishi, *The Japanese Tax System* (1989); T. Ito, *The Japanese Economy*, (1992); Kimura, "The Current Tax Situation Affecting Foreign Enterprises Doing Business With or in Japan," 4 *CCH J. Asian Pacific Taxation*, 26-28; (1992); Ministry of Finance, Tax Bureau, *An Outline of Japanese Taxes* (1991); Way, Brockman & Otsuka, *Business Operations in Japan*, 51-7th Tax Management Portfolio (updated February 10, 1992); and other periodical literature cited below.

Table 5.—Marginal Individual Income Tax Rates in Japan (1992)—Continued

Marginal rate	Taxable income (yen)	Dollar equivalent[67a]
40 percent	10,000,000–19,999,999	80,000–160,000
50 percent	20,000,000 and above	160,000 and above

[67a] All currency conversions in this table and this section are made at a rate of 125 yen to the dollar. This was the rate prevailing on July 14, 1992, as reported in the *New York Times* of July 15, 1992.

Tax base

Similar to U.K. income tax law, but in contrast to U.S. Federal income tax law, an individual can have one of three types of residence status under Japanese national income tax law: permanent Japanese residence, nonpermanent residence, and nonresidence.

(1) Permanent residents of Japan are subject to individual income taxation in Japan on their worldwide income, whether or not remitted to Japan, at graduated rates (citizenship or nationality is not a criterion for taxation on a worldwide basis).[68]

(2) Nonpermanent residents of Japan are subject to individual income taxation in Japan, at the usual graduated rates, on their income from sources within Japan and on their income from sources outside Japan to the extent that the foreign source income is either remitted to Japan or paid within Japan (or charged against the income of a Japanese company).[69]

(3) Nonresidents of Japan are subject to income taxation in Japan, generally at flat rates, only on certain types of income from sources in Japan. These types of income generally include interest, dividends, rents from real estate, and compensation for services rendered in Japan. If the compensation for services rendered in Japan is paid by a foreign employer, that income may be treated as foreign source, and thus exempt from Japanese tax, in cases where the employee is physically present in Japan for 183 days or fewer in the taxable year. The Japanese source income of nonresidents generally is subject to tax on a gross basis (i.e., no deductions are allowed), and generally is collected by withholding. Tax treaties to which Japan is a party modify both the types of Japan-source income taxable to nonresidents and the rates at which taxation is imposed.

An individual's ordinary income subject to the national income tax is the sum of the individual's income in eight categories: interest income, dividend income, rental income, business income, employment income, certain capital gains, occasional income, and miscellaneous income.

[68] Residents of Japan who are Japanese citizens are presumed to be permanent residents of Japan, while residents of Japan who are not Japanese citizens are presumed to be permanent residents of Japan only after residing in Japan for five years.

[69] Nonpermanent residents of Japan are those individuals who come to Japan with the intention to be domiciled in Japan for at least one year but not permanently. Citizens of countries other than Japan who come to Japan to engage in business (including employment) generally are presumed to be nonpermanent residents of Japan for the first five years after they arrive in Japan.

Four types of income are treated separately from aggregate ordinary income. Forestry income is subject to special, favorable treatment. Long-term gains from the sale of land and buildings are eligible for a 50-percent exclusion.[70] Short-term gains from the sale of land and buildings, along with business income from the short-term sale of land [71] (but not buildings) are taxed at higher rates than apply to ordinary income. Retirement income (including both private pensions and government social insurance) generally is subject to a 50-percent deduction after a generous statutory exclusion based on years of service, and is treated separately for purposes of the graduated income tax rates.

Specific features of Japan's national income tax

Notable features of Japan's national income tax, by comparison with U.S. Federal income taxation, are summarized below.

Collection.—Tax generally is collected by withholding, with employers required to adjust withholding rates late in the year to reflect income and deductions from sources other than employment. Interest and dividend income generally is subject to withholding at the rate of 20 percent.

Savings incentives (including capital gains).—Net gains from the sale of corporate stock and other securities generally are taxable at the flat rate of 20 percent, and are otherwise excluded from the computation of taxable income. Taxpayers trading through securities companies may elect, in lieu of 20-percent net taxation, to be taxed at the flat rate of 1 percent (0.5 percent in the case of convertible bonds) of the gross proceeds. Gains on the sale of ordinary coupon bonds are exempt from tax.

Broad categories of interest income may be taxed only at the 20-percent withholding rate, and otherwise excluded from the tax base. Individuals over age 65, along with certain widows and disabled persons, may exclude most interest income [72] from all taxation.

An individual who receives dividends from a single company aggregating not more than 100,000 yen [72a] in a year may elect to be taxed on those dividends only at the 20-percent withholding rate, and to otherwise exclude the dividends from gross income. If the individual receives dividends from a single company aggregating not more than 500,000 yen [72b] in a year and owns less than five percent of the company's stock, the same treatment may be elected at a withholding tax rate of 35 percent.

An incremental research and development credit is available only to individuals who file special "blue returns." Blue returns, which are available on an elective basis only to certain taxpayers reporting business income, offer favorable treatment in certain

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[70] A five-year holding period is required for long-term characterization.

[71] This category of taxation is intended to prevent avoidance of the severe tax on short-term gains from the sale of land by classification of such gains as ordinary business income. Way, Brockman & Otsuka, *Supra*, at A-119.

[72] Qualifying for this exclusion is interest income from postal savings accounts, which have been a major vehicle for tax-favored investment in Japan. Postal savings accounts provide most of the funding for a program of governmental capital investment, which is more than half the size of Japan's general-account budget. See Ito, *Supra*, at 163-164.

[72a] Approximately $800.

[72b] Approximately $4,000.

areas but require the use of a standardized systematic method of accounting.[73]

Other special features.—A special deduction is allowed against employment income in a decreasing marginal percentage. The deduction permits the first 650,000 yen [73a] of employment income to be deducted plus 40 percent of employment income in the first bracket above that amount, with the highest earners eligible to deduct 2,095,000 yen plus 5 percent of their employment income over 10 million yen.[73b] Instead of the employment income deduction, taxpayers may deduct their total expenses for commuting, relocation, education necessary for the employee's work, and travel expenses to return home from an assignment away from the employee's family.

Employee benefits that are excluded from employment income include reimbursement of commuting expenses (beyond amounts treated as covered by the employment income deduction) as well as substantial housing subsidies.

Personal interest expense, including mortgage interest on the principal residence, is not deductible. Limited tax credits are available, however, with respect to mortgage interest payments in certain circumstances. In addition, interest paid on a residential mortgage may be capitalized and added to the basis in the property.

No deductions are permitted for local income or property taxes (except for the local enterprise tax, which is deductible in computing business income for national income tax purposes).

Gain is not recognized on the disposition of property transferred as a contribution to a government entity or to certain designated public interest organizations. Nor is gain recognized on the disposition of property transferred as a payment in kind to satisfy inheritance tax liability (even though the transfer satisfies tax liability to the extent of the fair market value of the property).[74]

Although gifts and bequests from individuals are excluded from income, gifts from corporations are subject to income tax as occasional income.

Deductions are allowed for all premiums paid by an individual for social insurance, including amounts withheld by the employer. In addition, a portion of commercial insurance premiums are deductible for life insurance (up to 50,000 yen per year) and for household casualty insurance (up to 15,000 yen per year).

A tax credit is allowed for construction of a new residence, or acquisition of a residence less than 10 years old, meeting certain conditions. The credit is 1 percent of the outstanding balance up to 20 million yen of loans used to construct or acquire a qualifying residence, plus 0.5 percent of the outstanding balance over 20 million but less than 30 million yen of such loans. The credit may be taken in the year of acquisition and in the next four years, but not in any

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[73] Some features of the corporate tax system, including some features available to corporations filing blue returns, are available to individuals only if they file blue returns.

[73a] Approximately $5,200.

[73b] Approximately $80,000.

[74] As noted below, although property generally is valued at its fair market value at death for inheritance tax purposes, inherited property generally is not "stepped up" to that value for the heir's income tax purposes.

year for which the taxpayer's taxable income exceeds 20 million yen.[74a]

Certain undistributed profits from certain designated tax-haven subsidiaries (discussed under "3. Treatment of foreign income," below) are taxable as miscellaneous income.

Individual taxpayers generally are required to use the accrual method of accounting for tax purposes.

Japan employs no system of taxpayer identification numbers. However, a governmental tax panel is reportedly undertaking a study of proposals to introduce a numbering system.[75]

Minimum tax.—Japan imposes no separate minimum tax.

Local income taxes

Local inhabitants income taxation is imposed by prefectures and municipalities in Japan. The tax base for local income taxation is substantially the same as for national income taxation (including income from sources outside the jurisdiction). The principal difference is that charitable contributions are not deductible for local income tax purposes. Marginal prefectural income tax rates reach a maximum of 4 percent on incomes above 5 million yen. The standard municipal income tax rates reach a maximum marginal rate of 11 percent on incomes above 5 million yen, but may be increased by up to 50 percent (to a maximum marginal rate of 16.5 percent) by any individual municipality.

Local enterprise taxation is imposed by prefectures on most types of rental and other business income.[75a] After a special entrepreneur's deduction (for local enterprise tax purposes only) of 2 million yen, tax is imposed at a flat standard rate of 5 percent, but may be increased by up to 10 percent (to a maximum rate of 5.5 percent) by any individual prefecture.

2. Corporate income tax

Tax rates

The national corporate tax is imposed on most companies at a flat rate of 37.5 percent. Japanese companies are also subject to local inhabitants tax at a rate that cannot exceed 20.7 percent of the national corporate rate, plus local enterprise tax at a typical rate (for Tokyo) of 12.6 percent. The local enterprise tax is deductible against national corporate tax. In addition, Japan imposes a temporary corporate income surtax at the rate of 2.5 percent, which was enacted in connection with Japan's financial obligations to support Operation Desert Storm. For most corporate taxpayers, the surtax applies to the taxable year ending March 31, 1992, through the taxable year ending March 31, 1994.

Tax base

Private business entities established in Japan, regardless of form of organization, are subject to Japanese corporate taxation. Corpo-

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[74a] Approximately $160,000.

[75] See "Japanese Government Tax Panel to Review Variety of Tax Proposals," *Daily Report for Executives*, Bureau of National Affairs (Washington, D.C.), July 6, 1992, at G-1.

[75a] Income from sources in foreign countries is excluded from the computation of local enterprise tax.

rate tax thus is imposed on corporations (*kabushiki kaisha*), limited companies (*yugen kaisha*), and commercial partnership companies (*gomei kaisha* and *goshi kaisha*). Corporate tax is imposed on the entity's worldwide income, including foreign income of branches (whether or not remitted to Japan) but excluding the income of foreign subsidiaries other than certain designated tax-haven subsidiaries (discussed under "3. Treatment of foreign income," below).

Specific features of Japan's corporate income tax

Notable features of Japan's corporate income tax, by comparison with U.S. Federal corporate income taxation, are summarized below.

Investment incentives.—Capital gains are subject to full corporate taxation, with no specific preference.

Accelerated depreciation generally is allowed only for specified types of assets. These include newly constructed rental housing, certain energy-related equipment, certain pollution-control equipment, certain new machinery of small corporations, and certain plant and equipment located in specified underdeveloped areas of Japan. Accelerated depreciation takes the form of additional depreciation allowed in the first year, in amounts ranging from an additional nine percent of acquisition cost in the case of certain aircraft, to a total first-year allowance of 50 percent of the cost of machinery and equipment used in the Okinawa free-trade zone. Depreciation after the first year follows the taxpayer's normal method (straight line or declining balance) and schedule. Useful lives are prescribed by statute, and include such periods as 65 years for reinforced concrete buildings (commercial), 26 years for wooden buildings (commercial), 10 years for aircraft used in international service, four years for automobiles, six years for computers, 14 years for steel manufacturing plants, 15 years for metal office furniture, and eight years for patent rights.

Intangible assets (including purchased goodwill) may be amortized over periods as short as five years.

An incremental research and development credit is available.

Other special features.—Japanese corporations are not permitted to file tax returns on a consolidated basis. Financial reporting is required to be consolidated, however, for all corporations listed on a stock exchange in Japan.

Japanese tax laws require certain adjustments from generally accepted accounting principles for purposes of filing corporate tax returns. For this reason, and to eliminate the administrative burdens of maintaining separate financial and tax books, most Japanese corporations use tax accounting rules for purposes of their financial books as well as their tax books.[76] Japanese corporations generally are required to use the accrual method of accounting, and typically use a taxable year ending on March 31.

Transfer pricing is important in Japanese corporate taxation not only for international transactions but also for purely domestic related-party transactions on account of the inability to file consoli-

[76] Way, Brockman & Otsuka, *Supra*, at A-24.

dated returns. In the case of a transaction with a related foreign party, the law specifically requires that an arm's length price be determined on the basis of a comparable price standard, a reseller's profit standard, a cost plus supplier's profit standard, or (if impossible to use one of the three specified methods) by taking into account the taxpayer's expenses, assets, and other factors. Similar principles are applicable in the case of domestic transactions.

Japan enacted thin-capitalization rules in 1992. Under these rules, if a Japanese company's aggregate borrowings from a controlling foreign shareholder exceed three times the value of the company's net assets, the interest accruing on such excess borrowings generally is not deductible as a business expense.[77]

Any corporation may apply for the privilege of filing a blue return. As in the case of individual taxpayers, blue returns require the use of a standardized systematic method of accounting and offer favorable treatment in certain areas. Corporations filing blue returns are permitted to carry operating losses back one year[78] and forward five years, use accelerated depreciation, establish certain reserve accounts, and take certain tax incentive deductions and credits. These tax incentives include benefits for investment in developing countries, natural resources, nuclear power, and international economic cooperation, and allow special deductions for reserves against price fluctuations and overseas investment losses.

Minimum tax.—Japan imposes no separate minimum tax.

Integration.—Japan previously applied a split-rate system for the taxation of corporate earnings, where a reduced tax rate applied to corporate earnings that were distributed to individual shareholders, and the corporation's interest expenses of holding corporate shares were not deductible. The split-rate system was repealed in 1990.

3. Treatment of foreign income

In general

As discussed above, Japanese taxpayers are subject to income tax on their worldwide incomes, including income derived by foreign branch operations that is not remitted to Japan. Japanese taxpayers generally are not subject to taxation in Japan on the earnings of foreign corporations in which they own interests until the profits are repatriated to Japan (in the form of dividend or liquidating distributions, or upon sale of the interests). This general rule of deferral, however, does not apply to certain tax-haven subsidiaries.

Taxation of undistributed profits of certain tax-haven subsidiaries

Under tax-haven legislation enacted in 1978, certain Japanese taxpayers are taxable currently on their pro rata shares of the undistributed profits of Japanese-controlled corporations established in designated tax havens. Japanese taxpayers subject to this treatment are those owning (directly, indirectly, or constructively) five

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[77] See Kimura, *Supra*, at 26.

[78] The privilege to carry losses back to the previous tax year has been suspended for a period of two years. See *Id.*, at 28.

percent [79] or more of the stock in a tax-haven subsidiary that is owned (directly, indirectly, or constructively) more than 50 percent by Japanese taxpayers. The test of 50-percent ownership includes all Japanese ownership, not merely those owning at least five percent of the stock. "Undistributed profits" generally include all types of income, regardless of whether a type of income ordinarily may be subject to significant foreign income taxation.

"Designated tax-haven subsidiaries" generally are all Japanese-controlled corporations established in designated tax havens. Also included are Japanese-controlled corporations established elsewhere and either managed and controlled in a tax haven (and therefore treated not as residents of their jurisdictions of incorporation) or operating through a branch in a tax haven. Japan's Ministry of Finance has designated 41 jurisdictions as tax havens, classified in three categories. They are: [80] jurisdictions where all corporate income is tax exempt or taxed at a low rate,[81] certain jurisdictions where foreign-source income of a local corporation is tax exempt or taxed at a low rate,[82] and jurisdictions where corporate income from certain but not all lines of business is tax exempt or taxed at a low rate.[83]

A corporation established in a designated tax haven may avoid classification as a designated tax-haven subsidiary only by satisfying all of the following five tests: (1) It must have a fixed place of business in the tax haven; (2) its business must be managed and controlled by a local staff in the tax haven; (3) its principal business must be other than leasing vessels or aircraft, licensing intangibles, or holding stock or securities; (4) it may receive dividends from other designated tax-haven subsidiaries in amounts not exceeding five percent of its total revenue; and (5) most of its business transactions must be in the tax haven, or, in the case of sales, banking and trust, securities, insurance, shipping, and air freight companies, most of its business must be conducted with unrelated parties.

In 1992, amendments to the tax-haven law expanded the definition of a tax haven. Tax-haven countries now include any country where the effective rate of tax applicable to the Japanese-controlled corporation in question is "substantially low," which is defined in a Cabinet order as 25 percent or less. The effective rate of tax generally is computed under principles of Japanese law, and includes not only local taxes actually paid but also local taxes that are exempted or reduced to the extent that the exemption or reduction qualifies for a tax-sparing credit under the local country's tax treaty with Japan.[84]

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[79] Prior to the 1992 tax law amendments, this ownership threshold was 10 percent.

[80] Way, Brockman & Otsuka, *Supra*, at C&A-4.

[81] Andorra, Anguilla, Bahamas, Bahrain, Bermuda, British Channel Islands, British Virgin Islands, Cayman Islands, Djibouti, Hong Kong, Isle of Man, Liechtenstein, Macao, Maldives, Monaco, Nauru, New Caledonia, Turks and Caicos Islands, and Vanuatu.

[82] Costa Rica, Panama, Solomons, St. Helena, and Uruguay.

[83] Antigua, Aruba, Barbados, Cook Islands, Cyprus, Grenada, Gibraltar, Jamaica, Liberia, Luxembourg, Malta, Montserrat, Netherlands Antilles, Nevis, Seychelles, St. Vincent, and Switzerland.

[84] See Kimura, *Supra*, at 26.

Actual distributions of previously taxed tax-haven profits are free of additional income tax if distributed within the next five years after the undistributed profits are taxed.

Foreign tax credit

Japanese corporations may credit certain foreign taxes against income taxes payable to Japan on foreign source income. Both direct and deemed-paid taxes are eligible for the credit, with 25-percent ownership in the foreign corporation generally required for deemed-paid credits. Deemed-paid credits are allowed for only first-tier and second-tier foreign corporations.[85] The ownership threshold is waived for purposes of deemed-paid credits with respect to certain shareholders in designated tax-haven subsidiaries—any corporation that is taxable on its pro rata share of the undistributed profits of a designated tax-haven subsidiary is eligible for deemed-paid foreign tax credits with respect to those taxable profits. The ownership threshold also is reduced in certain tax treaties. For example, under the United States-Japan tax treaty, Japanese shareholders in U.S. corporations may take deemed-paid credits with as little as 10-percent ownership.

The foreign tax credit is subject to a limitation computed on an overall (as opposed to a per-country) basis. The limitation is computed on the basis of the national income tax only, although excess credits may be used, to a limited extent, against the corporation's local inhabitants income tax. Excess credits may be carried forward (but not back) for up to three years, and excess limitation may also be carried forward for up to three years (in effect, yielding a result similar to a carryback).

For purposes of determining the foreign tax credit limitation fraction, only one third of a taxpayer's foreign source income that is not subject to any foreign tax may be included in the numerator as foreign source income (although all of such income is included in the denominator as worldwide income), and the numerator (foreign source income) may not exceed 90 percent of the denominator (worldwide income). In addition, export sales from Japan are treated as foreign source income only if they are sold through a fixed place of business in a foreign country, or if the income from the export sales is subject to tax in a foreign jurisdiction.

Tax sparing

Japan has entered into a number of tax treaties that provide "tax sparing" benefits with respect to tax holidays or other incentives granted by developing countries to foreign investors. Under tax sparing, Japanese investors in business operations in the other treaty country may take foreign tax credits against their Japanese tax liability as if they had actually paid the foreign taxes that were "spared" pursuant to the tax holidays. Japan currently offers tax sparing in its treaties with Brazil, India, Ireland, Korea, Malaysia, Pakistan, the Philippines, Singapore, Spain, Sri Lanka, Thailand, and Zambia.

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[85] Deemed-paid credits for second-tier foreign corporations have been allowed only since Japan's 1992 tax amendments. See *Id.*, at 27.

C. Social Security Taxes

Japan's social security system is funded through payroll taxes. The health insurance tax is collected at the rate of 8.3 percent of standard regular monthly wages (i.e., not including bonuses), up to a maximum of 38,930 yen tax on wages of 710,000 yen [86] or more, shared equally by the employer and the employee. There is also a temporary tax of 0.8 percent of bonuses, of which 0.5 percent is paid by the employer and 0.3 percent by the employee. The welfare pension insurance tax on regular wages is collected at the rate of 14.3 percent for males (other than mine workers), 13.8 percent for females, and 16.1 percent for mine workers. The tax is shared equally by the employer and the employee, and is imposed on regular monthly wages up to 530,000 yen.[87] The unemployment insurance tax is collected generally at the rate of 1.45 percent of all compensation including bonuses, of which 0.90 percent is paid by the employer and 0.55 percent is paid by the employee. For certain designated industries such as forestry and construction, the unemployment insurance tax rate is 1.65 or 1.75 percent. The workmen's compensation accident insurance tax is collected at rates ranging from 0.5 percent to 14.5 percent of all compensation including bonuses, and is paid entirely by the employer.

D. Consumption Taxes

National value-added tax (VAT)

A national consumption tax (*shohi zei*) in the form of a value-added tax (VAT) was imposed in Japan in April of 1989. The tax is assessed generally at a flat rate of 3 percent of value added. The value-added tax was introduced as a replacement for the commodities tax, which had been viewed as a consumption tax on luxury goods.

The VAT was introduced for three principal reasons. First, taxing consumption was considered to be a desirable backstop to the loopholes in the individual income tax system. Second, the VAT was introduced to serve as an instrument for revenue increases in the next century, especially to pay for increased social security outlays. Third, the commodities tax was replaced by a VAT because the commodities tax, which applied to specific products, was unable to keep pace with advancing technology and the development of new consumer products.[88]

Under the Japanese VAT, the VAT liability for a taxable business generally equals (1) the amount determined by multiplying taxable sales by the 3-percent VAT rate, reduced by (2) a credit for the amount of VAT paid (or deemed paid) [89] to suppliers on purchases and the amount of VAT paid on imports. Like typical European value-added taxes, the Japanese VAT taxes international

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[86] Approximately $5,680.
[87] Approximately $4,240.
[88] Ito, *Supra*, at 154.
[89] Under the Japanese VAT, a taxable business generally is allowed a credit for purchases made from an exempt small business even though no VAT was paid with respect to such purchases. A VAT credit generally is not allowed for purchases of exempt goods or services.

transactions on a destination basis. Consequently, the 3-percent VAT applies to all imports, while exports are zero rated.

Certain transactions are exempt under the Japanese VAT, which means that no VAT is due on the provision of the good or service and no credit is allowed for the amount of VAT paid on taxable purchases that are attributable to the good or service. Among the most significant transactions that are exempt under the Japanese VAT are: (1) sales and leases of land; (2) sales of most stocks, bonds, and partnership interests; (3) lending and insurance transactions; (4) government-sponsored lotteries; (5) certain government services such as the sale of postage stamps and the granting of passports; (6) medical services provided under certain health insurance laws; (7) tuition for most schools; and (8) certain social welfare services.

A complete exemption from the VAT is also provided for businesses with annual taxable sales of less than 30 million yen,[90] while a partial exemption from the VAT is provided for businesses with annual taxable sales of less than 50 million yen. A business that qualifies for the exemption may elect, however, to be subject to the VAT in which case a credit would be allowed for the amount of VAT paid on taxable purchases.

In addition, a business with annual taxable sales of less than 400 million yen [91] may elect to determine the credit for VAT paid (or deemed paid) on taxable purchases under a simplified method. Under the simplified method, the credit for wholesalers generally would equal 90 percent of total sales, the credit for retailers generally would equal 80 percent of total sales, and the credit for other taxable businesses generally would equal 60 or 70 percent of total sales.

Finally, under the Japanese VAT, taxable businesses are allowed a credit for supplies purchased from exempt businesses, even though no VAT was paid with respect to such purchases. By providing a credit for supplies purchased from exempt businesses, the Japanese VAT discriminates against imports. It is unclear whether this feature of the Japanese VAT violates the General Agreement on Tariffs and Trade ("GATT").

Local level

No separate consumption taxes are imposed at the local level in Japan.

E. Taxation of Wealth

Inheritance and gift taxation

Japan imposes a tax on inheritance either by an heir resident in Japan or of property situated in Japan. Heirs resident in Japan are taxable on their inherited property wherever situated, but heirs resident outside Japan are taxable only on Japan-situs property. The total inheritance tax is computed on the basis of separate application of the progressive rate schedule to the shares of each heir

[90] Approximately two-thirds of all businesses in Japan have annual sales of less than 30 million yen (approximately $240,000). *The Nihon Keizai Shimbun Japan Economic Journal*, January 28, 1989, at 4.

[91] Approximately $3,200,000.

at law (at rates up to 70 percent on amounts over 500 million yen [92] allocated to a single heir), then the tax is imposed on the actual heirs and legatees in proportion to the shares that they receive.

A basic exemption is allowed in the amount of 40 million yen plus 8 million yen for each heir at law.[93] In addition, a marital tax credit is allowed in the amount of the tax due on the spouse's statutory share of the estate (e.g., half the estate if children also survive). A surtax in the amount of 20 percent is added to the tax due on an inheritance or bequest received by a person other than a spouse, parent, or child of the decedent.

Property generally is valued for inheritance tax purposes at fair market value on the date of death. Special valuations, however, apply to land [94] (including residential property) and certain other property that is difficult to value. For income tax purposes, heirs and legatees are assigned their shares of the decedent's cost basis ("carryover" rather than "stepped-up" basis).

Japan's gift tax operates under separate but similar rules, and applies to all property given to donees resident in Japan as well as to Japan-situs property given to nonresident donees. There is an annual exemption (per donee from all donors) of 600,000 yen.[95] Gift tax rates reach a maximum of 75 percent on gifts of over 70 million yen.[96]

Direct taxation of real and personal property

There are no taxes on real and personal property imposed at the national level in Japan. Local real and personal property taxes apply only to business property (including leased premises).

F. Other Taxes

Japan imposes a securities transfer excise tax on the gross sale proceeds of any transfer of stock or securities in Japan. Tax rates for transfers by ordinary sellers range from 0.3 percent for shares of stock to 0.03 percent for corporate and government bonds. Tax rates for transfers by licensed securities companies range from 0.12 percent for shares of stock to 0.01 percent for corporate and government bonds.

Japan also imposes a stamp tax on certain documents, a registration and license tax on businesses and business property, a liquor tax, a tobacco tax, and a tax on gasoline and certain other petroleum products.

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[92] Approximately $4,000,000.

[93] Japan's 1992 tax amendments are reported to have modified the basic inheritance tax exemption, as well as the rates of inheritance and gift tax. See "Japan—1992 tax amendments," *Tax News Service*, International Bureau of Fiscal Documentation, April 8, 1992, at 105. Further information is unavailable at publication time.

[94] In addition to exclusions and other reduced valuations under law, land is further undervalued in practice by the use of a special valuation map (*rosen ka*) for inheritance tax purposes, rather than either the national government's land price survey or the local government's property tax assessments. Barthold and Ito, *Supra*, at Appendix p. 5.

[95] Approximately $4,800.

[96] Approximately $560,000.

VI. ECONOMIC PERFORMANCE, INVESTMENT, SAVING, AND THE COST OF CAPITAL

A. Measurement of Productivity and National Welfare

Per capita GDP

The most basic measure of the level of national welfare is per capita gross national product (GNP) or per capita gross domestic product (GDP).[97] By these measures, the United States is an economically successful country. Table 6 provides a comparison of 1988 per capita GDP of the United States with that of Germany, Japan, and the United Kingdom. The table uses two different measures. The first converts the per capita GDP for each country to U.S. dollars by using the average 1988 dollar exchange rate of that country's currency.[98] Because exchange rates do not always reflect the relative price levels of different countries, particularly in the 1980s when exchange rates were unusually volatile, some argue that intercountry comparisons of output should measure the purchasing power of different countries. The second comparison in Table 6 provides one measure of the 1988 per capita purchasing power of the various countries.

Using the exchange rate method, the United States has the second highest per capita GDP of the countries listed. Under the purchasing power method, the United States has the highest per capita GDP.

Per capita GDP shows one measure of a country's standard of living in a single year. Growth rates of per capita GDP show the rate at which this measure of a country's standard of living has improved. To place the United States in an international context, data are presented below on the growth rates of real per capita GDP,[99] real wages, and labor productivity.

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[97] Gross Domestic Product (GDP) of a country is the value of all marketed goods and services produced in that country. Gross National Product (GNP) is GDP plus the net factor income received by residents of that country from abroad. Thus wages earned by a U.S. resident from temporary work abroad constitutes part of GNP but not GDP. Similarly, the returns from investment abroad constitute part of GNP but not GDP. Conceptual shortcomings of GNP or GDP as a measure of national welfare are discussed in Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States* (JCS-6-91), May 30, 1991.

[98] This table, several other tables, and the text often use 1988 data rather than more recent data in order to utilize comparative data gathered by the Organization for Economic Cooperation and Development (OECD). In addition, several of the empirical studies cited later in this pamphlet are based on data prior to 1990.

[99] The growth rate of each country's real per capita GDP is the growth rate of its nominal per capita GDP (denominated in its own currency) minus its inflation rate.

Table 6.—1988 Per Capita Gross Domestic Product (GDP) of Selected Countries

[Amounts in dollars]

Country	Per capita GDP	
	Computer using OECD 1988 exchange rate[1]	Penn World Table V purchasing power [2]
United States	$19,715	$19,851
Japan	23,226	13,645
Germany	19,560	14,621
United Kingdom	14,616	13,060

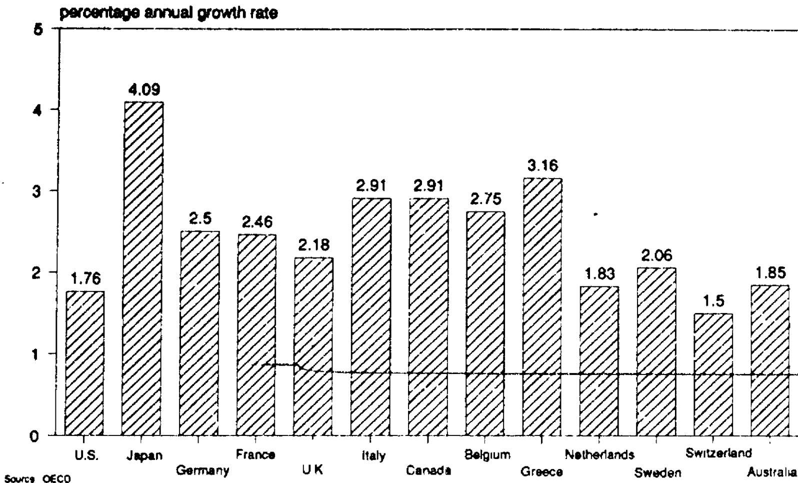
[1] Exchange rate based on average daily rate for the year 1988. Source: OECD, *National Accounting, 1960–89,* Volume 1, 1989, and OECD, *Labor Force Statistics, 1968–1988,* 1990.

[2] National currency expenditures are converted to an international, dollar-denominated currency to make real quantity comparisons across countries. The international, dollar-denominated currency is a weighted average of the relative prices for the same goods in all countries. Source: Summers, Robert and Alan Heston, "The Penn World Table (Mark 5): An Expanded Set of International Comparisons, 1950–1988," *Quarterly Journal of Economics,* Vol. 106, May 1991.

Growth of real per capita GDP

The growth rate of real per capita GDP may be the most direct measure of the rate of improvement in a country's standard of living. Figure 3 below compares the average annual growth rates of real per capita GDP for selected countries for the period 1969 to 1988.

As Figure 3 displays, the United States' growth rate of real per capita GDP is low in comparison to that of Germany, Japan and the United Kingdom. United States real per capita GDP growth averaged less than 1.8 percent per year from 1969 to 1988 compared to 2.2 percent for the United Kingdom, 2.5 percent for Germany, and 4.1 percent for Japan.



Growth in labor force participation

The growth rate of GDP per capita is equal to the sum of the growth rate of labor force participation and the growth rate of output per worker (productivity growth). To the extent that GDP growth is due to increased labor force participation, the growth rate of per capita GDP may overstate the increase in economic well-being of a society. An increase in labor force participation implies a contemporaneous decline in leisure time and services produced in the home. While leisure time and home-produced services clearly have value, they are not measured as part of GDP. Consequently, gains in GDP may mask losses of home-produced services and overstate economic well-being.[100] By examining labor force participation directly one can distinguish between the role of growth in labor force participation and productivity growth in determining GDP growth. Table 7 examines the growth in labor force participation and shows that increases in labor force participation in the United States accounted for roughly one half of one percentage point of GDP growth over the 1980s. Furthermore, the increases in labor force participation in the United States were higher than that in most other countries over both the 1970s and 1980s. Thus, more of the GDP growth of the United States can be

[100] For example, if two individuals initially laundered their own clothing, the value of the activity would not be part of GDP, but if each paid the other to launder his or her clothing, the activity would be part of GDP.

attributed to increases in labor force growth than in other countries.

Table 7.—Growth Rates of Labor Force Participation, 1970–1988

[Average annual percentage rates of change]

Country	1970–79	1980–88	1970–88
United States	0.66	0.60	0.63
Japan	−0.04	0.14	0.05
Germany	−0.38	[1] −0.28	[1] −0.34
United Kingdom	0.25	0.17	0.21

[1] Through 1986.
NA—not available.
Source: OECD, *Labor Force Statistics*, 1968-88, 1990.

Productivity growth in manufacturing

Table 8 examines productivity growth in manufacturing. As the table indicates, manufacturing growth was higher than GDP growth in the United States over the last decade. Because of the large changes in the manufacturing sector during the 1980s (generally associated with the wide fluctuations in the value of the dollar), manufacturing productivity growth may not be representative of the U.S. economy in general over this period. According to the Department of Labor, productivity growth of the non-farm sector of the U.S. economy in general averaged 2.67 percent per year from 1960 to 1969, 1.24 percent per year from 1970 to 1979, 1.10 percent per year from 1980 to 1989, and 1.64 percent per year from 1960 to 1989. Over longer horizons, productivity growth should be similar across industries (as less productive industries contract and more productive industries expand) and manufacturing productivity growth should provide a useful measure of productivity growth in general. As the table indicates, productivity growth in manufacturing in the United States was lower than that of Germany, Japan, and the United Kingdom over the period 1960 to 1989.

Table 8.—Output Per Hour in Manufacturing in Selected Countries, Decadal Averages, 1960s–1980s

[Average annual percentage rates of change]

Country	1960s	1970s	1980s	Average 1960–89
United States	3.1	2.4	3.6	3.0
Japan	10.7	7.2	5.5	7.6
Germany	6.2	4.5	1.8	4.1
United Kingdom	3.9	2.7	4.7	3.7

Source: U.S. Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, "Output per Hour, Hourly Compensation, and Unit Labor Costs in Manufacturing, Fourteen Countries or Areas, 1960-1989," April 1991.

Growth in real wages

Table 9 below reports annual real wage growth over the period 1960 to 1989 for selected countries. Over the long run, rising real wages are associated with increases in worker productivity, while stagnant real wages are associated with stagnant productivity growth.

Table 9.—Annual Growth Rates of Real Hourly Compensation in Manufacturing,[1] Decadal Averages, 1960s–1980s

Country	1960s	1970s	1980s	Average 1960–1989
United States	2.1	1.3	0.0	1.1
Japan	7.8	5.4	2.0	4.9
Germany	6.4	5.9	2.1	4.7
United Kingdom	2.9	4.4	2.0	3.1

[1] Compensation is in own country currency, deflated by own country consumer prices.

Source: U.S. Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, "Output per Hour, Hourly Compensation, and Unit Labor Costs in Manufacturing, Fourteen Countries or Areas, 1960–1989," April 1991.

As with GDP and productivity growth, U.S. wage growth is below that of the other three countries, showing stagnant real manufacturing wages in the 1980s and very low growth in the 1970s. While the growth in real wages generally mirrors the growth of labor productivity, real wage growth can differ from productivity growth if the share of non-wage compensation increases (e.g., if employer-provided health or pension benefits increase), or in the short-run, if there is a shift in the distribution of income between labor and capital.

B. Trends in the United States' Balance of Payments

The evidence in the preceding sections indicates that, while still at a high level, the standard of living of the United States is growing more slowly than that of other countries.

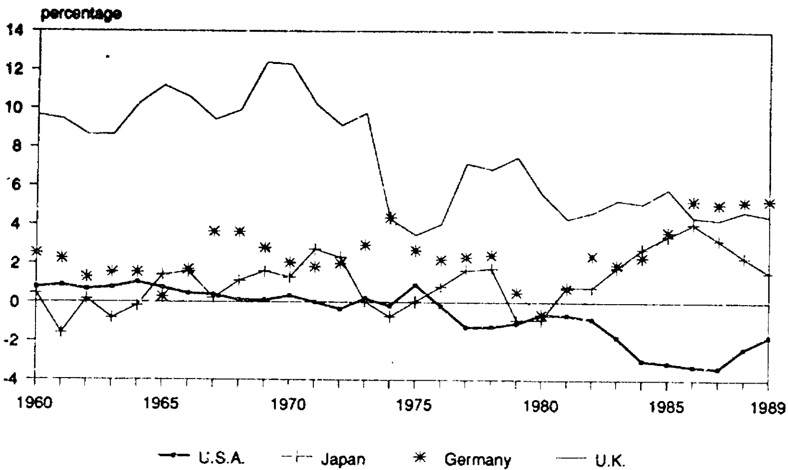
This section shows that trends in the recent growth rate of U.S. income may not be indicative of future U.S. living standards, because much of the growth over the past decade was due to investment financed by foreign savings. Servicing this foreign debt will require a slowdown in the future rate of growth of consumption of U.S. residents.[101]

While the rapid growth of both foreign-held assets in the United States and U.S.-held assets abroad is symptomatic of the increasing integration of the global economy, the change in the net interna-

[101] For a detailed discussion of this point, see Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States.*

tional position of the United States is directly related to the change in the U.S. trade balance in the 1980s. As has been widely reported, the merchandise (goods only) trade deficit has been over $100 billion per year since 1984. The current account as a whole, which compares exports of goods, services, and net interest income to imports (plus unilateral remittances), was positive as recently as 1981, but has been in deficit by over $100 billion per year from 1984 throughout the rest of the 1980s.

Figure 4 presents the net exports of goods and services as a percentage of GDP for the period 1960 to 1989 for the United States, Germany, Japan, and the United Kingdom. (Net exports are a positive entry, net imports a negative entry.) Scaling the trade surplus or deficit relative to GDP shows a country's trade deficit or surplus relative to the size of the country's economy. Since 1960, the United States has changed from a modest net exporter (net exports less than one percent of GDP) to a large net importer (net imports in excess of three percent of GDP in 1985 through 1987). Since 1965, with the exception of the years immediately following the two oil shocks of the 1970s, Germany and Japan have both been net exporters. The net export surpluses of Germany recently have exceeded five percent of GDP. The net export surpluses of Japan have declined from a peak of four percent of GDP in 1986 to 1.5 percent of GDP in 1989. The United Kingdom has consistently been a net exporter over the period, although in the 1980s its net exports were only about half as large a share of GDP as they were in the 1960s.



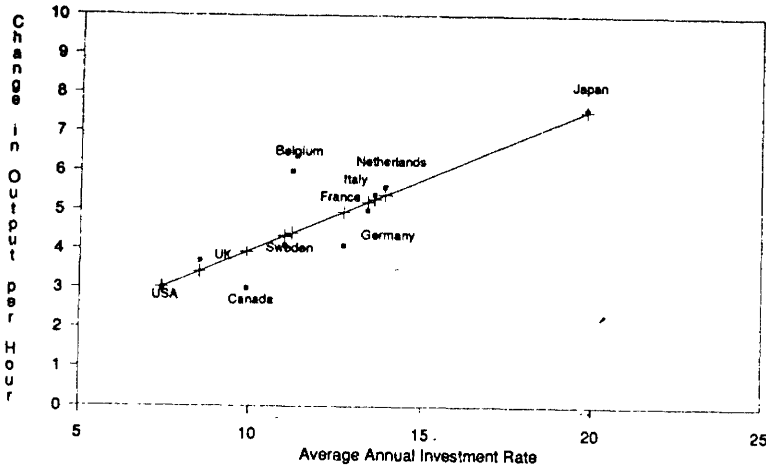
C. Role of Investment and Saving in Economic Performance

When an economy's rate of net investment (gross investment less depreciation) is positive, the economy's capital stock increases. A larger capital stock permits greater production of goods and services using a fixed amount of labor. The larger a country's capital stock, the more productive its workers and, generally, the higher its real wages and salaries. Thus positive net investment tends to cause future increases in a nation's standard of living.

As the capital stock increases, worker productivity increases and the economy will experience a higher rate of growth. Because a larger capital stock results in a larger amount of depreciation, in the long run any given rate of investment per worker will just offset the depreciation of the steady-state capital stock. Thus, in the long run an increase in the level of investment increases the level of a country's standard of living, but may not increase the rate at which a country's standard of living grows.

Figure 5 illustrates the relationship between investment rates and productivity growth in manufacturing. Countries that had high net investment rates during the period from 1960 to 1989 also experienced large increases in productivity (output per hour worked).

Figure 5
Investment & Manufacturing Productivity
Selected Countries, 1960-89



D. Trends in National Investment

The U.S. investment rate has long been lower than that of other countries. For instance, over the past 30 years, the Japanese investment rate has averaged over two and one-half times that of the United States, while that of Germany has been more than two-thirds greater. While the gap has narrowed in the past decade, the rate of investment in the United States remains significantly below that of other countries. Other countries have also experienced declining net investment rates in the 1980s. Figure 6 indicates that net investment as a percentage of GDP has been lower in the 1980s than in the 1970s or late 1960s for each of the United States, the United Kingdom, Japan, and Germany. Table 10 also documents this trend.

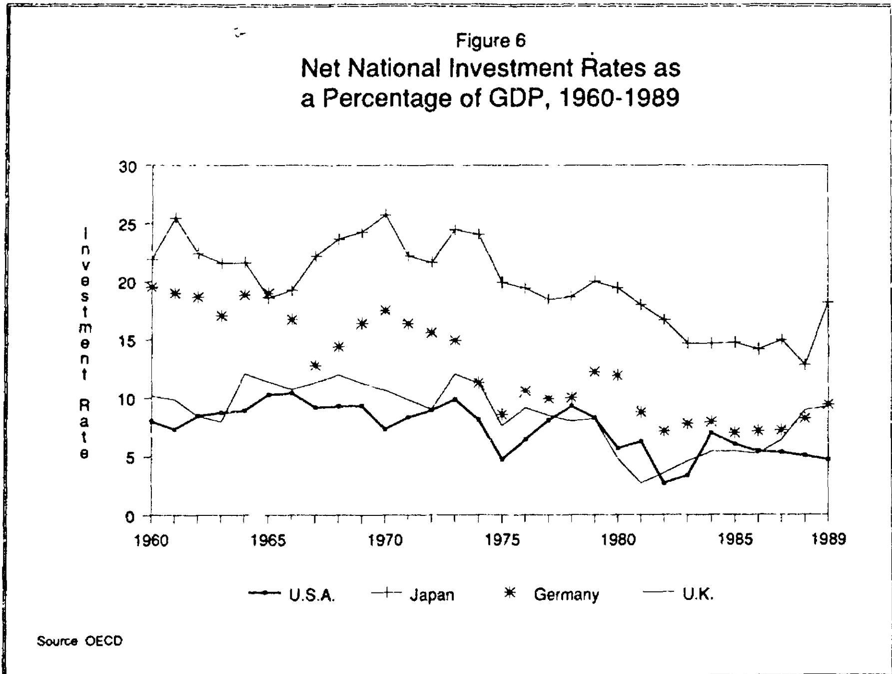
Table 10.—Net Investment as Percentage of GDP in Selected Countries, Decadal Averages, 1960s–1980s

Country	1960s	1970s	1980s	Average 1960–1989
United States	9.0	7.9	5.2	7.4
Japan	22.1	21.5	15.8	19.8
Germany	17.2	12.7	8.3	12.7

Table 10.—Net Investment as Percentage of GDP in Selected Countries, Decadal Averages, 1960s–1980s—Continued

Country	1960s	1970s	1980s	Average 1960–1989
United Kingdom	10.5	9.4	5.6	8.5

Source: OECD, *National Accounts, 1960–1989*, 1991.



E. Trends in Saving and Foreign Investment

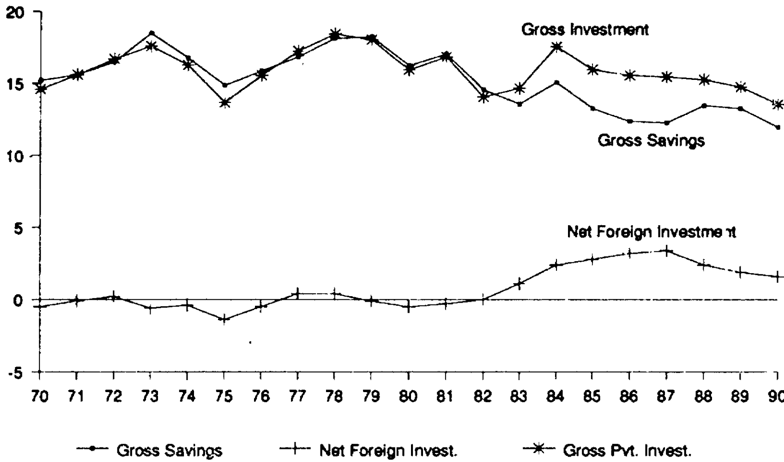
Sources of investment funds

Investment can either be financed by national saving or by foreign borrowing (saving by foreigners). Saving involves a tradeoff between consumption today and consumption tomorrow. A basic accounting identity of the national income and product accounts states that national investment must equal the sum of private saving, government saving, and net foreign borrowing.

The experience of the 1980s, when investment in the United States greatly exceeded national saving, demonstrates how important net foreign borrowing has become (see Figure 7). When demand for investment funds in the United States outstrips the supply of national savings, interest rates rise in response. Increases

in interest rates attract foreign capital to the United States, and the excess of domestic investment over national saving is financed by foreigners' saving.

Figure 7
Saving and Investment as a % of GNP
1970-1990

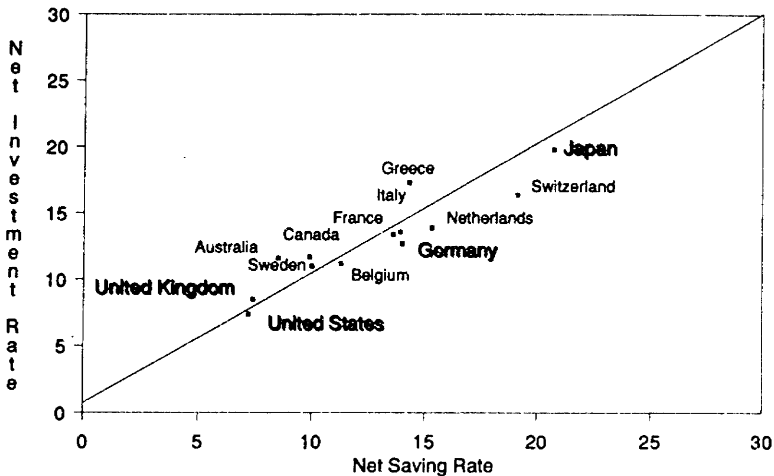


If capital is not perfectly mobile between nations, then the level of national saving can affect the level of investment. When the domestic saving rate is low, so is the domestic investment rate. Historically, there has been a strong positive correlation between a country's rate of investment and its rate of saving.[102] This relationship is illustrated for a number of countries in Figure 8. Although this relationship has become weaker over time,[103] it is still true that countries with high saving rates also generally have high investment rates.

[102] See, for instance, Martin Feldstein and Charles Horioka, "Domestic Saving and International Capital Flows," *Economic Journal*, vol. 90 (June 1980) pp. 314-29.

[103] See Martin Feldstein and Phillippe Bacchetta, "National Saving and International Investment," in B. Douglas Bernheim and John B. Shoven (eds.), *National Saving and Economic Performance*, (Chicago: University of Chicago Press), 1991, and Jeffrey A. Frankel, "Quantifying International Capital Mobility in the 1980s," in B. Douglas Bernheim and John B. Shoven (eds.), *National Saving and Economic Performance*, (Chicago: University of Chicago Press), 1991.

Figure 8
Net Saving and Net Investment Rates
Selected Countries, Averages 1960-89



Source: OECD

If capital is mobile (that is, if foreigners can invest in the United States and U.S. persons can invest abroad at low cost and without much added risk), then investment in a given country will not decline as much when that country's saving rate falls. Instead, investment will be financed by foreigners, either by direct foreign investment in the United States or by foreign portfolio investment in the United States. When domestic saving rates are low, foreign financing of domestic investment results in a higher rate of investment than would have been possible if investment were financed by domestic saving alone.

Trends in national saving

National saving is generally divided into private saving and public saving. Private saving is comprised of household or personal saving and business saving. Households save by not spending all of their disposable (i.e., after-tax) income. Businesses save by retaining some of their earnings. Public saving reflects the extent to which national, State, and local governments run budget surpluses.

The United States' national saving rate is low when compared to that of other nations. This comparison is shown in Table 11 for total national saving. Figure 9 also highlights the saving rate of the United States, the United Kingdom, Germany, and Japan from 1960-1989. As Table 11 indicates, the net saving rate of the United States during the 1980s was comparable to that in the United

Kingdom and much below the saving rates of Germany and Japan.[104]

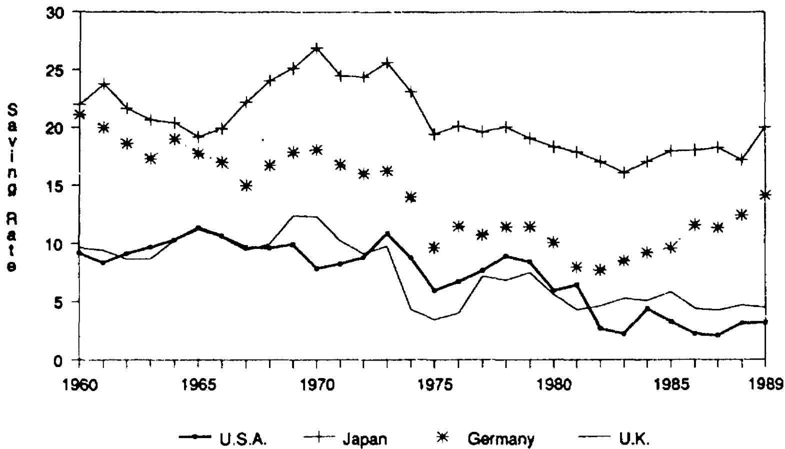


Table 11.—Savings as a Percentage of GDP in Selected Countries, Decadal Averages, 1960s–1980s

Country	1960s	1970s	1980s	Average 1960–1989
United States	9.8	8.2	3.6	7.2
Japan	21.9	22.3	17.8	20.7
Germany	18.0	13.6	10.2	14.0
United Kingdom	10.0	7.5	4.8	7.4

Source: OECD, *National Accounts, 1960–1989,* 1991.

Generally, saving rates of all nations have declined from the rates of the late 1960s. In percentage terms, the decline in the na-

[104] The data on international saving rates in Table 11 are not directly comparable, because such data are not always compiled consistently across nations. While the source of the international comparisons draws on data from the OECD, which attempts to provide data on an internationally comparable basis, the data are not fully comparable. For example, in computing household saving rates, the definition of the household sector is not identical across all countries. For the United States, the United Kingdom, and Germany, but not Japan, private nonprofit institutions are included in the household sector. See, Andrew Dean, Martine Durand, John Fallon, and Peter Hoeller, "Saving Trends and Behavior in OECD Countries," OECD, Economics and Statistics Department Working Paper, No. 67, June 1989.

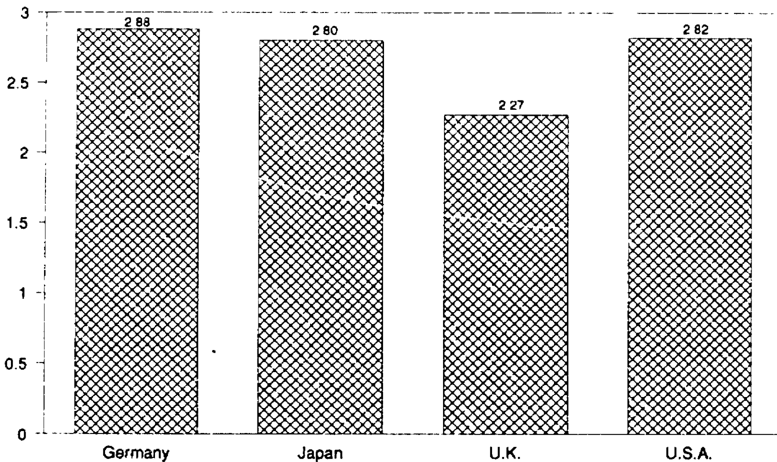
tional saving rate of the United States between 1960 and 1989 is greater than the decline in the saving rates of Japan and Germany.

F. Trends in Research and Development Expenditures

If they result in technological innovations, research and development (R&D) expenditures can contribute to economic growth by increasing productivity. Concern has been expressed that the United States spends too little on R&D relative to other countries.

Figure 10 charts R&D expenditures as a percentage of GDP in 1989.[105] As the figure reveals, the share of GDP devoted to R&D is actually quite similar across the United States (2.82 percent), the United Kingdom (2.27 percent), Germany (2.88 percent) and Japan (2.8 percent). This evidence does not support the assertion that the United States is disadvantaged, relative to these countries, by low R&D spending.

Figure 10
R&D Expenditure as a
Percentage of GDP (1989)



Source. OECD Main Science and Technology Indicators

[105] The OECD data in this figure have a number of limitations, implying that the comparison between the countries is suggestive rather than conclusive. For example, the data for Germany refer only to West Germany and the data for Japan (which are taken from the OECD's adjusted series) overstate research labor costs for research not performed in the higher education sector. Furthermore, the data for the United States exclude the expenditures of state and local governments, use depreciation in place of gross capital expenditure for business enterprises, include only current (not capital) expenditures for the private nonprofit sector and include only capital (not current) expenditures from universities' general funds.

G. Tax Policy and Investment

1. Investment and the cost of capital

The cost of capital is the pretax real return that a firm must earn, gross of depreciation, to satisfy the demands of its shareholders and bondholders and to pay corporate taxes. The cost of capital measures the opportunity cost of funds, and therefore is the rate at which firms discount the future returns of an investment in order to determine whether the investment is worthwhile. If new projects do not earn a return at least as great as the cost of capital, the capital markets will penalize managers for wasting capital resources. When the cost of capital is low, more investments will be determined to be profitable. Thus, the lower the cost of capital, the higher the level of investment. Since, in theory, firms invest in all projects that yield a rate of return equal to or greater than the cost of capital, the cost of capital also measures the return on the marginal investment.

2. Comparisons of the cost of capital across countries

One common explanation for the higher levels of investment in other countries relative to that in the United States is that the United States has a higher cost of capital. However, comparing the cost of capital in different countries can be quite difficult. Because firms finance investments with both equity and debt, the cost of capital cannot be measured simply by the interest rate. Similarly, a simple comparison of two or more countries' tax systems is insufficient to determine the cost of capital applicable to the countries in question.

Several analysts have attempted to measure properly the cost of capital in a number of countries, although most of the recent effort has focused on comparisons between the United States and Japan. The conclusions have been mixed. A recent study compares the cost of capital in the United States with that of Germany, Japan, and the United Kingdom.[106]

This study found that the cost of capital in the United States and the United Kingdom is substantially higher than the cost of capital in Japan and Germany. However, another study [107] suggested that, when properly measured, the cost of capital in Japan in the 1980s may have been similar to that in the United States. Finally, a third study [108] concluded that although the cost of capital in the 1980s was cheaper in Japan than in the United States, currently the cost of capital in Japan is approximately as high as in the United States.

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[106] Robert McCauley and Steven Zimmer, "Explanations for International Differences in the Cost of Capital," *Federal Reserve Bank of New York Quarterly Review*, Summer 1989.

[107] Albert Ando and Alan J. Auerbach, "The Cost of Capital in Japan: Recent Evidence and Further Results," *Journal of the Japanese and International Economies*, 3, December 1990.

[108] Jeffrey A. Frankel, "The Japanese Cost of Finance," *Financial Management*, 20 spring, 1991, p. 123.

3. Problems in measuring and comparing the cost of capital across countries [109]

The measurement problems encountered in calculating comparative costs of capital or effective tax rates are large. This section briefly summarizes some of the empirical and conceptual difficulties that can lead one to question the results of such studies.

Because investment is financed by a combination of equity and debt, the cost of capital must measure the required return to each. Measuring the cost of debt requires making assumptions about the underlying riskiness of the assets and about investors' expectations of inflation. Many studies assume that the riskiness of corporate bonds is identical across countries. This need not be the case. For example, to the extent corporate leverage differs across countries, perceived risk of corporate debt may differ. Similarly, some studies assume that the inflation rate that acctually prevailed is what investors anticipated at the time they purchased the bonds. To the extent that this assumption is incorrect, the expected return on securities is mismeasured. It also may not be appropriate to assume identical term structures of debt across countries.

Measuring equity returns is even more difficult than measuring returns to debt. A common measure of the required return to equity uses the ratio of stock price to earnings. However, there are theoretical reasons to doubt that price-earnings ratios correspond to investors' current required rates of return. This concern may be particularly acute in the case of measuring the required return on equity in Japan, given the unusual performance of the Japanese stock market in the 1980s.

Furthermore, accounting earnings do not always properly measure true earnings. First, accounting earnings do not include accrued but unrealized capital gains. This is a significant issue in measuring the Japanese cost of capital, because Japanese firms hold a significant amount of land, which experienced rapid increases in value during the 1980s. Ando and Auerbach [110] found that when the Japanese cost of capital is calculated for only the non-land component of firms (subtracting the value of a firm's land holdings from the firm's value, and then recomputing the price-earnings ratio), there is very little observed difference between the United States' and the Japanese cost of capital, especially in recent years.

Second, countries have different accounting practices. Comparing Japan and the United States, for instance, requires adjusting for the prevalence in Japan of reporting unconsolidated earnings for related firms (which understates earnings), the presence of reserve accounts for future severance pay to workers, and differences in accounting for depreciation. All three of the above differences would tend to understate true earnings in Japan. Corrections for these differences reduce the price-earnings differential by about half.

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[109] For detailed criticisms of the methodology employed in cost of capital studies see, James M. Poterba, "Comparing the Cost of Capital in the United States and Japan: A Survey of Methods," *Federal Reserve Bank of New York Quarterly Review*, Winter 1991. Also, see Frankel, "The Japanese Cost of Finance."

[110] Ando and Auerbach, "The Cost of Capital in Japan: Recent Evidence and Further Results."

Finally, analysts of financial markets stress that risk premia are likely to vary through time, making it difficult to use historical data to assess risk-adjusted equity returns, yet many studies of the opportunity cost of equity rely on historical data.

4. Possible explanations for differences in the cost of capital across countries

Even after accounting for these measurement issues, some analysts find that the costs of capital do vary across countries. Several explanations for the difference between the cost of capital in the United States and that in other countries have been explored. In particular, analysts have focused on the reasons for the differences between measurements of Japanese and U.S. capital costs.

Tax-related reasons for differences in international costs of capital

Taxation affects the cost of capital because it creates a wedge between the returns investors receive and the actual returns on investments. The larger is the tax wedge, the higher is the required return on investments. Taxation of capital income in the United States and abroad could differ because of differences in debt-equity ratios, depreciation allowances, and other investment incentives, corporate tax rates, or personal tax rates.

Because corporations can deduct their interest payments, both the Japanese and the United States' tax systems provide a corporate tax advantage to debt financing over equity financing. Since Japanese investments generally have a higher share of debt financing than United States investments, it is possible that this difference in financing could explain the difference between the costs of capital in the two countries. However, empirically, the value of the interest deduction can explain at most a small fraction of the differences in the costs of capital.

Effective tax rate studies

One method used to evaluate the effects of corporate and personal taxes on the cost of capital is the calculation of an effective tax rate. This approach was pioneered by King and Fullerton.[111] They attempted to consistently measure the wedge imposed by the tax system between the pre-tax rate of return on a corporate investment and the after-tax rate of return that can be paid to the investors who financed the project. This approach does not measure the cost of capital per se, but rather provides the analyst with a measure of that portion of the cost of capital that must be paid over to the government.

The King-Fullerton approach analyzes the tax system of each country to determine the marginal effective tax rates applicable to a variety of investment projects. The calculation of the tax wedge depends upon the system of corporate taxation, the personal tax code, and the existence of wealth taxes. Of course, as discussed above, the burden of a tax system depends in part on other eco-

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[111] Mervyn A. King and Don Fullerton, *The Taxation of Income from Capital: A Comparative Study of the United States, the United Kingdom, Sweden, and West Germany* (Chicago: The University of Chicago Press), 1984.

nomic variables. For example, deductions for interest expense are more valuable when inflation is high than when inflation is low. Consequently, the King-Fullerton approach requires assumptions about inflation rates and interest rates.[112]

Several analysts subsequently have used the King-Fullerton methodology. Bernheim and Shoven [113] used the King-Fullerton approach to calculate the cost of capital and the tax wedge on capital in the United States, Japan, Germany and the United Kingdom. The study sought to determine whether differences among countries' cost of capital are the result of differences in taxation or credit conditions within the countries. For the 1970s, Germany is calculated to have had the highest cost of capital and the highest tax wedge for equity capital. The United States' tax wedge was about 80 percent of Germany's and was the second largest of the four countries. Both Japan and the United Kingdom had a negative cost of capital (capital investment effectively was subsidized). For the 1980s (through 1983), the United States has the highest cost of capital and the second largest tax wedge (about 94 percent of Germany's). Bernheim and Shoven conclude that while "under prevailing tax systems the differences in the cost of capital between countries are largely attributable to differences in domestic credit market conditions, rather than to taxes",[114] structural changes in the United States' tax system could have an effect on the cost of capital relative to other countries.

Shoven and Tachibanaki [115] use the King-Fullerton methodology to calculate the effective tax rate on capital in Japan. The effective marginal tax rate on capital is low in comparison to the United States and Germany because of two factors. First, low tax rates on dividend and interest income offset high statutory corporate rates. Second, the heavy use of debt finance reduces the weighted-average cost of capital. (To the extent that debt-equity ratios have converged to those in the United States since the period covered by this paper, financing is less of a reason for differences in cost of capital.) The paper concludes that the low rate of effective tax for capital income in Japan is the result of the presence of savings vehicles with tax-free treatment, source withholding of tax on dividends and interest (and the option to forego taxation at personal tax rates) and the lack of capital gains taxation on securities.

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[112] Generally, the King-Fullerton approach is restricted to domestic savings and investment. International capital flows may be important in a number of industries, but the King-Fullerton approach does not try to tackle the complexities of multiple bilateral tax treaties and the accounting behavior of multinational enterprises. See, John Norregaard and Jeffrey Owens, "Taxing Profits in a Global Economy," *Tax Notes International*, March 9, 1992. Norregaard and Owens extend the King-Fullerton approach to calculate effective tax rates on foreign investments, both in-bound and out-bound. The Norregaard and Owens study does not account for personal taxes however. See also, A. Lans Bovenberg et al., "Tax Incentives and International Capital Flows: The Case of the United States and Japan," in Assaf Razin and Joel Slemrod (eds), *Taxation in the Global Economy* (Chicago: University of Chicago Press), 1990.

[113] B. Douglas Bernheim and John Shoven, "Taxation and the Cost of Capital: An International Comparison," in Charls E. Walker and Mark A. Bloomfield (eds.), *The Consumption Tax: A Better Alternative?*, 1987.

[114] Bernheim and Shoven, "Taxation and the Cost of Capital: An International Comparison," p. 62

[115] John B. Shoven and Toshiaki Tachibanaki, "The Taxation of Income from Capital in Japan," in John B. Shoven (ed.) *Government Policy Towards Industry in the United States and Japan*, 1988.

Although analysts have found differences in the effective tax rates across countries, in general they have found that, given a country's required return on saving, the tax wedges do not differ enough to explain the difference in the cost of capital, although this does not imply that changing taxes could not affect the cost of capital.[116] Rather, most analysts find that the differences in international costs of capital can be attributed largely to differences in credit market conditions—i.e., in the return required by investors.

Differences in saving rates

One explanation for the relatively high cost of capital in the United States is that the U.S. saving rate has been below that of other countries. This explanation requires the existence of barriers to international capital mobility (for example, if foreigners investing in the United States incur more risk or costs than they would investing in their own country). If capital were perfectly mobile internationally, then differences in saving rates could not explain differences in capital costs. Because the cost of capital measures the rate of return on the marginal investment, a higher cost of capital in the United States than elsewhere would indicate that the marginal investment in the United States yields a higher return than investments elsewhere. If capital were perfectly mobile, then foreign savings would flow into the United States to take advantage of the relatively high-yielding investments, and international costs of capital would be equalized.

However, capital may not be perfectly mobile. As was discussed above, empirically there is a strong positive relationship between countries' investment and saving rates. This has been interpreted by some as evidence of imperfect capital mobility, although other explanations are also possible.[117] If capital is not perfectly mobile, then countries with higher saving rates will have lower capital costs, and countries with lower saving rates will have higher capital costs.

It is widely believed that international capital mobility increased substantially in the 1980s, and there is evidence that the relationship between domestic saving and investment rates has become less strong. If the differences in the cost of capital between the United States and other countries are indeed due to differences in saving rates, then the increased capital mobility of the 1980s should have resulted in a convergence of international costs of capital. As noted above, once measurement problems have been accounted for, several analysts do find convergence between at least the United States' and the Japanese cost of capital during the 1980s.

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[116] See Robert McCauley and Steven Zimmer, "Explanations for International Differences in the Cost of Capital."

[117] For instance, Lawrence Summers argues that government policies are often aimed at minimizing current account deficits. This has the effect of minimizing international capital flows, thereby creating a correlation between national saving and investment. Other possible explanations for this correlation focus on underlying factors, such as population growth or changes in wealth, which may affect both saving and investment. See Lawrence Summers, "Tax Policy and International Competitiveness," in *International Aspects of Fiscal Policies*, University of Chicago Press, 1988.

Institutional differences

Other analysts suggest that financial intermediation practices may explain some of the differences in the cost of capital. For instance, the Japanese industrial structure based on the *keiretsu*, or industrial group, may help foster a lower cost of capital. The *keiretsu*, through interlocking ownership, coordinates the activities of member firms which include large banks and other financial intermediaries.[118] This structure may more easily facilitate the flow of information about investment projects, resulting in less perceived risk, greater liquidity, and a lower cost of capital for member firms.[119] The interlocking ownership with banks also may reduce the cost of capital by reducing the costs involved when a member firm faces financial distress.[120] Similarly, the more interventionist government policies in Germany and Japan toward firms in financial distress may be important in lowering the required rate of return on debt and equity.[121]

H. Tax Policy and Saving

Tax policy and private saving

Tax policy would be expected to affect private saving by affecting the after-tax return to saving. Taxing the return to saving reduces the after-tax return. By reducing taxes on the returns to saving, the after-tax return is increased. This means the price of future consumption decreases in terms of present consumption, because the taxpayer has to forego fewer dollars today to consume a dollar in the future.

This price decrease can affect saving in two ways. If future consumption is cheaper compared to current consumption, taxpayers may choose to substitute future consumption for current consumption. This effect increases saving. When the price of future consumption falls, though, the amount of saving necessary to achieve any particular level of income in the future decreases. For example, a taxpayer in the 28-percent marginal tax bracket may set aside $1,300 today to help defray tuition expenses of a child 15 years from now. If the taxpayer's investment earns eight percent annually and those earnings are taxed annually at a 28-percent tax rate, in 15 years the investment will be worth $3,000. If the taxpayer could invest tax-free, an investment of only $946 today would be worth $3,000 in 15 years (assuming the same eight-percent return). The tax benefit may decrease saving because it permits the taxpay-

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[118] There are six primary *keiretsu*, Mitsui, Mitsubishi, Sumitomo, Fuyo, Sanwa, and Ikkan, as well as smaller groups generally not based upon interlocking ownership with a large bank or "independent" firms. For example, the Sony group has 87 subsidiaries, and Sony owns a large portion of the shares of these affiliates. The six primary *keiretsu* account for one-seventh of the sales in the Japanese economy, approximately one-seventh of the assets, more than a tenth of the profits, and more than four percent of employment. For more information on Japanese industrial structure see, Ito, *The Japanese Economy*.

[119] Takeo Hoshi, Anil Kashyup, and David Scharfstein, "Corporate Structure, Liquidity, and Investment: Evidence from Japanese Industrial Groups," *Quarterly Journal of Economics*, 106, February 1991.

[120] For a specific example, see James Abegglen and O. Stalk, *Kaisha, the Japanese Corporation* (New York: Basic Books), 1985. For a more general analysis, see Takeo Hoshi, Anil Kashyup, and David Scharfstein, "The Role of Banks in Reducing the Costs of Financial Distress in Japan," *Journal of Financial Economics*, 1991.

[121] See McCauley and Zimmer "Explanations for International Differences in the Cost of Capital".

er to save less in order to accumulate the same amount of money in the future.

Substantial disagreement exists among economists as to the effect on saving of increases in the net return to saving. Some theoretical studies have argued that one should expect substantial increases in saving from increases in the net return.[122] Other studies have argued that large behavioral responses to changes in the after-tax return need not occur.[123] Empirical investigation of the responsiveness of personal saving to after-tax returns provides no conclusive evidence. Some find personal saving responds strongly to increases in the net return,[124] while others find little or a negative response.[125]

Deficit reduction and national saving

National saving is equal to the sum of private and public saving. When the government borrows, public saving falls. If this decline in public saving is not met by an increase in private saving of the same magnitude, national saving also falls. Thus, one way to increase national saving would be to decrease public dissaving by reducing the deficit. If taxes were increased to reduce the deficit, it is likely that part of the tax increase would come from funds that individuals would otherwise have saved, but part would come from funds that individuals would have otherwise consumed. The net increase in saving would be equal to the decrease in government dissaving less the decrease in private saving.

The disadvantage of increasing national saving by increasing taxes is that most taxes distort behavior and thereby introduce inefficiency (in terms of the allocations of resources) into the economy. The inefficiency increases as tax rates increase. Thus, any policies that could increase national saving without increasing marginal tax rates would be more efficient than policies that increase saving while increasing marginal tax rates.

VATs and saving

As discussed above, a low saving rate can contribute to a high cost of capital. Some analysts have noted that most of the United States' major trading partners have a value-added tax, or other consumption tax, and have suggested that this fact may help explain differences in national saving rates. In fact, the United States has long had other types on consumption taxes (see Table 1 for historical trends in VATs and other taxes on goods and services in the United States, the United Kingdom, Germany, and Japan).

Consumption taxes and saving

The most frequently cited benefit of a consumption tax is that, unlike an income tax, it does not distort saving behavior. It is often

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[122] See, Lawrence H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model," *American Economic Review*, 71 (September 1981).

[123] See, David A. Starrett, "Effects of Taxes on Saving," in Henry J. Aaron, Harvey Galper, and Joseph A. Pechman (eds.), *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (Washington: Brookings Institution), 1988.

[124] See, Michael Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, April 1978, 86.

[125] See, George von Furstenberg, "Saving," in Henry J. Aaron and Joseph A. Pechman (eds.), *How Taxes Affect Economic Behavior* (Washington Brookings Institution), 1981.

argued that current U.S. saving rates are relatively low compared to earlier years and compared to other countries, and the current low rate of saving is related to income taxation.[126] Imposition of a broad-based consumption tax alone is not perceived as increasing saving; it is the replacement (or reduction in the rate of growth) of income taxation by consumption taxation that could promote savings.[127] In general, replacement of an income tax by a consumption tax should increase saving since there is only a substitution effect—the income effects of eliminating the income tax and imposing the consumption tax offset each other.

VAT border tax adjustments and international trade

It is sometimes argued that a VAT (based on the destination principle that imposes taxes on imports and provides rebates on exports) would help the U.S. balance of trade.[128] However, economists have long known that there is no direct effect of a VAT on the volume of exports or imports.[129] In fact, the imposition of a tax on imports—equal to that imposed on goods produced domestically—and a similar tax rebate on exports is intended to maintain a level playing field between domestic and foreign producers in their competition for business in both domestic and foreign markets.

To help understand why border tax adjustments do not distort or subsidize international trade, consider the following example. Suppose a certain good produced both overseas and domestically, such as wheat, sells at $4.00 per bushel. With the enactment of a broad-based U.S. VAT at a rate of 10 percent, the price of wheat in the U.S. would increase by 10 percent to $4.40 (under the assumption that the tax is passed forward to consumers) for wheat produced domestically as well as overseas since both are subject to the tax—the domestically produced wheat being subject to the normal value-added tax and the wheat produced overseas subject to the import tax at the same rate as the VAT. Thus, even though imports are subject to tax, United States buyers' choice between imported and domestically produced wheat is not altered.

Similarly, foreign consumers' choice between goods produced in the U.S. and goods produced in their own country is not altered even though U.S.-produced goods are provided VAT rebates when

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[126] For a discussion of the determinants of rate of saving, see Joint Committee on Taxation, *Present Law, Proposals, and Issues Relating to Individual Retirement Arrangements and Other Savings Incentives* (JCS-11-90), March 26, 1990; and Joint Committee on Taxation, *Description and Analysis of S. 612 (Savings and Investment Incentive Act of 1991)* (JCS-5-91), May 14, 1991.

[127] To the extent that revenues are dedicated to deficit reduction, and not to new government spending, *any* tax increase reduces the Federal deficit and thereby directly increases net U.S. saving.

[128] Some also argue that the competitiveness of United States owned firms would be enhanced by the imposition of a value-added tax, if the VAT replaced part or all of the corporate income tax. This issue is discussed in detail in Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States.*

[129] See, for example, Martin Feldstein and Paul Krugman, "International Trade Effects of Value-Added Taxation," in Assaf Razin and Joel Slemrod (eds.) *Taxation in the Global Economy*, Chicago: University of Chicago Press, 1990 ("A VAT is not, contrary to popular belief, a tariff-cum-export subsidy. In fact, a VAT is no more inherently procompetitive trade policy than a universal sales tax. . . . The point that VATs do not inherently affect international trade flows has been well recognized in the international tax literature." (p. 263)); and Charles E. McLure, *The Value-Added Tax: Key to Deficit Reduction?*, Washington, D.C.: American Enterprise Institute, 1987 ("Although this patently absurd argument is heard less frequently now than in earlier episodes of the continuing debate of the pros and cons of the VAT, it is encountered often enough that it deserves brief discussion." (p. 56)).

exported. Wheat produced outside of the U.S. and sold to foreign consumers remains at its world price of $4.00 and wheat produced inside the U.S. remains at $4.00 since no U.S. VAT is imposed on the exported wheat.

From the preceding discussion it might seem that a value-added tax without border tax adjustments (an origin principle VAT) could disadvantage domestic producers relative to foreign producers in overseas markets. However, border tax adjustments may not be the only mechanism operating to maintain neutrality. Other self-executing adjustments by the markets, such as reductions in wage rates or in the value of the domestic currency, could wholly offset any potentially detrimental trade effects of origin-based taxation on exported goods.

Continuing the above example, if the world price of wheat is $4.00, the burden of the tax cannot be shifted forward to consumers in the form of higher prices. If the markets are competitive, the seller cannot both reduce price and remain in business. However, labor may bear the burden of the tax through reduced wages. This allows the seller to remain in business with a price of $4.00. Therefore, there is no effect on foreign trade. Alternatively, the domestic currency may depreciate so that although the *nominal* price has increased to $4.40, the price paid for domestic wheat by foreign consumers in their currency is unchanged from its before-tax level.[130]

[130] See Martin Feldstein and Paul Krugman, "International Trade Effects of Value-Added Taxation," in Assaf Razin and Joel Slemrod, eds. *Taxation in the Global Economy* Chicago: University of Chicago Press, p. 270.

APPENDIX:

Top Marginal Corporate and Individual Income Tax Rates Imposed by U.S. States

States	Corporate tax rate (Percent)	Individual tax rate (Percent)
Alabama	5.0	5.0
Alaska	9.4	N/A
Arizona	9.3	7.0
Arkansas	6.5	7.0
California	9.3	11.0
Colorado	5.2	5.0
Connecticut	11.5	1.5
Delaware	8.7	7.7
District of Columbia	10.0	9.5
Florida	5.5	N/A
Georgia	6.0	6.0
Hawaii	6.4	10.0
Idaho	8.0	8.2
Illinois	4.8	3.0
Indiana	3.4	3.4
Iowa	12.0	9.98
Kansas	4.5	5.15
Kentucky	8.25	6.0
Louisiana	8.0	6.0
Maine	8.93	9.89
Maryland	7.0	5.0
Massachusetts	9.5	6.25
Michigan	2.35	4.6
Minnesota	9.8	8.5
Mississippi	5.0	5.0
Missouri	6.5	6.0
Montana	6.75	11.0
Nebraska	7.81	6.92
Nevada	N/A	N/A
New Hampshire	8.0	5.0
New Jersey	9.375	7.0
New Mexico	7.6	8.5
New York	9.0	7.875
North Carolina	7.75	7.75
North Dakota	10.5	12.0
Ohio	8.9	6.9
Oklahoma	6.0	7.0
Oregon	6.6	9.0

Top Marginal Corporate and Individual Income Tax Rates Imposed by U.S. States—Continued

States	Corporate tax rate (Percent)	Individual tax rate (Percent)
Pennsylvania	12.25	2.8
Rhode Island	9.0	8.525
South Carolina	5.0	7.0
South Dakota	N/A	N/A
Tennessee	6.0	6.0
Texas	N/A	N/A
Utah	5.0	7.2
Vermont	8.25	8.68
Virginia	6.0	5.75
Washington	N/A	N/A
West Virginia	9.15	6.5
Wisconsin	7.9	6.93
Wyoming	N/A	N/A

Source: Prentice Hall, *All States Tax Guide*, 1992. Corporate tax rates are from para. 222 (as of 10/29/91) and generally ignore surtax rates; individual tax rates from para. 228 (as of 10/29/91). "N/A" signifies that the State does not impose a corporate or individual income tax.

PREPARED STATEMENT OF JOHN ISAAC

The UK tax system

I hope that it will be most helpful, if, in this first intervention, I give a very brief, and necessarily very bald and incomplete summary of the UK tax arrangements; if I concentrate to some extent on the taxes affecting business; and if I then try to respond in more detail to questions on any aspect that you find of particular interest. I am, of course, speaking in a strictly personal capacity.

Income tax

Income tax is charged on all incomes of individuals. It is charged at the same rates on all types of income. However, the income tax is a schedular system; and the UK income tax, like other tax systems, applies rules which differ in some respects in their treatment of employment income, self-employment income and investment (in US terminology passive) incomes.

Taxpayers are entitled to a personal allowance, which is currently £3,445 (a little more for the elderly). The personal allowance is indexed for inflation. That is, the statutory provisions require that the allowance is increased each year by an amount sufficient to offset the increase in the cost of living, as measured by the Retail Price Index, unless Parliament explicitly provides otherwise.

The first £2,000 of taxable income is charged at 20%; the next £21,700 [from £2,001 to £23,700] at 25%; and everything over £23,700 at the top rate of 40%. The top rate was reduced to its present 40% in the 1988 Budget.

Out of some 25m. or more taxpayers, some 2m. may be liable at the 20% reduced ate and 1 1/2m. at the higher 40% rate. The very great majority of taxpayers thus remain liable at the basic rate of 25%. [The long basic rate band, coupled with the special arrangements for deduction of tax from employment income on a cumulative basis, and other withholding or similar arrangements on investment income, help to explain how the great majority of employees are able to end the year having paid the correct amount of tax, with no need to submit a personal tax return, to pay additional tax or claim a tax repayment.]

Since 1990 husbands and wives have been taxed independently: that is, each is entitled to his or her personal allowance and rate bands. In addition, there is a Married Couple's Allowance of £1,720, which is particularly relevant to, but is not restricted to, the one-earner couple.

These figures do not include National Insurance - that is social security - contributions, which are charged separately.

Income from savings is as a general rule taxed on normal income tax principles; but there are significant exceptions to this rule - for example, long standing tax-privileged arrangements for pensions and owner-occupied houses, and more recently for some other more or less modest personal savings.

Capital Gains Tax

Capital Gains Tax is charged on disposals of chargeable assets. Since the 1988 reforms, when the top rate of income tax was reduced to 40%, gains have broadly been charged as the top slice of income up to 40%.

However, this is subject to three significant qualifications. First, as part of the 1988 package, the charge was limited to gains accruing from 1982. Second, indexation relief exempts from tax merely nominal "gains", resulting from a fall in the value of money, as measured by the retail price index. Third, largely, if not wholly for administrative reasons, the threshold for CGT is set at the relatively high figure of, currently, £5,800, indexed for inflation. The effect of these qualifications is that effective rates of capital gains tax are commonly significantly lower than the nominal rates, and than the effective rates of tax on income.

Again, married couples are taxed independently, but gifts between husband and wife are handled on a "no gain, no loss" basis.

The two main kinds of chargeable assets are stocks and shares and real property: with paper and real assets each accounting very roughly for half of the yield. CGT is not charged on government securities and certain corporate bonds; it is not charged on the taxpayer's home; and it is not charged on death..

Companies are charged to Corporation Tax on their chargeable gains, broadly on CGT principles, but of course without any "personal" threshold. There is a form of roll-over for gains on certain business assets re-invested in an unincorporated or family business, and for gifts of such assets. There is also a relief, within certain financial limits, from capital gains tax for disposal of assets used in an unincorporated business, or of shares in a family company, on the occasion of retirement for reasons of age or health.

In general, non-residents are not liable to CGT, other than in the special case of a non-resident trading in the UK and realising a gain on an asset used in the trade.

Corporation Tax

The UK has a partial imputation system. That is, part of the Corporation Tax paid by the company Is imputed to the shareholder, and covers his or her liability to income tax on distributed profits.

The UK imputation system was introduced in 1973, on a revenue-neutral basis. That is, the rate of corporation tax under the imputation system was set at a level at which it could yield the same revenue as the combined revenue of corporation tax on profits and income tax on dividends under the previous classical system. Specifically, the rate of corporation tax went up from some 40% to some 50%.

The present structure of tax rates and tax base for the UK Corporation Tax dates largely from the 1984 tax reforms. These aimed at a broadening of the tax base and a consequent reduction of the tax rate, in a way that is reminiscent of some of the United States tax reforms of 1986.

The rate of CT was reduced in stages from 50% to 35% in the 1984 reforms; and it is now 33%. There is no "minimum tax" in the United States sense.

The 1973 imputation system introduced a reduced rate of corporation tax for small companies - which commonly pay little or no dividends, and which would otherwise have suffered a significant increase in their tax burden as a result of the reform. The small companies rate is now 25% - the same as the basic rate of income tax. It applies to companies with profits not exceeding £250,000. There are marginal provisions where the profits exceed £250,000 but are less than £1,250,000.

The 1984 reforms brought about, indeed were financed by, a staged abolition of some generous investment incentives, and by the abolition of stock relief for the effects of inflation on stock values.

Very broadly, profits tend to be treated for tax in accordance with accepted accountancy principles, unless the tax legislation explicitly provides otherwise. Capital expenditure is allowable for tax in accordance with specific provisions in the Taxes Acts.

The present depreciation arrangements have 3 main components;

- plant and machinery generally is depreciated for tax at 25% per annum on a declining balance basis, with special arrangements for short-life assets, such as computers;
- industrial buildings are written down at 4% per annum on a straight line basis;
- commercial buildings, as such, receive no depreciation allowance for tax - though in practice an increasingly high proportion of the cost of commercial buildings is now represented by plant and machinery.

For plant and machinery, UK capital allowances are probably fairly close by international standards to commercial depreciation, but overall probably still write off most assets for tax, if anything, rather faster than firms write off the assets in real life; and capital allowances may thus be said to include a margin of protection against inflation, at least at present relatively low levels. But this is of course an average; and the precise comparison will vary from asset to asset, and from company to company.

Under the UK imputation system, when a company pays a dividend or other "qualifying distribution" of profits, it pays Advance Corporation Tax - ACT. This is charged at 1/3rd of the dividend, or 25% of the sum of the dividend and the tax credit to the shareholder. ACT can be set against the eventual CT on the company's profits, up to certain limits. In the great majority of cases, the company will be able to set the whole of the ACT against its CT bill. However, reliefs available to the company, including double tax relief, cannot be used to reduce ACT: in the terminology of the US Treasury paper of 7 January, ACT is described as a "compensatory tax". Partly as a consequence, there are some significant cases where the company does not have a sufficient CT liability to absorb the whole of its ACT payments. In such cases, the ACT will be surplus, but may be carried back to a past year, or forward to a future year.

The dividend to the shareholder carries a tax credit. This, similarly, is at 1/3 of the dividend, or 25% of the sum of the dividend and the tax credit itself. Thus, the tax credit covers the income tax liability of a basic rate tax shareholder. The tax credit can be paid in whole or in part to an exempt body or to a shareholder below the tax threshold. A higher rate tax payer will be liable to pay the excess tax over 25%. In the US Treasury terminology, the tax credit is described as "refundable".

Part of the tax credit is payable to certain overseas shareholders, including US shareholders, under the terms of double taxation agreements.

At this point, Mr. Chairman, I think that I need, with great respect, to echo some comments that you made a few minutes ago in introducing this Session. Certainly, my experience in the UK has been that we are living in a market economy in which international business is integrated, and mobile, across international frontiers, to a degree that few of us had foreseen ten or twenty years ago. And it follows that tax policy has needed to keep very clearly in sight the possible implications of policy options, not only for domestic policy objectives, but also for the economy's ability to compete in and for the international business market.

As a rule, relief for overseas taxation is given by the credit method. The UK has a very wide network of international double tax agreements; and has taken a leading role, in co-operation with the United States and other partner countries, in arrangements with the familiar dual aim: by direct action and by exchange of information, to tackle attempts to avoid or evade the proper tax liability; and at the same time, to tackle the kind of economic double taxation, or onerous compliance requirements, that would leave all international business, and all countries, worse off.

Inheritance Tax

Inheritance Tax is charged on estates passing on death, with tapering provisions on lifetime gifts more than 3 but within 7 years of the taxpayer's death. The tax is also charged on certain other lifetime gifts - for example to discretionary trusts and to closely held companies. The rate is 40% on the excess over an indexed threshold, currently £150,000.

There is business and agricultural relief, at 100% or 50%, depending on the nature and scale of the taxpayer's business or farming interests. 100% relief for bequests of unincorporated businesses and interests of over 25% in unquoted and unlisted businesses; and owner-occupied farmland and farm tenancies. The relief is 50% for controlling shareholdings in quoted companies and 25% or less (non-controlling) shareholdings in unquoted or unlisted companies; and agricultural landlords' interests.

Husband and wife are taxed independently, but there is generally no tax on gifts within a marriage.

PREPARED STATEMENT OF YOSHIO NAKAMURA

Mr. Chairman, members of the Committee, my name is Yoshio Nakamura and I am Deputy Director of International Economic Affairs Department of Keidanren. I am happy to appear before you today, and do so willingly in response to your invitation, to explain to you about the tax system of Japan and to answer any questions you may have.

I have submitted a detailed written statement that I respectfully ask the Committee to include in the record.

Before I begin my testimony, I feel I must explain my office in Tokyo. Keidanren is a private and non-profit economic organization in Japan, which represents all branches of economic activities in Japan except the agricultural sector. What we do is to create a consensus among the business community and voice corporate interest in the formation of Japan's domestic and international economic policies.

SHOUP RECOMMENDATION

I begin my testimony by saying that Japan's present tax system owes enormously to Professor Carl S. Shoup. As Professor of Economics at Columbia University, Professor Shoup was asked in 1949 to come to help reform the tax system and to improve tax administration. Professor Shoup and his mission accomplished what was then considered a dream. They called for an overhaul of the tax structure which emphasized individual and corporate income taxes; they applied the principle of aggregation to all types of income; they introduced the concept that corporate taxes were an advance payment of individual shareholders' income tax; and they strengthened local government's power to tax independently.

But dreams do not last forever. During the years after Shoup recommendations, the Japanese tax system has brought about distortions and imbalances in all phases of direct and indirect taxes. Japan's social and economic changes can be accounted for, such as industrial and employment structural changes, higher income level and more even income distribution, diversified and service-centered consumption pattern, aging of the population, and internationalization of economic transactions.

EFFECTS OF TAXATION

Changes of tax policy create a positive or a negative impact on the behavior of economic entity. Reduction in tax on labor facilitates work effort and reduction in tax on capital facilitates capital accumulation. This analysis is the incentive effects of taxation. As one of instruments of government's economic policy, tax policy is expected to achieve the efficient resource allocation, fair income distribution and economic stabilization and growth.

But, at the same time, governments have to raise tax revenues to finance their current and future expenditures. Therefore, governments have to structure their tax systems in order to achieve these policy objectives and at the same time to raise needed revenues.

Tax Reform—Consumption Tax

In 1992, the ratio of direct taxes to total national tax revenues is 74% (Table 1). The percentage is high compared to most other industrial nations except the U.S. As individual and corporate income taxes are the major source of tax revenues, the government's receipts fluctuate with the conditions of the economy. This has meant that during periods of high economic growth, the increase in tax revenues made it possible to reduce income taxes. However, after the oil crisis, the government faced huge fiscal deficits and had difficulty in reducing the tax burden enough to stimulate domestic demand while tax revenues stagnated. Such problems gave rise to criticism against the Japanese tax system. Therefore, an urgent task was to eliminate distortions, imbalance and perceptions of excess tax burdens, and to equip the tax system with functions of stimulating domestic demands.

The tax reform was implemented in 1989. In order to expand tax bases for the whole tax system and to institute a system imposing tax burdens lightly and broadly, a consumption tax was introduced. The former indirect tax system, based on an excise tax, could not completely cope with the rising consumption level and diversified and service-oriented pattern of consumption. Raising tax rates and additions of taxable items would have merely aggravated the situation. Therefore, it was desirable to adopt a new method of indirect taxation which covered consumption in general, including services, and which specifies non-taxable items. The government chose Japan-type value-added consumption tax.

In the system, the tax is imposed at 3% rate at each stage of transactions without accumulation, and maintains the neutrality for economic activities. It intends to shift tax burden through accounting records instead of invoices and exempts some

transactions from taxation, including financial transactions, medical services, welfare services and education services from taxation. It contains arrangements to mitigate tax compliance costs, including simplified method for small-and medium-sized companies with annual sales lower than 400 million yen, who are allowed to calculate tax based on the sales amount using deemed rate of purchases, exemption of small-sized companies with annual sales below 30 million yen and marginal exemption by which a part of the tax payment is exempted to narrow the gap between taxable and tax-exempt companies.

CORPORATE INCOME TAX

- *Effective Tax Rate*

National corporate income tax in Japan is 37.5% on distributed and undistributed profits, plus a prefectural inhabitant's tax of 5.0% of corporate taxes, a municipal inhabitant's tax of 12.3% of corporate taxes, and an enterprise tax—12% on profits, but deductible. According to Japanese government calculation, this brings the aggregate statutory effective tax rate to 49.98% of profits. In the United States, the statutory effective tax rate is 40.14% which is lower by about 10% than in Japan.

Moreover, the special provisional corporate surtax is introduced in 1992 to provide temporary fiscal revenues for two years. The 2.5% rate is imposed on the amount of corporate tax payable minus 4 million yen.

However, this calculation of the effective tax rate is based on certain assumptions. First, that taxable income is computed in a uniform manner, and that no special tax measures exist. Second, that no tax deductions such as MACRS (Modified Accelerated Cost Recovery System) apply. Third, that all taxes are paid by corporations on an individual basis, as opposed to a consolidated tax payment method. It is important, therefore, in any international comparison to take into account the following factors: To what extents are the generally accepted principles of business accounting utilized in the computation of taxable income? What special tax measures are available in that country? And what effect do different methods of tax treatment have on the tax burden of corporations?

- *Special Tax Measures*

A marked disparity between corporate profits and taxable income has developed in many advanced countries, resulting in a major reduction in the corporate tax structure. For example, to avoid inflation-boosted tax growth, as well as to encourage investment, special measures including accelerated depreciation, investment tax credits and changes in inventory valuation have been widely applied. In addition, there is often a difference between business and tax accounting practices. Accordingly, U.S. corporations can take advantage of the MACRS for tax purposes, while at the same time applying straight-line depreciation in their financial statement. As might be expected, this provides a very flexible adjustment of corporate profits for tax purposes. By excluding interest received from the corporations' gross income, including interest received from industrial development bonds, taxable income is reduced.

In Japan, criticism of the special tax measures granted to the corporations has sustained them to a low ratio over corporate tax revenues, as shown in Table 2, with the result that these provisions currently have little effect on mitigating the tax burden.

- *Depreciation*

Under present Japanese corporate tax law, taxpayers choose one of the following methods of depreciation: declining balance method; straight-line method; units of production method; and miscellaneous.

(1) Declining Balance Method—Under the plan, the depreciation basis is reduced each business year by the amount of the deduction taken and a uniform rate is applied to the resulting balance. The uniform rate is calculated by taking into account the useful life applicable for the depreciable asset, and the residual value which is legally determined to be 10 percent of the acquisition cost.

(2) Straight-Line Method—A uniform rate is applied to the acquisition costs of the depreciable assets. The acquisition costs minus the residual value are deductible each business year in equal amounts over the useful life of the depreciable assets.

(3) Units of Production Method—This method is applicable only to the mining industry.

(4) Miscellaneous—Any other method approved by the director of the district tax office. In this respect, the depreciation system in Japan is more flexible than in other countries, where corporations are permitted to use only the declining balance or straight-line devices.

However, other countries have introduced special depreciation systems to meet the problems of an inflation-induced shortfall and to permit the early recovery of invested capital. Naturally, these accelerated depreciation deductions significantly reduce the corporate tax burden.

Japan, however, applies special depreciation measures to only a limited range of assets, including pollution control equipment, equipment and machinery acquired by small businesses. None on these is high enough to offer any major tax relief; reductions in corporate tax revenues resulting from special depreciation are estimated at 148 billion Yen ($1.2 billion at $1=125 Yen) in fiscal 1992, or a mere 0.8 percent of total corporate tax revenues.

- *Reserve*

No reserves, except those enumerated by law, are tax-free in Japan. Even some existing special reserves and provisions have been cut in the face of criticism about the tax system. Article 22 of the Corporate Income Tax Law stipulates that taxable income will be computed according to the generally accepted standards of financial accounting. However, in practice not all the liability provisions which apply to corporations either as a deductible item from gross revenue or as a business expense are deductible. For tax purposes, the following tax-free reserves are justified: (a) bad debts, (b) losses on returned unsold goods, (c) bonus payments, (d) retirement allowance payments, (e) special repairs and (f) aftercare of construction work or products. Moreover, the allowable rates at which the retirement and bad-debt reserves may be credited are fixed by law. The deduction for retirement allowances is particularly restricted. Despite the fact that payments to retiring workers are clearly a liability for employers, the justifiable amount of money that can be credited to the reserve is limited to no more than 40 percent of the total payment.

- *Dividends*

Taxes on dividends are treated somewhat differently in Japan and in other countries. In the United Kingdom, the entire amount of dividends received from corporate investments is excluded from taxable income in order to avoid double taxation. In the United States, such dividends may be deducted from taxable income, but there is a limit to the deduction allowed which is determined by the percentage of shares owned. In Japan, 80 percent of dividends received is exempt. In the event the taxpayer has interest charges on money borrowed to finance the acquisition of the dividend-yielding stocks, only the dividends received minus the interest charges can be excluded from taxable income.

- *Capital Gains*

The Japanese practice is to regard a net increase in worth as taxable income regardless of the source of the income. The sale of assets used for business purposes is not an exception to this rule. Capital gains are taxed at the ordinary rate without consideration as to how long the assets have been held by the taxpayer. As for profits from land sales, however, an additional tax is levied, depending on the length of time the property has been held.

- *Tax Credits*

In Japan, tax credits are granted for increased research and development expenditures, for energy-efficient equipment and for import promotion. These credits are severely limited in their application, however, and in the case of increased research and development expenditures apply to narrowly defined expenses.

- *Consolidated Tax Return*

Taxes in Japan are payable only by individual companies, while in the U.S. affiliated companies are permitted to compute profits and losses as if they were a single firm. This system, used in the United States, brings benefits. For example, if member companies of the group are not eligible to take special tax measures because they have no taxes to pay, the consolidated tax return enables the group as a whole to take the deduction—assuming some of its members are liable for taxes. This system also provides the additional merit of exempting from taxes all profits derived from transactions between the parent and its subsidiaries.

- *Foreign Tax Credits*

In order to eliminate international double taxation on income, the foreign taxes imposed on Japanese domestic companies are credited against corporate tax. The foreign taxes imposed on foreign subsidiaries of Japanese domestic companies are credited against Japanese corporate tax imposed on the Japanese parent companies.

Japanese corporations were not permitted to claim an indirect foreign tax credit for the foreign income taxes attributable to subsidiaries below the first tier. But the

tax rules were amended in 1992 and the indirect foreign tax credit is extended to second tier subsidiaries.

On the taxation of subsidiaries of foreign companies in Japan, the 10% withholding tax is imposed on dividend to the parent companies, in addition to ordinary corporate tax. There is a request from foreign companies in Japan that the 10% withholding tax should be reduced to 5% which the OECD model double taxation convention provides.

- *Real Tax Burden*

Thus, Japanese corporations do not realize exceptional benefits from the methods used to compute taxable income. Significantly, special tax measures favoring corporations have been curtailed to lower level in recent years and revenue losses attributable to these measures are estimated at 570 billion Yen ($4.6 billion) in FY 1992 or only 3.1% of total corporate tax revenues. There is not a consensus between the government and the business community that tax policy should be used as an instrument of industrial policy. Rather, tax measures to provide relief for corporations have been abolished and a heavier tax burden has been applied, partly in order to reduce the large deficit in the budget.

In total, those special tax measures reduce the Japanese effective corporate tax rate to 48.62% which is higher by 16.70% than the U.S. in 1991.

INDIVIDUAL INCOME TAX

Japan has not established an effective mechanism for enforcing tax compliance, though the consumption tax has been introduced, because the current consumption tax is based on the accounting records instead of invoices and has some exemptions. We still have an expression, 10, 5, 3 or 9, 6, 4. That means income of salaried wage earners will be caught by 100% or 90%, income of small businesses by 50% or 60% and income of farmers by 30% or 40%, respectively.

Japanese taxpayers have strong feelings of burden and pressure from income taxation. To eliminate such feelings of increasing burdens and imbalances resulting in discontent and dissatisfaction with individual income taxation, the framework of individual income taxation was revised in 1989.

In view of asking taxpayers to bear tax burdens corresponding to their progressively rising capability, four progressive brackets are established above the basic tax rate bracket. Tax rates for these brackets increase by 10% from a bracket to the next, up to 50%. Accordingly, there are six brackets in total (Table 4). Finally, central and local combined, the highest marginal tax rate amounts to 65% (Table 5).

Joint tax return is not introduced in order to alleviate tax burdens on household. Instead, giving a thought to spouses' contribution to the taxpayers' earning of income, a special exemption for spouses is provided.

In computing taxable income, individuals are allowed to take basic, spouse and dependent exemptions, an employment income deduction, social insurance deduction, and so forth. The minimum taxable income level for a married wage-earner with two children is 3,198 thousands Yen (about $25,600) in Japan and $15,200 in the U.S. in 1992. However, the tax burden of 20 million Yen ($160,000) for a married wage-earner with two children increases to 21.4%' in Japan and to 22.2% in the U.S., because of progressive income tax structure.

- *Interest Income*

Interest income from deposits in commercial banks used to be exempt from tax if the principal amount did not exceed 3 million yen, interest accruing from postal savings used to be exempt from tax in the same amount, interest on national or local government bonds used to be exempt from tax at the same face value. Savings deducted from employee salaries used to qualify for tax free interest as long as the principal did not exceed 5 million yen. All of these measures were abolished in 1987, because these caused inequity of burdens among income categories.

Now, interest income from all savings and deposits is subject to withholding income tax at the flat rate of 20%. As a result of this change, private savings and postal savings are on an equal footing for taxation purposes.

Though the level of saving is determined by other factors, including the social welfare system, a desire for higher education, the high cost of housing and the semi-annual bonus system in Japan, tax incentives for saving encourage personal saving.

- *Dividends*

Dividends receivable are taxed separately from other income at the taxpayer's option at the rate of 35%, if the recipient owns less than 5% of the equities of the company paying the dividends, and the amount of the yearly dividends paid to the

recipient by that company is less than 500,000 yen. Otherwise, dividends receivable are required to be included in the ordinary income with the 20% withholding tax.

The 10% of dividends are credited from income tax, but, if taxable income, including dividends, exceeds 10 million yen, the reduced 5% is applied to dividends.

In order to attain the effective tax compliance on the taxation of interest and dividend income, I feel the introduction of taxpayers' numbers is indispensable.

• *Capital Gains*

Capital gains from sale of securities are taxed at 26%, including 6% local tax or at 20% on the deemed capital gains of 5% of the proceeds from selling securities on the individual income tax, but are included into the taxable income on the corporate income tax.

TAXATION ON PROPERTY

• *Inheritant Tax*

Inheritant tax is imposed on the total value of all properties acquired through inheritance less liabilities. The properties are appraised on the basis of current price or value at the time of acquisition. Heirs are allowed to take basic exemption of 48 million Yen plus 9.5 million Yen times number of statutory heirs. The value of properties attributed to each heir corresponding to the number of statutory heir is multiplied by the corresponding progressive tax rate from 10% to 70%. Heirs may take tax credits, including credit for a spouse.

• *Property Tax*

Property tax is imposed on land, buildings or depreciable business assets. The tax base is the market value assessed by the municipality. Municipality appraises the fair market value of land and buildings every three years. A tax rate is higher than 1.4%, but not higher than 2.1%

CAPITAL COSTS

These tax measures reduce capital costs for companies. There is the claim that the U.S. companies have faced significantly higher capital costs than the Japanese companies. If capital costs in Japan would be lower than in any other countries, all companies—U.S., Japanese, European and others—could raise capital in the Japanese financial market. We should notice how quickly Japanese companies moved to raise capital outside Japan as soon as Japan's Foreign Exchange Control Law was relaxed in 1980 and to repay domestic borrowings. One research by Japanese economists shows that capital costs for the Japanese companies were higher by about 5% than for the U.S. companies from 1980 to 1990, ranging from 9 to 13% for the Japanese companies compared with 5 to 8% for the U.S. companies.

COMPETITIVENESS

Japanese companies have made a great effort to enhance their competitiveness which should be evaluated highly, but created frictions with other countries. Now, the term of competitiveness has less positive connotation in Japan. Japanese business leaders review their behaviors, asking themselves "Weren't we inconsiderate in some respects in the efforts to strengthen our competitiveness?"

We, at Keidanren, resolved at the 1992 General Meeting to promote Kyosei—economic symbiosis—with other countries. Kyosei consists of two Chinese character—"Kyo" meaning "together" and "sei" meaning "to live." Combined, the two means "existing together."

Japanese corporations have tended to spend more financial and human resources to enhance their industrial competitiveness rather than to improve working conditions of their employees, to pay higher dividend to their shareholders, to create an equal partnership with their suppliers and to make contribution to their communities. Through Kyosei, economic symbiosis, we are attempting to enhance compatibility with foreign economies, while at the same time providing a more equitable distribution of the fruits to our people—including a better tax structure.

I congratulate you on your dedication to the important subject of taxes and hope that my presentation has helped your efforts in some small way.

Thank you very much.

Table 1.—REVENUE BY TAX ITEMS; FY 1992

[In 100 millions of yen]

Tax item	Amount	Percent
National Taxes		
I. General Account:		
Direct Taxes	484,560	74.1
Income Tax	272,790	41.7
Corporate Tax	181,220	27.7
Special Provisional Corporate Surtax	4,040	0.6
Inheritance Tax and Gift Tax	22,260	3.4
Land Value Tax	4,200	0.6
Indirect Taxes, etc.	169,174	25.9
Consumption Tax	49,680	7.6
Liquor Tax	20,250	3.1
Tobacco Tax	10,120	1.5
Gasoline Tax	15,760	2.4
Liquefied Petroleum Gas Tax	169	0.0
Aviation Fuel Tax	690	0.1
Petroleum Tax	5,070	0.8
Bourse Tax	400	0.1
Securities Transaction Tax	6,150	0.9
Motor Vehicle Tonnage Tax	6,740	1.0
Customs Duty	8,790	1.3
Tonnage Due	90	0.0
Stamp Revenue	16,630	2.5
II. Special Accounts:		
Consumption Tax	12,420	1.9
Local Road Tax	3,828	0.6
Liquefied Petroleum Gas Tax	160	0.0
Aviation Fuel Tax	125	0.0
Motor Vehicle Tonnage Tax	2,247	0.3
Special Tonnage Duty	113	0.0
Customs Duty on Oil	987	0.2
Promotion of Power Resources Development Tax	3,116	0.5
Gasoline Tax	5,528	0.8
Secial Provisional Petroleum Surtax	120	0.0
Total	653,734	100.0
Local Taxes		
1. Ordinary Taxes		
(1) Prefectural Taxes:		
Prefectural Inhabitants Tax	51,501	33.2
Enterprise Tax	63,225	40.7
Real Property Acquisition Tax	5,716	3.7
Prefectural Tobacco Excise Tax	3,649	2.4
Golf Course Utilization Tax	1,017	0.7
Special Local Consumption Tax	1,371	0.9
Automobile Tax	13,240	8.5
Mine-lot Tax	6	0.0
Hunters License Tax	21	0.0
Prefectural Property Tax	188	0.1
Earmarked Taxes	15,260	9.8
Total	155,194	100.0
(2) Municipal Taxes:		
Municipal Inhabitants Tax	94,124	50.9
Municipal Property Tax	68,603	37.1
Light Vehicle Tax	929	0.5
Municipal Tobacco Tax	6,455	3.5
Mineral Product Tax	22	0.0

Table 1.—REVENUE BY TAX ITEMS; FY 1992—Continued

[In 100 millions of yen]

Tax item	Amount	Percent
Special Landholding Tax	834	0.5
Earmarked Taxes	13,542	7.3
Total	185,046	100.0

Source: Ministry of Finance

Table 2.—REVENUE LOSSES FROM USE OF SPECIAL TAX MEASURES BY CORPORATIONS

[Billions of Yen]

	1987	1988	1989	1990	1991	1992
Corporate Tax Revenues (A)	15,811	18,438	18,993	18,384	17,458	18,122
Revenue Loss from Use of Special Tax Measures by Corporations (B)	455	457	507	564	630	570
B/A	2.8%	2.4%	2.6%	3.0%	3.5%	3.1%

Source: Ministry of Finance

Table 3.—USEFUL LIFE OF SELECTED FIXED ASSETS

Description of Assets	Useful Life (Years)
1. Tangible fixed assets other than machinery and equipment:	
• Reinforced concrete buildings (for offices)	65
• Reinforced concrete buildings (for factories)	45
• Electronic computers	6
• Passenger automobiles	3–6
2. Machinery and equipment	
• Iron and steel manufacturing plants	14
• Electrical machinery and appliance manufacturing plants	11
• Automobile manufacturing plants	10
• Semiconductor manufacturing plants	7

Source: Ministry of Finance

Table 4.—INDIVIDUAL INCOME TAX RATE

[Unit: 1,000 yen]

Taxable Income	Tax Rate Percent
0–3,000	10
3,000–6,000	20
6,000–10,000	30
10,000–20,000	40
20,000–	50

Source: Ministry of Finance

Table 5.—INHABITANT TAX RATE

[Unit: 1,000 Yen]

Taxable Income	Tax Rate		
	Prefecture	Municipality	Total
0–1,600	2%	3%	5%

Table 5.—INHABITANT TAX RATE—Continued

[Unit: 1,000 Yen]

Taxable Income	Tax Rate		
	Prefecture	Municipality	Total
1,600–5,500	2	8	10
5,500–	4	11	15

Source: Ministry of Home Affairs

RESPONSES OF MR. NAKAMURA TO QUESTIONS SUBMITTED BY SENATOR BAUCUS

1. It seems to me that one of the big problems here is determining exactly what is going on. To what extent is the alleged activity avoidance rather than tax evasion?

There are some difficulties in attaining the effective tax compliance on the taxation in Japan. The difficulties arise from various factors: non-existence of taxpayers' numbers, accounting records instead of invoices and some arrangements to mitigate tax compliance costs in the consumption tax, and the limited numbers of government officials in tax authority. We still have an expression, 10, 5, 3, or 9, 6, 4. That means income of salaried wage earners will be caught by 100% or 90%, income of small businesses by 50% or 60% and income of farmers by 30% or 40% respectively. We do not have any data on the tax avoidance released and therefore can not compare tax avoidance with tax evasion.

2. (For the witness's country or area of expertise) I am curious as to how other governments perceive this issue of transfer pricing and tax avoidance. Do they feel it to be a serious threat, either to revenues or to the competitive position of their local firms? What steps do other governments take to minimize the problem?

The purpose of transfer pricing taxation is not to secure tax revenues or enhance competitiveness, but to attain fair taxation.

3. Are there any prospects for coordinating the policies of the industrialized nations with respect to transfer pricing by multinationals? I am curious about the prospects for this both in terms of legislation and treaties, and in day-to-day enforcement.

It is extremely necessary to introduce an international provision on the transfer pricing taxation in order to avoid an international double taxation on income. We strongly expect bilateral and multilateral efforts in the international organizations, including OECD, on this issue.

4. Recently there has been some friction between the U.S. and some of its trading partners, as the U.S. has tried to deal with the transfer pricing issue. If the U.S. were to become more aggressive in this area, what possible retaliatory measures would the U.S., Germany, or Japan take?

If the U.S. were to strengthen the transfer pricing taxation irrationally or not in accordance with international practices, Japan would have to take the counteractive retaliatory measures on the transfer pricing taxation.

PREPARED STATEMENT OF ORRIN G. HATCH

Thank you Mr. Chairman. I would like to applaud you for holding these hearings today. The tax systems of our trading partners are an important part of our evaluation of the U.S. tax system and its effect on U.S. companies and our economy. This is especially important in context of an emerging global marketplace where exports are so important to U.S. businesses. One example is my home state of Utah. Since 1989, exports have exploded, increasing by 46 percent. This represents 4.1 percent of the state domestic product, or $1.7 billion. I am sure that my colleagues on the Committee have seen similar increases in their own states.

As we evolve from an independent to a global economy, the U.S. must evaluate and adjust its tax and trade policies to reflect this changing environment. The current tax code has largely evolved from the Revenue Act of 1962. This Act was designed to slow the movement of capital from the U.S. to foreign locations, but has had the unfortunate effect of producing economic impediments for the competitiveness of U.S. multinationals in international markets. For example, as a result of U.S. tax policies, U.S. exporters rely on foreign subsidiaries more than do their foreign counterparts. 72 percent of U.S. exports are moved through foreign subsidiaries. This is substantially more than is the case with our trading partners.

As this Committee evaluates and considers altering our tax system, we must maintain a high level of neutrality. We must ensure that we do not put into place policies that will create roadblocks to foreign trade and investment. We also do not want to create policies favoring one country over another. We need to follow the lead of many of our counterparts and develop U.S. tax and trade policies that are consistent and cohesive.

Mr. Chairman, the marketplace is indeed becoming a global one. The United States can no longer afford to continue to ignore the tax systems of our foreign counterparts as we craft our own domestic policy. We must take into account other tax systems, and how they will relate to ours. We must be cognizant and sensitive to tax treaties and how the tax policies set by Congress relate the these agreements. I believe that we should follow a modified golden rule in setting tax policies. That is, we should set tax policies that we would be willing to accept if adopted by other countries. This is only fair.

I welcome the distinguished witnesses here today. I appreciate the time and effort they expended to be here today. am' looking forward to what they will say.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF DR. ALBERT J. RADLER

INTRODUCTORY REMARKS ON GERMAN TAXATION

Federal system

As a federal state Germany has three different levels of Government which receive tax revenues the Federal government, Lander (states), local communities). The right to legislate on tax law basically rests with the federal institutions (Bundestag and Bundesrat, the latter representing the Federal States). For the major taxes there is revenue-sharing between the three levels of government. The sharing ratios are renegotiated from time to time. The taxpayer's obligations are not affected by revenue sharing allocations.

In principle, major tax laws within the Federal Republic are uniform (there are few exceptions now for the former GDR and former West-Berlin). Tax rates differ only as far as local taxes are concerned. Local Trade Tax (Gewerbesteuer) is levied both on business income and business net worth; its effective rates range between 10% to 22% on income and 0.4% and 1% on business net worth. The income and net worth components of the Trade Tax are fully deductible for Federal tax purposes.

The main taxes, their respective rates and their shares in total tax collection are as follows:

SHARE OF MAIN TAXES IN TOTAL TAX COLLECTION (EXCLUDING SOCIAL SECURITY CONTRIBUTIONS) (1990: 550 BILLION DM)

	Percent	Percent
Value Added Tax		26.83
Personal income tax		
—Wage tax	32.29	

SHARE OF MAIN TAXES IN TOTAL TAX COLLECTION (EXCLUDING SOCIAL SECURITY CONTRIBUTIONS) (1990: 550 BILLION DM)—Continued

	Percent	Percent
—Assessed income tax	6.64	
—Withholding tax	1.97	40.90
Local Trade Tax		7.06
Corporate Income Tax		5.47
Main Excise Taxes		
—Petroleum products	6.29	
—Tobacco	3.16	
—Spirits	0.77	
—Coffee	0.35	
—Beer	0.25	10.82
Property (Land) Tax		1.59
Car Tax		1.51
Insurance tax		0.81
Net Worth Tax		1.15
Land transfer tax		0.71
Inheritance tax		0.55
Other taxes		2.60
		100.00

In 1989, total tax revenue in Germany was about 24.3% of GDP; if social security contributions are included, this figure increases to 38.1%. This compares with the U.S. rates of 21.3% and 30.0% respectively. Due in large part to reunification, the German ratio of tax revenue to GDP will go up by several percentage points.

Social security contributions are high: they consist of unemployment insurance, health insurance and pension insurance. Together they amount to a total of 34% to 40% of salaries paid up to certain limits. The contribution to social security is shared equally by employer and employee.

The different types of taxes compare as follows (in % of GDP[1]):

Types of Taxes on	Germany	USA
Income and Profits	13.3	13.3
Social Security	13.8	8.8
Property	1.2	3.1
Goods and Services	9.7	4.9
Total	38.0	30.1

The revenue from taxes on income and profits in relationship to GDP in 1989 was the same in both countries; on the other hand, revenue from U.S. taxes on goods and services and contributions to social security was substantially lower than in Germany.

Personal Income Taxation

(a) Taxation of spouses and family

Germany follows the classical income-splitting approach for married couples; income is split equally between husband and wife, regardless of which spouse earned the income. Children are taxed separately on their own income.

After a basic exempt amount for taxpayer/spouses of DM 5,610/11,232 there is a proportional tax rate of 19% for income of DM 8,151/16,306. Thereafter a progressive rate structure reaches a 53% marginal rate at a net income of DM 120,042/240,084.

The cost of child care is taken into account both by an exemption of DM 4,104 for each child and a cash grant to the parent of DM 840 annually for the first or second child and 1,680 for each additional child. In case of low-income earners, the cash grant is increased for the second and any additional child.

[1] Source: Revenue Statistics of OECD Member Countries 1965–1990 p. 75

(b) Categories of income

Germany follows the schedular approach in taxing personal income. There is a clear distinction between the two main classes of income: unincorporated business, professions and farming on the one hand and four other categories of income such as salaries, rentals, capital income and other income on the other hand. The difference between the two main income classes is very important in several aspects, such as the treatment of capital gains and the method of income determination (accrual or cash method).

For the second class of income only the cash method is possible, whereas for the first group the accrual method is the rule with an option for the cash methods for professionals, farmers and smaller businesses.

In the first group all capital gains (with a few exceptions) are fully taxable (exception: the gain from selling a complete business or a partnership share is only taxed at one-half of the applicable marginal rate). There is no capital gains taxation for the second group except for:

—sale of real estate held for less than two years after acquisition,
—sale of other assets including stocks held for less than six months after acquisition,
—sale of a substantial interest (more than 25%) in a company. After a holding period of six months, the sale of a substantial interest in a company of more than 25% will be taxed at half the ordinary income tax rates.

1. Taxation of capital investments

(a) Business investments

As explained, a strict distinction is made between investments within a business and private (portfolio) investments.

Leaving aside temporary incentives for investments in East Germany, the main incentive for business investment is declining-balance depreciation based on three times straight-line rate. The tax administration publishes tables containing the useful life for different types of assets. These tables are neither binding for the taxpayer nor for the tax courts, however. Important differences between the U.S. and Germany in tax accounting of capital investments seem to be:

—there is a rather strong relationship (linkage) between tax accounting and financial accounting in Germany (see below),
—trademarks and acquired goodwill can be regularly depreciated in Germany (goodwill only over 15 years straight-line),
—permanent losses in fixed assets can be taken into account when such losses occur and there is no "realization" requirement apart from a permanent decline in value (i.e. writedown in shares of subsidiary companies, goodwill etc.). A write-off to the lower "going concern value" is permitted.

There are only limited tax incentives for education or worker training. Parents may deduct DM 4,200 per year for each child studying away from home. However, there are direct expenditure programs including grants from the unemployment office.

(b) Private investments

For the private investor, there are some incentives to invest in building such as adequate depreciation rates, under some conditions even an accelerated depreciation and full deduction of interest charge, whereas any future capital gains are fully exempt from tax. Losses can be offset against domestic income from other sources.

There is an inheritance tax which taxes each beneficiary on the value of his inheritance. The tax rate is based on two factors: the value of the inheritance and the relationship of the beneficiary to the deceased. The maximum tax rate (of an inheritance of over DM 100 million) is 35% for a surviving spouse and children, 50% for grandchildren, 70% for nonrelated persons. The inheritance tax also applies to gifts. Gifts made in the ten year period ending with the decedent's death have to be taken into account in rate determination.

The impact of the inheritance tax is largely reduced by special valuation rates for real estate, which normally result in values between 20% and 35% of the fair market value. Mortgages and other debts can be deducted in full. It is thus not surprising that that revenue from inheritance tax is only slightly more than 0.5% of total tax collection.

The same valuation principles also apply to the Net Worth Tax which is levied at a rate of 0.5% of total net worth after personal exemptions of DM 90,000 for the taxpayer, spouse and children are deducted. The tax revenue raised is slightly more

than one percent of total tax collection. It is worth noting that half of the revenue comes from corporations which are subject to a slightly higher tax rate of 0.6%.

Both taxes seem to be rather unfair taxes because of their preference for real estate investment.

The local property (land) taxes are usually much lower than those in the United States; the reason may be that the communities only have to pay for the school buildings but not for the teachers' salaries.

2. Taxation of savings

(a) Business sector

In the business area savings may be generated through accelerated depreciation and also through the fact that provisions for future expenses or costs set up in the commercial balance sheet are also accepted for tax purposes. A special aspect in this area is the possibility to set up internal pension plans. Such plans allow a deduction for contributions for future pensions of employees. This scheme differs from a pension fund in so far that the cash can be kept within the business. The real advantage which accrues to the employee is the deferral of current tax. As in the case of a separate pension fund, he is not taxed on the contributions on his behalf until they are received as a pension many years later.

(b) Personal sector

Tax-advantaged saving accounts are not important. However, the reporting of interest income from bank deposits and bonds has been extremely poor. According to government statistics, two-thirds of the interest received by individuals has not been reported. There has been no withholding tax on interest and there is no reporting requirement for banks (except for a 10% withholding tax during the first six months of 1989 which was repealed). Professional bank secrecy is in effect unless a criminal tax investigation has been initiated.

This situation led to a decision of the Constitutional Court which required legislative changes to be enacted before 1993 to improve compliance. The result is now a substantial increase of exempt interest (DM 6,000 a year, DM 12,000 for a resident couple) and a withholding tax of 30% on interest over that amount (35% for certain interest income).

As a general rule it can be said that the proceeds from life insurance are exempt while pensions from social security are taxed. On the other hand life insurance premiums etc. can be deducted within certain limits.

Another aspect is that investment income from many modern financial instruments such as options remain untaxed when earned outside of a business, because the highest tax court has placed this income in the same category as gambling income.

3. Taxation of foreign-source income

Whereas Germany taxes individuals and corporations on a world-wide basis, this principle is modified in tax treaties which usually exempt from German tax income earned by permanent establishments abroad and from foreign real estate. For corporations, dividends from a foreign subsidiary are also exempt. Therefore, Germany is perhaps the industrial country where a close tax treaty network is most important for its multinational companies.

In case of an exemption of foreign-source business income, expenses and particularly net losses cannot be deducted. An important exemption is made for losses arising in a foreign permanent establishment. In a country where the treaty provides for an exemption the loss can still be deducted but has to be recaptured when the foreign permanent establishment is profitable again.

Deferral of foreign companies is basically accepted; however, since 1972 there has been a legislation on controlled foreign corporations which permits current taxation of undistributed income, provided the foreign company is controlled by German residents and earns "tainted" income which is subject to a tax rate of less than 30%.

Earlier this year this provision was amended to also include income of a specific capital investment character of a company in which the German taxpayer holds at least 10%; this expressly includes a company of a country where the tax treaty provides for exemption of intercompany dividends.

4. Double taxation of corporate dividend

Germany always had some kind of relief for double taxation. Before 1977 this was granted by a reduced tax rate on that part of corporate income which was distributed.

In 1977 the change-over to a full imputation system took place.

That part of income which is retained has to carry a 50% tax burden and that part which is distributed a 36% burden. If retained income is distributed in subsequent years, the rate on retained income is accordingly reduced to the rate for distributed income, and the distributing corporation gets a refund of the rate differential.

The domestic shareholder receiving a dividend from a German company has to gross-up the dividend for the underlying corporation tax, i.e., by 56.25%. The tax is calculated on that amount and the corporation tax paid is credited on the individual tax rate. In case of low taxable income an excess is refunded.

Although double taxation of income is avoided, there still remains double taxation by net worth tax.

The mechanics of the imputation system is extremely complex. One of the reasons for this complexity is the basic decision by the German legislator to give a credit only for German corporation tax paid. As far as German corporations with foreign activities are concerned, the system became operable by the legislative decision that fully-taxed income is deemed to be distributed first and only then income not subject to German tax (such as exempt foreign source income) will be deemed to be distributed.

Although Germany has the most important stock exchange in Europe, a large number of companies quoted are foreign ones. However, the number of new German companies going public has substantially increased since 1977.

In general, this integration system is working well; for most resident shareholders it is disadvantageous not to report German dividends. Especially as far as non-resident shareholders are concerned there is some dividend-stripping going on in Germany: portfolio investors tend to sell shares shortly before the dividend date (only once a year) and to buy them or other stock back a few days later after dividend payment. The price of the share usually falls less than the benefit to a German taxpayer.

5. A minimum tax for corporations or individuals

Germany does not have a minimum tax for corporations or individuals.

For corporations and other enterprises there is no need for a minimum tax because of the German concept of determining business income: Under the German concept the starting point for the tax computation are the statutory commercial accounts. The German computation starts from the balance-sheet rather than from the P&L statement.

This linkage/dependence (Masgeblichkeit) of tax accounts and commercial accounts can be summarized as follows:

—Assets can only be accrued for tax purposes if they may be accrued for commercial purposes.
—Liabilities are only accepted for tax purposes if they must be accrued for commercial purposes.
—Tax depreciation and similar deductions can only be taken to the extent that the accumulated depreciation for that asset in the commercial accounts is at least as high. Consequently, declining-balance depreciation can only be taken for tax purposes if it has also been taken in the commercial accounts.
—Provisions set up in the commercial accounts can also be taken for tax purposes if under GAAP there is an obligation to enter them in the financial statement.
—Of course, specific tax provisions always prevail.

Since Germany follows more the schedular approach for non-business income which does not tax private capital gains, a minimum tax would not fit into the system.

6. Tax rates

(a) Corporate Income Tax

As already explained, corporations are subject to a tax rate of 36% on distributed income and 50% on retained income; on top of that there is a local trade tax (Gewerbesteuer) ranging from 10% to 22% with an average of about 15%, so the tax computation will be as follows:

	distributed income	retained income
—Profit before tax	100.0	100.0
—less: 15% local trade tax	−15.0	−15.0
	85.0	85.0
—less: 36% tax on distributed income	−30.6	

	distributed income	retained income
—less: 50% tax on retained income		–42.5
—Income after tax	54.4	42.5

In Germany there is almost a general consensus that total tax rates are too high and some reductions in tax rates are necessary in view of international tax competition, particularly on retained income. The EC-Committee of Independent Experts on Company Taxation recently proposed a minimum tax rate of 30% and a maximum tax rate of 40% (including local taxes). In the current fiscal situation imposed by reunification it seems unlikely that the 40% objective could be reached. However, there must be at least a substantial reduction of the overall tax burden to somewhere below 50%.

The German rates mentioned are for example in competition with 34% in France (which also has an imputation tax system), 34 % in the UK, 35% in the Netherlands etc. Although macroeconomic data indicate that the average overall tax burden cannot be dramatically higher than in the neighboring countries, and in view of the existence of some investment incentives and a very strict field audit system, it must be concluded that particularly some of the more mature German companies are suffering from a very heavy tax burden, particularly if German inflation continues at over 4%.

(b) Individuals

For individuals, as already explained, the maximum tax burden for unincorporated business is 53% plus local trade tax (Gewerbesteuer does not apply for professionals and agriculture). This brings the total tax burden to more than 60%.

(c) VAT

VAT is charged at a normal rate of 14% and a reduced rate of 7%; in 1993 the normal rate will be increased to 15%.

RESPONSES OF DR. RÄDLER TO QUESTIONS SUBMITTED BY SENATOR BAUCUS

1. It seems to me that one of the big problems here is determining exactly what is going on. To what extent is the alleged activity avoidance rather than tax evasion?

In most languages the term "tax evasion" is not clearly defined. The main issue is whether tax evasion constitutes illegitimate tax practice which is sanctioned by the criminal code (and which is more clearly described by tax fraud?) or whether it is simply illegitimate tax practice which is not accepted under the tax laws.

In most cases transfer pricing issues are not issues of tax fraud, but rather are issues of appreciation of facts, particularly if the yardstick is "arm's length price". As a rough estimate I would guess that about 75% of the transfer price cases are those in which the taxpayer is taken completely innocent by surprise, in about 20% he may have made use of agressive tax-planning involving tax rate differentials which were not accepted by the tax inspector; and in less than 5% he may have used illegal practices such as intentionally presenting wrong or incomplete facts.

2. **(For the witness's country or area of expertise) I am curious as to how other governments perceive this issue of transfer pricing and tax avoidance. Do they feel it to be a serious threat, either to revenues or to the competitive position of their local firms? What steps do other governments take to minimize the problem?**

Basically, Germany applies the same rules to international transfer pricing as to purely domestic transfer pricing (constructive dividend distribution and constructive capital contribution). Special rules for international purposes apply only in marginal areas. Basically, the yardstick is the price which a conscientious and diligent business manager would have agreed upon in normal business dealings with third parties, i.e., the arm's length standard.

It is fully accepted that there is not only a single correct arm's length price but that there is a certain range of reasonable prices.

Of course, Germany also sees transfer pricing as a serious threat, particularly in view of its extremely high nominal tax rates (50 to 60 percent), which are an invitation to transfer pricing manipulation to the detriment of the German fiscus. However, this is seen more as a threat to fair taxation and as a competitive disadvantage than as a loss of revenue. In comparison to total revenue, transfer pricing adjustments are almost marginal: revenue from all field tax audits (including purely domestic issues) accounts for roughly 2% of total tax collection.

Germany has tried to educate both tax inspectors and taxpayers by developing (in cooperation with the tax professionals and industries) guidelines for transfer pricing. There is also a high degree of cooperation with other foreign tax administrations. Most cases are finalized by compromise with either the other tax administration, or with the taxpayer. There have been no important court cases in recent years.

Germany has started to sign tax treaties which include arbitration clauses, for example with the United States and France. There also exists a convention between the 12 EC-Countries to solve transfer pricing issues by arbitration; however, this convention is still waiting for ratification by all 12 member states.

3. Are there any prospects for coordinating the policies of the industrialized nations with respect to transfer pricing by multinationals? I am curious about the prospects for this both in terms of legislation and treaties, and in day-to-day enforcement.

Since the beginning of the League of Nations, the arm's length price has been introduced as the common yardstick for transfer prices between related persons. No doubt, in many cases this term is very vague and ambiguous; but certainly between the major trading partners there does not seem a better solution. The OECD Tax-Committee took the initiative to prepare a report on transfer pricing and multinational enterprises which was published in 1989. This was an extremely valuable contribution, though on some issues not even a theoretical consensus was found.

In general this interpretation has substantially narrowed the range of discretion by taxpayers and tax inspectors in different countries. Usually, Germany tries to resolve disputes on transfer pricing by bilateral negotiations with the home country of the other related person. Although those negotiations quite often may take many years, the issue is usually resolved in such a way that double taxation is avoided. I have already mentioned a trend to arbitration for resolving transfer pricing disputes. Although much is written about joint audits, actual cases are extremely rare.

These issues are also discussed within the European Community. From the

recently published report of the Ruding Committee, of which I was the member from Germany, the relevant pages 228 to 232 are enclosed.

The classical arm's length concept has its advantages and its flaws. Its major advantage certainly is its worldwide acceptance by industrial countries. This acceptance has been reflected in domestic laws, in bilateral tax treaties and by international organizations such as OECD.

4. **Recently there has been some friction between the U.S. and some of its trading partners, as the U.S. has tried to deal with the transfer pricing issue. If the U.S. were to become more aggressive in this area, what possible retaliatory measures would the U.K., Germany, or Japan take?**

The friction was created by unilateral U.S. changes of what other industrial countries consider accepted international rules concerning international transfer pricing: These changes which are considered to be contrary to established OECD practice concern mainly

- the look-back rule, meaning that the correctness of a pricing arrangement is reviewed from the position of the day when the transaction is consumated and not, as in the case of the OECD rules, when the contract is signed;

- the new CPI standard overlaps with the OECD rules,

- special discretion is given to the District Commissioner which goes far beyond the established arm's length concept;

- the "commensurate with income standard" will be expanded from intangibles to tangibles; this is neither in line with section 482 nor with the international arm's length standard.

Certainly, cases involving mutual agreement procedure and arbitration will increase, as well as cases of litigation.

I think that Germany would continue to apply its traditional rules also vis-à-vis American companies and their German subsidiaries. However, gradually international cooperation between the tax administrations of the two countries will go back, the tax climate between tax administrations and taxpayers of the two countries will get frostier. I cannot exclude that reciprocity, to the extend possible, will be introduced in legislation. By all means, such a development must be avoided.

Albert J. Rädler

United States is not deductible if the excess of the US company's interest expenditure over interest income exceeds, broadly, 50% of taxable income, and if the ratio of loan to equity capital exceeds 1.5:1.

Distribution policy

A further area for tax planning in a financial context is the distribution policy of international groups. This policy depends not only on economic considerations such as the group's overall profits position, and future investment needs, but also on tax factors such as the features of the corporation tax system (e.g. whether or not there is a credit to the shareholder for tax paid at the corporate level), on the level of withholding taxes, and on taxation in the hands of the controlling company.

Lastly, international tax planning can help reduce the risks associated with capital maintenance in countries with a high inflation rate.

Transfer-pricing

Transfer prices, that is the price at which goods or services are transferred from one body to another under the same control, provide potential for manipulation by some taxpayers on the one side and for adjustments by the tax authorities on the other side. Precise figures on the volume of transfer-pricing which relate to EC countries do not exist. However, total trade in goods between the different Member States amounts to as much as ECU 614 billion.[1] On the assumption that 50% of this amount is trade between related persons (some estimates put the proportion higher), ECU 307 billion of transfer prices in terms of volume would have to be scrutinized by the tax authorities. Moreover this figure does not include trade between the EC and third countries so an estimate of total transfer prices for goods involving EC countries amounts to:

	(billion ECU)
Transfer prices within the EC (as above)	307
Transfer prices between the EC and North and South America	108
Transfer prices between the EC and Asia/Pacific areas	90
Transfer prices between the EC and the rest of the world	226
Total volume of transfer prices	731

This would suggest that Member States' tax authorities have to examine the validity of transfer prices for goods worth over ECU 730 billion a year. On top of this payments for services interest, royalties, licences, know-how fees, etc. have also to be taken into account. Finally, transfer-pricing investigations often have to consider what is missing, for example, the need to impute the price of an interest-free loan or the failure to contribute to research and development expenses.

[1] EC information No 5/1991, p. 7, numbers refer to 1989 and were converted from US dollars into ecus at the average exchange rate of ECU 1 = USD 1.1075.

On the other hand, transfer-pricing manipulation is probably less prevalent today than it was two decades ago. This is mainly due to two developments:

(a) An increasing number of multinational companies have switched to the profit centre form of organization. Artificially engineered transfer prices are difficult to reconcile with this.

(b) Tax authorities of industrialized countries are attaching increasing importance to compliance with the arm's-length principle. Examples are the US guidelines concerning Section 482 of the Internal Revenue Code and the principles of the recently released regulations supplementing them; the same line is taken in the OECD reports on transfer-pricing (1979 and 1983) and the German administrative principles of 1983.

However, it should be remembered that in some countries tax administrators are less sophisticated in auditing transfer prices than in others.

From a tax planning point of view, transfer-pricing may lead to situations in which costs arise where nominal tax rates are relatively high and profits are taken where they are relatively low. However, these principles can conflict with ordinary corporate management, particularly where there is a system of profit centres, as arbitrary profit shifting can be disruptive. And, of course, the costs of defending a transfer-pricing adjustment can be high for a small company.

Application of the arm's-length principle

The arm's-length principle which is the main criterion governing transfer-pricing practices, is not always easy to implement in practice. The three standard methods generally employed to reach such a price are the 'comparable uncontrolled price method', the 'resale price method', and the 'cost-plus method'.

Two general issues are involved in the application of the arm's-length principle. First, should there be some hierarchical approach to the order in which standardized methods are applied? In accordance with the OECD 1979 guidelines, the Committee preferred flexibility, taking the view that the appropriate method to apply had to depend on the facts of the case, but national practices sometimes take a more rigid hierarchical approach. The second problem relates to the relative freedom of business to choose its method and the taxation authorities to refuse and accept a method which they consider does not give a reasonable approximation to the prices which should prevail between independent parties. Country practices among EC Member States sometimes diverge (e.g. the taxpayer in Germany has greater freedom in choosing the method *vis-à-vis* the authorities than the taxpayer in the United Kingdom). This diversity of treatment within the EC could not only lead to distortions, but also to disputes between tax administrations on what is the appropriate transfer price to accept for the purpose of reaching a taxable base. This underlines the need for cooperation between tax administrations and perhaps coordination by the Commission in an attempt to reach greater uniformity of transfer-pricing practices under the arm's-length principle. In this regard, the Committee expressed its preference for the OECD guidelines. The Committee also considers that the taxpayer's choice of method should carry a presumption of correctness with the burden of proving that the chosen method does not meet accepted criteria falling on the tax authorities.

Arm's-length versus allocation formulae

Under the arm's-length approach, the objective is to arrive at what would be the price paid between unrelated enterprises; under allocation formulae, the view is taken that with certain integrated transactions between multinational enterprises, traditional arm's-length methods are not feasible from a technical point of view, and the formulae therefore seek to fix transfer prices by reference to pre-determined formulae based on the respective costs, or turnover, or labour force, or various combinations of these factors.

Noting that formula allocation methods are used in federal countries such as Canada, Germany and the United States, the Committee examined the question of whether it should recommend the introduction of a common system of apportionment of taxable income for companies operating within the Community (the 'water's-edge' principle), it being understood that the arm's-length principle would continue to be used in transactions with non-EC countries.

However, while appreciating that within a single country with separate and local taxing jurisdictions, allocation formulae methods might often be the best proxy for an arm's-length solution when integrated or group operations are involved, for a number of reasons the Committee endorsed the view of previous studies that a move from arm's-length to formula allocation had many drawbacks, when the tax systems of more than one country were involved:

Firstly, and foremost, allocation is suitable only if States have reached an advanced degree of integration, such as common currency, common company law, common accounting standards and common expertise in the tax administrations.

Secondly, formula allocation bears the danger that profits are allocated to a country in which they were not earned; moreover, recent information from the United States suggests that even under formula allocation both economic double taxation and transfer-pricing manipulations continue to occur.

Thirdly, a shift to formula apportionment would involve a renegotiation of all tax treaties between Member States and possibly also with third countries.

Fourthly, the use of different principles such as allocation formulae within the EC and the arm's-length standard outside the EC may make the resolution of double taxation disputes more difficult.

Fifthly, tax inspectors would have difficulty in applying two separate standards (arm's-length and formula allocation) to a transaction involving more than one Member State and a third country.

In the Committee's view, there is no case for introducing a system of formula allocation within the Community in the foreseeable future. The Committee endorses the continued use of the arm's-length principle, which is the international norm in double taxation conventions, as the standard to be used for transfer-pricing. It rejects the use of formula allocation or global methods except in the relatively rare case where no arm's-length price is available or could be arrived at by the traditional methods, for example, in the case of unique intangibles or global trading arrangements. Introducing an allocation system on an optional basis for enterprises might be reconsidered when a much higher level of integration between Member States is achieved, in particular, when group treatment has been introduced for enterprises located in different Member States.

Special cases

Group headquarters' costs

Large multinations' companies frequently spin off a number of functions from thei subsidiaries and transfer them to headquarters. The costs arising at headquarters' leve are normally charged to the subsidiary; this is a managerially acceptable principle sinc the subsidiaries are relieved of costs as a result of the transfer of functions. There i some dispute, however, about whether these costs can be charged to the affiliates wit a profit margin added. And of course, problems arise concerning the amount of cos that can be passed on. There are two practical views about this:

The first, held in particular by the business community and tax inspectors of countri in which large group headquarters are situated, assumes that in the case of a pu holding company there is basically a need for two persons only: a lawyer who ensur that all legal formalities are complied with by group subsidiaries, and a financi manager who reinvests the dividends arising. All other costs are then allocated to th individual subsidiaries as headquarters' costs.

The second assesses the individual service performed. Transactions regarded as eligib for recharging are those in the direct interest of the subsidiary concerned, and charg at a level in line with the subsidiary's market. According to this view, the costs production coordination, for example, cannot be set off within the group, but must covered by the holding company out of taxed profits.

One consequence of these views, however, is that some elements of headquarters' co may not be deductible anywhere.

Research costs

Another important area is the method of charging for research costs. In the past 20 years two systems have emerged under which companies charge research costs to their subsidiaries:

(i) The traditional method is for the group headquarters to undertake all research and development at its own expense. As soon as exploitable results are available, licensing agreements are then concluded with the manufacturing subsidiaries. The research costs are then recovered by way of royalties determined according to the arm's-length principle.

(ii) A more recent method is for the group headquarters to conclude a cost-sharing agreement with the subsidiaries which will be the future users. Compensation fo the share in research expenditure is then made as it arises and the risk of researc passes to the manufacturing subsidiaries. Such agreements are very rarely conclude with independent companies outside the group.

From the group headquarters' point of view, opting for a cost-sharing agreement is no only an important tax decision but also an important managerial one. This is becaus it provides substantial cash-flow benefits: the apportioned costs are payable as an when the expenditure is incurred, and the need for advance financing by the grou headquarters is accordingly removed. Under the traditional method, research expend ture must be financed centrally for many years with group headquarters also bearing the full risk of failure. Given the lower financing and risk costs, the costs apportionment method ought to be lower than the royalty method. A system of cost sharing by the group does, of course, require complete transparency as far as the tax authorities of the countries concerned.

PREPARED STATEMENT OF ANTHONY J. SAGGESE

Mr. Chairman and Members of the Committee: I am Anthony J. Saggese, General Tax Attorney to TEXACO Inc which is headquartered at White Plains, New York. With me today is Robert Ragland, Managing Director and Chief Tax Counsel to the National Chamber Foundation. I have primary responsibility for the company's tax matters in major sections of the world including Western Europe, Eastern Europe, the Commonwealth of Independent States and China. I am appearing today on behalf of the National Chamber Foundation, the tax and public policy research affiliate of the Chamber of Commerce of the United States.

My comments do not necessarily reflect the views of the Chamber. With the exception of limited in-kind contribution, NCF is not funded by the Chamber of Commerce. Also, the Foundation operates under the direction of its own board of directors which is chaired by J. Paul Sticht, retired Chairman of the Board of Directors of RJR Nabisco of Winston-Salem, North Carolina.

We appreciate the opportunity to discuss the findings of *U.S. International Tax Policy for a Global Economy*, a major study evaluating factors affecting U.S. competitiveness in the global marketplace. This report represents the collaboration of a multi-industry working group including: extractive industry, electronics, pharmaceuticals, food and grocery products, and financial services. Our data was assembled over 18 months, released to the public in May 1991, and presented to the House Committee on Ways and Means in testimony on July 18, 1991. The study includes case study examples which were assembled by Price Waterhouse as consultant to the NCF working group that prepared this work.

TEXACO and the other member companies of the NCF working group agreed to provide technical and financial support to this project because we believe that U.S. tax policies are adversely affecting the foreign operation of U.S. companies. The empirical data contained in our study confirmed our fears and demonstrated the pressing need to reform U.S. tax law, both domestic and foreign, to remove provisions that are confounding efforts to succeed in the highly competitive global marketplace.

All of us are painfully aware that the U.S. economy has not been performing up to its potential. Fewer of us, however, are aware that the foreign activities of U.S. multinationals is one of the few happy chapters in our otherwise disappointing economic book. The Commerce Department notes that:

> U.S. exports were a vital source of growth in U.S. output and employment over the last half of the 1980's. In fact, the number of jobs supported by merchandise exports reached a record 7.2 million in 1990.

In its examination of the increased importance of exports' contribution to U.S. employment, Commerce found that:

- Jobs supported by U.S. merchandise exports rose 42 percent from between 1986 and 1990. This includes jobs directly required to produce the exported products; jobs indirectly required upstream to produce the intermediate inputs and capital goods used in producing exports; and downstream to provide the transportation and other services used in moving the goods to the port of exportation.
- The share of total U.S. civilian employment supported by U.S merchandise exports rose from 5.7 percent in 1986 to 7.4 percent in 1990. This was mainly the result of the rapid growth of U.S. merchandise exports and slower growth of the rest of the economy.
- U.S. merchandise exports supported 25 percent of the growth in U.S. civilian jobs between 1986 and 1990. In 1990, merchandise exports accounted for 17 percent of the job growth.
- An average of 19,100 U.S. jobs were supported by each billion dollars of U.S. merchandise exports in 1990.

Quite clearly, this is an area of public policy that Congress would do well to favor. In current economic terms, it is unfathomable that lawmakers would burden companies doing business in the world marketplace. Instead of penalizing multinationals, U.S. policies should be aggressively promoting foreign investment by U.S. companies. As shown in our study, this can be accomplished by:

- Repealing provisions that are based in the misguided notion that foreign trade exports U.S. jobs. This is archaic thinking which, in fact, is restricting the growth of the type of high quality employment ordinarily associated with export trade.
- Repealing provisions that are unique to U.S. law. We must all accept the fact that the U.S. is one of many important economies in the global marketplace. Unlike after World War II when we were the only meaningful economy, we can

no longer dictate tax policy to other industrial nations. This kind of national arrogance is both unseemly and counterproductive.

- Simplifying provisions that add compliance cost without adding to competitiveness. In many cases, the compliance burden has increased because lawmakers were seeking revenue sources. It is wrong to argue that the foreign activities of U.S. companies are irrelevant to domestic jobs creation and economic growth. One example is the foreign tax credit; which by recent statutory change, has been mutated from a provision that avoids double taxation to one magnifying the incidence of cascading levels of tax on the same income.
- Adopting a package of pro-economic growth incentives that undo decisions made in the 1980's to raise the tax rates on capital and capital gain. This domestic provision is a key element to growth in foreign trade, particularly in manufactured goods.

My complete statement offers a number of specific reform suggestions. These are drawn from *U.S. International Tax Policy for a Global Economy.*[1] Under separate cover, NCF has provided each member of the Finance Committee with a copy of the full study, and I am asking that the full text of its Executive Summary, which is attached hereto, be included in the hearing record.

I should note that even the Democratic Policy Committee of the U.S. Senate agrees with our assessment that foreign trade is key to domestic economic growth. While we do not agree with all of the policy recommendations contained in their special study, we do find merit with their premise that:

> There is a new competition in the world today—an economic competition. The fate of individuals and nations will no longer be decided by who can win an arms race, by who can produce a better bomber or missile. The United States is secure in its defense today, and it will remain so for the foreseeable future. The fate of individuals and nations today and into the next century will be decided by which countries can mobilize their national resources to win the global economic competition. It will be decided by which nations can create more high-quality, good paying jobs, better educate their workers, produce and market high-quality products, and raise the standard of living of their citizens.
>
> Right now, America is falling behind in the economic competition—badly. Real wages for U.S. workers are declining for all but the upper one-fifth of the work force. America has gone from the world's greatest creditor to the world's greatest debtor nation. We continue to run a major trade deficit—a trillion dollars over the last decade. The rate of savings and investment in future U.S. productivity is lower than all of our major economic competitors. And the level of education and job training of American students and workers continues to be dismal by international standards.[2]

THE U.S. ROLE IN THE WORLD ECONOMY

This committee has every right to be concerned with foreign tax issues. The United States is participating in a declining share of an expanding world marketplace. This lamentable status is attributable in part to an overwrought and archaic tax system developed after World War II when the United States was the only meaningful economy in the world. In those halcyon days we could afford to adopt unilateral standards and pressure other industrial and developing nations to follow our lead. Today, we can not.

U.S. goods and services must compete on a price and quality basis with virtually identical products and services offered by competitor companies headquartered in other countries. Those countries differ in their treatment of foreign income in a number of key ways that are described in more detail herein. As a general matter, however, our study confirms that U.S. headquartered companies pay more tax on foreign income, labor under a compliance burden that is measured in terms of complexity and lack of clarity, and work under a capital cost recovery system that is the most hostile in the industrial world.

GLOBAL COMPETITION MEANS DOMESTIC JOBS

Fundamentally, Mr. Chairman, this is a domestic jobs issue. There is a direct relationship between foreign tax simplification and reform and corporate employment.

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[1] Price Waterhouse *U.S. International Tax Policy for a Global Economy,* ed. Robert Ragland (Washington, DC: National Chamber Foundation) 1991.

[2] *U.S. Economic Leadership Strategy* Special Report SR-43-Economy by the Democratic Policy Committee (United States Senate, Washington, DC) July 1992.

I can assure you that TEXACO has never adopted a corporate strategy to limit the size and competitive abilities of our company. We would be delighted if economic conditions permitted us to hire tens of thousands of new employees—either because we were producing and exporting more product from domestic points of manufacture or because our foreign branch and affiliate operations require us to hire more domestic employees to service their activities. Unhappily, those conditions do not exist; and U.S. tax policy is, at least in part, responsible.

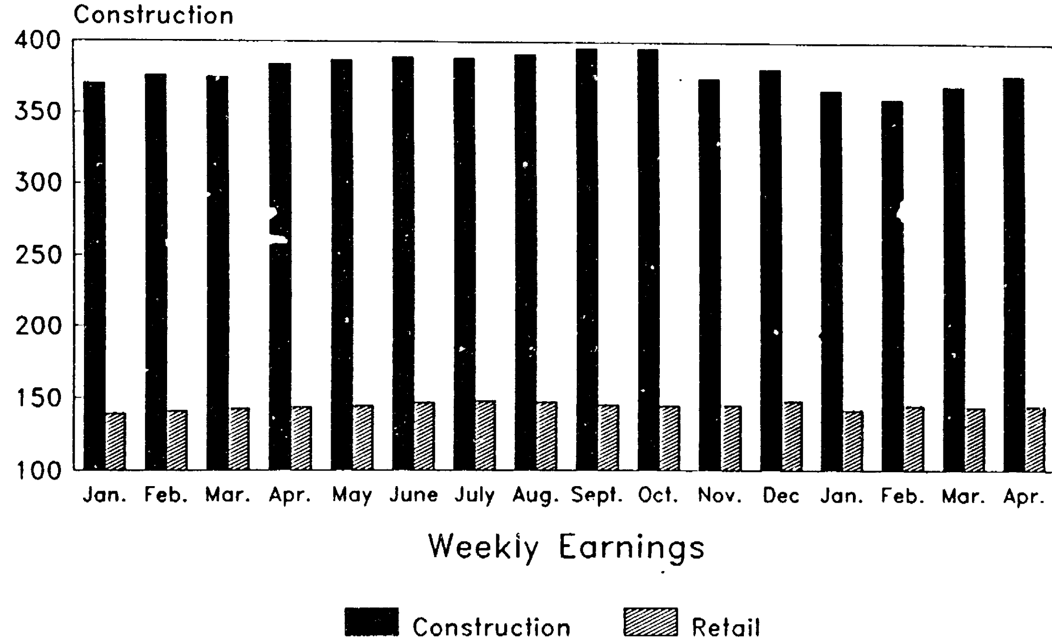
In recent years the domestic job mix has shifted out of high paying industries such as the extractive industry, durable and non-durable goods manufacturing, construction, banking, telecommunications and infrastructure, and into other sectors of the economy which pay lower wages. For example, the real disposable income for a construction worker is three times that of a retail employee. This is shown at CHART I. At CHART II we show recent changes in the mix of jobs and confirm that the trend is toward lower paying service sector work. To preserve domestic wealth, the economy must create three retail jobs for each job lost in construction.

The recession and anemic recovery can be explained, at least in part, by changes in the tax law enacted in the 1980's. Lawmakers were anxious to reduce tax rates while preserving spending. Perforce this meant that other sectors of the economy would have to pay for rate reductions. Accordingly, Congress shifted the tax burden off of income and onto capital and labor. Despite partisan rhetoric to the contrary, by 1986 Congress had five years of experience with the 1981 tax cuts and understood that low rates of tax accounted for the longest post-war economic recovery in our nation's history. Thus, it was easy to gamble that additional rate reductions would preserve or expand the recovery and more than offset the burden being placed on capital. And if it didn't, lawmakers could retreat to academic understanding which argued that investment was more efficiently decided when tax played little or no role in the process.

Unfortunately, U.S. based basic and capital intensive industries were unable to meet the new hurdles. Thus, employment shifted out of construction, durable and non-durable goods manufacturing, extraction, banking and infrastructure and into other less well paying sectors of the economy.

To be fair, we have selected extreme examples. Construction tends to be comparatively well paid and retail not. The point, however, remains the same: that the loss of our industrial base is making America a less wealthy country and is contributing to the weakness of our economic recovery.

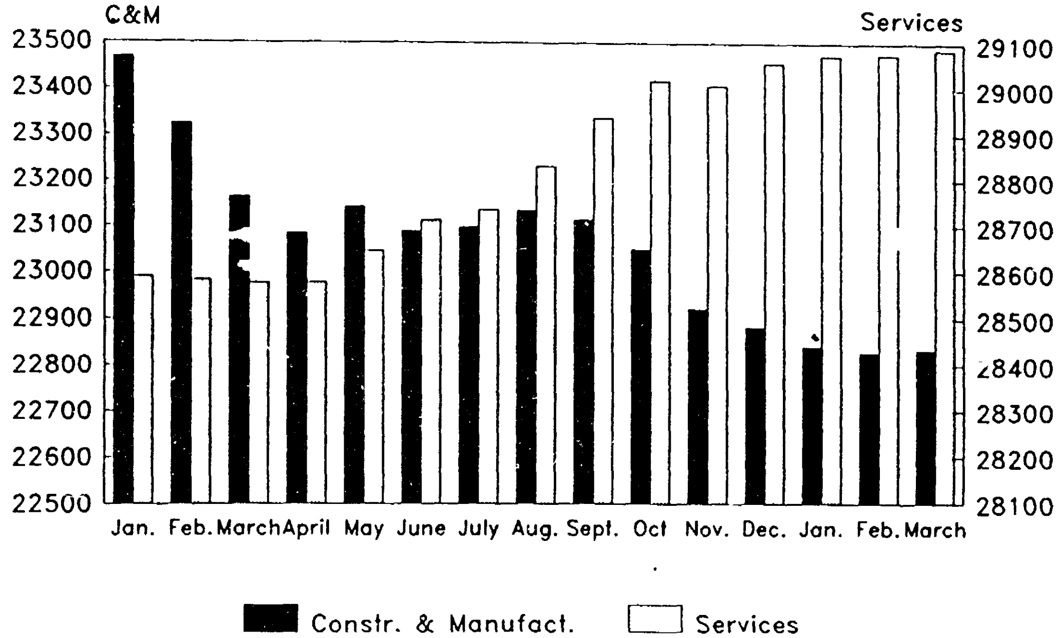
REAL DISPOSABLE INCOME
1991–1992



Constant (1982) Dollars

CHART I

EMPLOYMENT
1991–1992



Number Employed (Thousands)

CHART II

THE CONCEPT OF A ZERO SUM GAME

Slowly but surely Congress is coming to understand that the Internal Revenue Code is a mighty engine that can drive domestic jobs creation and economic growth. Efforts to translate this understanding into tangible forward movement, unfortunately, are being frustrated by the rules of the House and Senate which require offsetting revenue to pay for tax incentives. This sort of zero sum game was a guiding principle in the enactment of the Tax Reform Act of 1986; legislation which undoubtedly has contributed to changing employment patterns, and current economic weakness.

The 1986 Act, as you know, reduced personal taxes by roughly $300 billion over five years, and financed those cuts, on a dollar for dollar basis, by tax increases on capital intensive businesses. The error was compounded by increases in the direct and indirect tax on capital and gain, and by the Alternative Minimum Tax. These multiple assaults on our basic and capital intensive industry was suicidal; and would not have been necessary if lawmakers had continued to believe in the power of tax cuts as an economic growth stimulus. Thus the concept of revenue neutrality was born.

Revenue neutrality became an informal procedure requiring members to offset the cost of tax preference items with spending cuts or new taxes. Predictably and intentionally, these informal rules had a chilling effect on the desire of most members to restore tax preference items repealed or limited by the Tax Reform Act of 1986 and other enactments in 1982 and 1984. In 1990, these rules were formally adopted by the House and Senate as a part of the Omnibus Budget Reconciliation Act of 1990.

Although the well meant intention of the "pay-go" rules was to preserve low rates of tax on business and individual taxpayers and to prevent the deficit from growing, just the opposite has occurred, reducing federal tax policy to a zero sum game—or worse.

Some academic theorists argue that tax laws have little or no effect on economic activity. Some of these theorists are employed by the Congress and many members of this committee rely on their counsel. NCF, however, flatly disagrees with the school of thought that taxes have only a marginal effect on behavior. The merits of our view have been borne out in the marketplace time and again. For example, the theorists argued that the repeal of the capital gain differential would produce $225 billion in tax realizations in 1990. NCF research argued that higher rates of tax on gain would have a chilling effect on realizations and would tend to produce less tax revenue, not more. When actual data became available, the tax realized was $134 billion less than projected by the Congressional Budget Office, a factor of more than 100 percent.

Conversely, low rates of tax on capital gain have produced tax revenue. According to the Joint Economic Committee, when taxes on capital gains were reduced—in 1965, 1978, and 1982—realizations doubled to around four percent of GNP.

This raises our second point. In addition to being wrong about the behavioral effects of tax policy, staff theorists are routinely wrong in their estimates of revenue to be gained or lost by a given provision. Consequently, the pay-go procedural approach that was intended to have a chilling effect on the temptation of members to undo tax reform initiatives or to increase the deficit through unproductive tax favors to special interests, has failed. Instead, all Americans, and members of the business community in particular, have been forced into a nasty game of tax shifting, pitting taxpayers against one another in an effort to obtain desirable changes to the tax code. And, the economically damaging side effect has been to freeze the tax policy debate, pitting sound policy objectives against dollars and cent considerations.

The Foundation commends Congressmen Rostenkowski and Gradison for having offered legislation reducing the harmful effect of U.S. tax law on the foreign activity of U.S. companies. Unfortunately, the beneficial aspects of H.R.5270 are being purchased by changes in other areas of the tax code which arguably raise enough money to offset the cost of forward movement.

We believe that Congress should first determine if foreign tax reform and/or simplification are pro-economic growth issues; and more particularly, which provisions of the code most merit attention. If foreign tax reform is forward movement, and we think it is, then the committee should consider it as a component part of a comprehensive economic growth plan, the adoption of which may more than offset the cost. To the extent Congress believes additional offsets are required, they should take place in the form of spending reductions and not tax increases.

FOREIGN TAX AND ECONOMIC GROWTH

We know that the United States is participating in a declining share of the expanding world marketplace because the effective tax rate paid by U.S. companies on foreign source income is 4 to 10 percentage points higher than the effective rate paid by U.S. competitors in other industrial nations. A second factor not included in this computation is the cost of capital. Presently, the United States is the single most capital hostile jurisdiction in the industrial world. The April-June 1991 edition of the London Stock Exchange's *Quality of Markets Review* notes that "in general, equity investors are most heavily taxed in France and the USA. It is particularly surprising that the USA, as the nation which has most consistently adopted the capitalistic ethic, currently treats its equity investors so harshly."

The repeal of the investment tax credit, lengthening of depreciation lives, high rates of tax on capital gain, and the Alternative Minimum Tax make capital acquired in the United States the most expensive in the world. We estimate that American business recovers only 85 percent of each dollar invested in new equipment. If the investor is a company paying under the Alternative Minimum Tax, the recovery is further diminished to an estimated 65 percent. Accordingly, companies are increasingly making their capital intensive investment in other more friendly countries. This strategy, which preserves the ability of U.S. based companies to remain competitive in global markets, has a negative effect on U.S. employment; and this is not necessary.

In the context of foreign tax reform and simplification, the Senate should be guided by data now becoming available which confirms that tax policy is not a zero sum game. If a provision tends to promote economic growth then it should be viewed as an item that pays for itself through items such as tax revenue on wage and labor income, and reduced levels of social services attendant to fuller employment.

NCF understands that the committee is in a procedural box: you are required by your own rules to offset the cost of tax preference items and simplification measures with either spending cuts or tax increases. You are not, however, required to accept the quality of advice that has been coming out of staff assigned to advise you in these matters.

REVENUE ESTIMATING TECHNIQUES

Already, Congress is in the process of retreating on the luxury taxes. This moment of legislative chagrin and resulting economic dislocation could have been avoided if lawmakers had given appropriate regard to competing cost estimates; more specifically, dynamic revenue estimating models.

The major problem with pay-go is the measurement of cost. The yardstick most commonly used in government to estimate the tax revenue to be lost from any given reform measure is known as a revenue estimate. The techniques most often used are either a static technique, or a modified static technique. This means estimators either ignore likely behavioral changes that result when the law is changed, or factor them in at low levels and in a limited way.

The alternative is dynamic revenue estimation. This yardstick assumes behavioral changes. For example, if bottles of soda were suddenly taxed at $1.00 while some close substitute, such as bottled carbonated water, was not, some consumers would decide to shift their consumption from taxed soda to tax-free water. Not so in the world of static estimation. This Twilight Zone image of tax policy would argue that if Americans historically consume X bottles of untaxed soda they will continue to consume X bottles of taxed soda. Thus, if the tax rate increased by Y percentage points, the amount of new revenue would equal Y times X.

A more dynamic model would try to determine how consumption of soda would change and estimate the new revenue by multiplying the estimated *new* level of consumption by the new tax rate. Obviously, the actual amount of new revenue will fall below the static revenue estimates.

Even more dynamic estimating techniques would attempt to track investment in water companies bottling tax free water as opposed to taxable soda; changes in employment in those industries; increases in social service provided to the former employees of soda companies closed by the new tax; etc.

Static modeling has been shown to be notoriously unreliable. For example, in 1986 Congress enacted the single largest tax increase on capital gain in history. The lawmakers were told by the staff of the Joint Committee on Taxation, and the Congressional Budget Office that treating capital gains as ordinary income would generate a steadily increasing stream of revenue as Americans went about ordinary investment activity. The CBO estimate for 1990 was $254 billion in capital gains tax in-

come. CBO was off by over 100 percent.[3] In fact, the federal government realized only $120 billion; and the steady stream, is a trickle.

Another example is offered by the National Wine Coalition (NWC), a Washington, DC based business association representing vintners, wholesalers, retail distributors, hospitality providers and suppliers to the wine industry.

The Coalition examined the Bureau of Alcohol, Tobacco and Firearms estimate that excise tax increases enacted in 1990 "did not have an adverse effect on overall tax collections." Indeed, the Bureau reports that Fiscal Year 1991 wine tax collections totalled $449 million, up 47.9 percent over the previous year's revenue.

Not so reports the National Wine Coalition which tracked the effects of the excise tax increases through the economy. Using an econometric model developed by Oregon economic consultant Dr. Steve Barsby, the NWC estimates that state governments actually lost over $22 million in wine excise tax revenue in FY 1991 because the higher federal excise tax on wine hampered wine sales. In addition, state revenues were cut by nearly $168 million due to lower collections of state income and property taxes, and reduced by another $45 million because of higher unemployment insurance payments. Higher wine prices also affected imports, reducing duties by about $2 million. The most glaring omission in the Bureau's analysis was the failure to account for more than $93 million in federal income tax not collected by the U.S. treasury due to the loss of an estimated 40,000 jobs in the wine industry and related business.

Therefore, the trumpeted $239 million gain—$224 million in federal excise tax increases and $15 million in additional state sales taxes—really turned out to be a combined federal/states revenue loss of $91 million.

Table I.—THE FLOW THROUGH EFFECT OF EXCISE TAX INCREASES

[In millions of dollars]

State losses	Taxes	Jobs	Wages	GDP
California	39.1	8,300	181	618
Connecticut	4.0	600	13	34
Florida	20 8	1,900	32	87
Illinois	7 8	1,800	40	120
Massachusetts	6.7	1,000	21	56
Michigan	6.4	1,500	30	92
New Jersey	9 2	1,600	36	108
New York	17.54	3,100	70	208
Ohio	5.1	2,000	34	110
Pennsylvania	11.8	1,700	30	111
South Carolina	2 0	400	7	21
Texas	10.0	2,100	40	129
Virginia	4.1	900	15	44
Washington	7.3	1,500	26	81
Other	68.3	11,600	202	620
United States	220.1	40,000	777	2,439

Source National Wine Coalition

Table II.—THE REAL ACCOUNTING

Tax Revenue Gains	
Federal Wine Excise Tax	$224
Sales Tax Gain	15
Gross Tax Revenue Gain	$239
Revenue Losses/Expenses	
Federal Income Tax Lost	$93
State Wine Excise Lost	22
Other State Taxes Lost	168
Unemployment Pay Increased	45
Import Duties Lost	2

[3] Joint Economic Committee, Minority Staff, Information "A LA CHART" (United States Congress, Washington, DC) April, 1992.

Table II.—THE REAL ACCOUNTING—Continued

Tax Revenue Gains	
TOTAL Revenue Losses/Expenses	$330
NET TAX REVENUE LOSS	$91

Source: National Wine Coalition

FOREIGN TAX SIMPLIFICATION

Last summer the Ways and Means Committee took exhaustive testimony on factors affecting U.S. competitiveness in global markets. A fair summary of the testimony is that the United States is participating in a declining share of an expanding world marketplace. The share of world GDP going to U.S. headquartered firms declined from nearly 40 percent in 1965 to just over one-quarter in 1988.

TABLE III offers a summary of the declining role of the United States in the world economy. With the rebuilding of Europe and Japan and the transfer of technology to newly industrializing countries, the U.S. economy now accounts for a much lower share of world income, trade, and capital flows than it did after World War II. Although part of this is attributable to the natural and benign effect of global economic development, a significant share of the decline is the direct result of anti-competitive U.S. tax policies.

TABLE III
THE CHANGING U.S POSITION IN THE WORLD ECONOMY

U.S. Trade Balance (percent of GNP)	1950-1959	1980-1989
Merchandise Balance	0.7%	-2.2%
Service Balance	0.1%	0.8%
Current Account Balance	0.2%	-2.0%
Index of Openness*	6.7%	15.0%
U.S. International Investment Position at Year-End (billions of dollars)	1970	1989
Direct Investment:		
U.S. direct investment abroad	$75.5	$373.4
Foreign direct investment in the U.S.	$13.3	$400.8
Net International Investment Position (private and official assets)	$58.5	($663.7)
U.S. Corporate Profits	1950-1959	1980-1989
Share from foreign Sources	5.1%	15.4%
World GDP	1965	1988
U.S. share of world total	39.9%	28.5%
World Exports	1960	1988
U.S. share of world total	16.6%	12.0%
World Direct Investment	1967	1987
U.S. share of outward direct investment	50.4%	31.5%
U.S. share of inward direct investment	9.4%	25.2%
World's 20 Largest Industrial Corporations (ranked by sales)	1960	1988
Number of U.S. headquartered corporations	18	9

* Merchandise exports plus imports as a percentage of GNP.

NCF evaluated our competitive position in global markets and published our findings in *U.S. International Tax Policy for a Global Economy* which offers a wide variety of reform options and simplification measures which this committee should consider. Our intention was to provide a document that can be a resource for further discussion and debate as the United States addresses the economic challenges of a post Cold War world. The report identified principles which we believe should guide the development of international tax policy and suggests options for reform and simplification consistent with these principles. A significant finding of the NCF study is that the tax treatment of foreign-source income under U.S. rules may no longer be competitive with the tax systems used by other major industrial countries.

NEW INTERNATIONAL ECONOMIC ENVIRONMENT

In the 1960s, U.S. corporations accounted for over half of all multinational investment in the world, our nation produced about 40 percent of world output, and we were the world's largest lender of capital. As you can see from TABLE III above, U.S. corporations now account for less than one-third of multinational investment, the U.S. economy produces less than 30 percent of world output, and we are the world's largest debtor. Three decades ago, 18 of the 20 largest corporations in the world were headquartered in the United States; today only 9 U.S. corporations rank in the top 20.

In the new international economic environment, Europe and the Pacific Rim rival North America as regional superpowers. The single European Community market in 1992 and the conversion of the Eastern European economies from centrally planned to market-oriented economies will further expand European influence.

In the 1960s, the U.S. economy was so dominant that tax policy makers felt little need to analyze how the tax system affected the competitiveness of U.S. companies. A careful review of legislative history confirms that the attitude persisted right through the enactment of the Tax Reform Act of 1986; and may, in fact, exist today.

Today, the U.S. economy is no longer so dominant that we can afford to ignore global competition in formulating our nation's tax policy. It has become increasingly obvious that relying on exports alone to penetrate foreign markets is not, in most cases, a viable strategy. International competitiveness frequently requires global manufacturing and marketing strategies to avoid tariff and non-tariff barriers, to reduce manufacturing and transportation costs, and to maximize the value of intangible assets such as know-how, brand name, etc. The critical importance of international operations is illustrated by the fact that foreign affiliates now account for 30 percent of worldwide sales and 43 percent of worldwide profits of U.S. multinationals.

Arguments that we must discourage U.S. investment abroad to protect domestic employment are thoroughly obsolete in the new international economic environment. In an increasingly open economy, discouraging U.S. companies from producing in low-cost locations will not protect U.S. jobs; instead, these jobs will go to foreign-based multinationals with lower costs. Indeed, the evidence suggests that multinational investment promotes exports: two-thirds of U.S. merchandise exports were associated with U.S. multinationals and the industries which are most active overseas tend to be the same industries which are the most effective exporters.

In short, global investment strategies are critical to the competitiveness of the U.S. economy.

At the same time the importance of the United States in the global economy has declined, the importance of foreign markets to the U.S. economy has greatly increased. Referring again to TABLE V, you can see that over the last four decades the value of trade has more than doubled relative to national income and the share of U.S. corporate profits from foreign sources has more than tripled.

It is not always recognized that our nation's Gross National Product, or GNP, *includes* net income earned by U.S. citizens and U.S. owned capital located overseas, but does not include profits generated by foreign-owned capital located within the United States. Income earned by foreign affiliates of U.S. companies is a rapidly growing share of our GNP which should not be overlooked when formulating policies designed to increase the growth of national income.

CASE STUDY ANALYSIS

On behalf of the Foundation and its working group, Price Waterhouse developed case study examples to assess the extent to which the U.S. system for taxing foreign-source income is competitive with other major industrial countries. The cases compare the effective tax rate that results when the same operations are conducted by foreign affiliates of parent corporations based in the United Sates, Canada, France, Germany, Japan, the Netherlands, and the United Kingdom.

The situations presented are not isolated examples. The facts are based on the average characteristics of U.S. corporations engaged in manufacturing and trade as reported by the IRS. Comparative tax computations are made for a representative corporation which performs manufacturing operations in Italy and sells to Europe through a sales subsidiary in Switzerland.

In these case study examples, the U.S. multinational incurs a significantly higher effective tax rate on foreign income than would a similarly situated multinational headquartered in any of the six comparison countries. Referring to TABLE IV the U.S. multinational corporation confronts an effective tax rate of 35.2 percent as compared to an average effective tax rate of 29.2 percent in the six other countries. The higher effective tax rate for the U.S. multinational as compared to foreign based multinationals—ranging from four percentage points in the case of Germany to ten percentage points in France—is tantamount to a surtax that foreign based multinationals do not bear.

The higher effective tax rate for U.S. companies result from three sources:

- First, U.S. multinationals cannot avoid allocating interest and other expenses to foreign-source income. Because many U.S. multinationals have excess foreign tax credits, the allocated expenses effectively are rendered nondeductible, a form of double taxation that other multinationals do not suffer.
- Second, unlike other countries, the subpart F rules deny a U.S. multinational the benefit of deferral where a base sales company is used to reduce foreign taxes. This increases the income on which a U.S. multinational is subject to current tax relative to the amount on which the other multinationals are currently taxed.
- Third, the U.S. rules for claiming a "deemed paid" foreign tax credit essentially produce more U.S. taxable income from a foreign operation than on an otherwise identical domestic operation. This occurs because the United States, unlike other countries, requires the deemed paid credit to be based on earnings and profits other than foreign taxable income.

Table IV.—COMPARATIVE TAX RATES

Parent Corporation Headquarters	Effective Tax Rate on Foreign Income (percent)
United States	35.2
United Kingdom	29.3
Japan	29.5
Netherlands	28.6
France	25.1
Germany	31.8
Canada	31.1
Average (Excluding U.S.)	29.2

Source: National Chamber Foundation

The final example describes how U.S. tax rules discourage participation by U.S. multinationals in foreign joint ventures that they do not control. The U.S. rule requiring a separate foreign tax credit limitation for dividends from each noncontrolled foreign corporation results in a competitive disadvantage relative to foreign multinationals in the use of joint ventures. These joint venture arrangements are increasingly important vehicles for spreading risk and penetrating new markets, such as Eastern Europe.

IMPLICATIONS FOR U.S. INTERNATIONAL TAX POLICY

Much of U.S. international tax policy was formulated in prior decades under very different economic circumstances than we confront today. In view of these changes in the global economy, it is entirely appropriate that the Finance Committee review U.S. rules for taxing foreign-source income.

The two features of the new international economic environment that we have discussed: (1) the lack of U.S. dominance in global markets; and (2), the increased reliance of the U.S. economy on foreign markets, have important policy implications.

First, we should seek to remove from the Internal Revenue Code those provisions which discriminate against foreign investment. The ability of U.S. companies to compete in global markets is sufficiently important to the domestic economy that it should not be discouraged through discriminatory tax policy. Indeed, tax law changes enacted in the 1980's, which are unlikely to be undone, are compelling U.S. companies to invest abroad in order to remain competitive. While it would be help-

ful if more of this investment were domestic, the fact that it is not should not disturb the Senate provided that American goods and services are producing jobs at home. This is not happening with the type of gusto that we would otherwise expect because certain provisions of domestic tax law are having a chilling effect on domestic investment. Clearly, foreign investment by U.S. companies is accounting for a larger share of otherwise shrinking domestic corporate profits. Similarly, it is accounting for domestic jobs and economic growth. It could account for much more.

Second, we should seek greater harmonization of U.S. tax rules with those of our major competitors. When the United States overwhelmingly dominated the world economy, the adverse consequences of nonconforming tax rules were limited by the lack of major foreign competitors and the tendency for other countries to follow U.S. tax developments. With increased worldwide economic integration, however, differences among U.S. and foreign country tax rules are much more likely to interfere with international flows of capital, both portfolio and direct investment. As illustrated by the case study examples, when inconsistencies among tax systems interfere with decisions relating to location of operations, research, or financing, American companies often are the losers.

Third, we should strive to reduce the complexity of our tax rules regarding foreign-source income which impose enormous compliance costs relative to the revenues raised from foreign operations. U.S. rules for taxing foreign-source income are the most complicated in the world, and handicap the competitiveness of foreign affiliates of U.S. headquartered companies as compared to foreign-owned corporations operating in the same markets. One indication of this complexity is the comprehensive Joint Committee on Taxation pamphlet issued in conjunction with last summers Ways and Means Committee hearing, which required 150 pages just to describe the relevant U.S. tax rules.[4]

OPTIONS FOR CHANGE

U.S. tax law departs in numerous respects from international norms in ways which impose higher tax burdens on U.S. multinationals. For example:

- Foreign headquartered multinational companies are permitted full deductions for their interest, research expenses and other costs, while U.S. expense allocation rules effectively prevent the benefit of a full deduction for many taxpayers.
- Foreign governments allow tax deferral for a wider scope of foreign subsidiary operations. Thus, foreign-based multinationals can use a single company to sell and service products throughout the European Community and defer home country tax and sales and service income. By contrast, the United Sates imposes immediate tax on foreign affiliates of U.S. companies involved in cross-border sales and service activities.
- The United States imposes a minimum tax on foreign income when foreign income is a high percentage of total income, which often results in double taxation.
- The United States fragments its foreign tax credit into different lines of business income while other countries either exempt broad categories of foreign business income or permit a simpler foreign tax credit calculation. Thus, many foreign jurisdictions do not require the computation of multiple limitations which raise the total tax burden on foreign-source income.

U.S. International Tax Policy for a Global Economy contains an extensive discussion of options to modify particular tax rules consistent with the principles of eliminating discrimination against foreign-source income, achieving greater harmonization with international tax norms, and reducing the complexity of the international tax rules. We recommend a thorough review of U.S. tax laws affecting the foreign operations of U.S. companies. Some possible options include:

- Generally permitting deferral for the following types of active business income: base company sales and services income where there is no direct reduction in the U.S. tax base; oil-related income; and financial services income for those taxpayers actively engaged in the financial services business on a worldwide basis.
- Restoring a *de minimis* exception to anti-deferral rules that is based on a meaningful percentage of gross income.
- Restricting foreign tax credit limitations to two primary categories: active business income and passive portfolio income, with special limitations for high withholding tax interest; and, U.S. source income. The need for separate limita-

[4] *Factors Affecting the International Competitiveness of the United States* Joint Committee on Taxation document #43-419 (United States Congress, Washington, DC) May 1991.

tions for active banking (and other financial services income) and shipping income merits further consideration; if retained, the financial services category should be broadened to encompass all related income from the conduct of the business.

- Eliminating the separate foreign tax credit limitation for noncontrolled section 902 corporations and allowing look-through based on a simplified approach; e.g., using gross income of the foreign corporation as measured by financial statements or the foreign tax return; eliminating the special rules applicable to foreign oil and gas income; eliminating the 90 percent limitation on the use of foreign tax credits against the alternative minimum tax; and allowing an election with respect to the high withholding tax interest separate limitation to apply the 1985 House bill approach, with modification that would allow a deduction for the non-creditable amount and that would make the calculation by aggregating all loans whose interest bore a five percent or greater withholding tax.
- Reflecting foreign borrowings in the allocation and apportionment of interest expense; allowing a U.S. corporation borrowing on its own ability, to allocate and apportion its interest on the basis of its assets (including the assets of any lower-tier subsidiaries); reconsidering present interest expense allocations rules as applied to finance companies operating in a conglomerate group; and providing a more equitable methodology for allocation of interest and research expenses.
- Providing symmetrical treatment of domestic and foreign income and expense including domestic loss recapture.
- Reviewing and revising U.S. tax laws to facilitate participation by U.S. taxpayers in international joint ventures.
- Encouraging the extension of foreign country corporate/shareholder tax integration relief to U.S. direct investment.

ALTERNATIVES TO THE PRESENT SYSTEM OF TAXING FOREIGN SOURCE INCOME

The NCF study also examines more fundamental alternatives to the present U.S. tax system in the form of: (1) foreign income exemption systems, like those found in the tax laws of Canada, Germany, France, and the Netherlands; and (2) worldwide tax consolidation of income of U.S. controlled foreign affiliates with their U.S. parents, as proposed in 1978. The first option would move the tax system in the direction of source-basis taxation and capital import neutrality, while the second option would move the system toward a more comprehensive resident-basis taxation and, in some respects capital export neutrality.

The current U.S. rules for taxing foreign-source income reflect a balance between these difference approaches. The tax systems of other countries differ in emphasis, but most reflect a compromise between source and residence taxation. Moving the tax rules sharply in either direction, and away form the current hybrid system, does not appear necessary to achieve the broad policy principles outlined in this paper. Indeed, either of these policy options would present many of the same issues that must be resolved under existing law; e.g., transfer pricing, allocation of expenses, and taxation of royalties and portfolio income.

As a result, there is little assurance that either option would necessarily produce a simpler and more internationally harmonized tax system as compared to undertaking a more modest repair of the current hybrid system. Moreover, unilateral implementation of an exemption system may not be acceptable without increased coordination between U.S. and foreign income tax systems. Thus, modification of the current tax system is more likely, at least in the short run, to achieve important tax policy objectives.

ALTERNATIVES TO THE PRESENT SYSTEM OF TAXING DOMESTIC INCOME

In an increasingly open economy, tax rules that are considered "domestic" can also have important international ramifications. Consequently, the NCF report concludes with a brief examination of two aspects of U.S. domestic tax policy which depart from the conventions of other major industrialized countries: (1) the heavy U.S. reliance on income tax revenues and the absence of a national consumption tax; and (2) the absence of any mechanism for relieving double taxation of corporate dividends at the corporate or shareholder levels.

Unlike the other members of the Group of Seven, and 20 of the 24 Organization for Economic Co-Operation and Development (OECD) member countries, the United States does not have a broad-base consumption tax. From the standpoint of international trade, however, studies have shown that the adoption of a value-added tax in the United States would not, by itself, affect U.S. competitiveness. Any potential

trade benefit depends upon inducing an increase in net national savings which have fallen from 7.3 percent of GNP in the 1950s to 2.9 percent in the 1980's. Savings might be increased if the revenues from a national sales tax were dedicated to reduction of the federal budget deficit or to reducing taxes on income from capital.

Unlike other members of the Group of Seven and over two-thirds of the OECD member countries, the United States does not have any mechanism for relieving the double taxation of corporate dividends. Moreover, the shareholder credit systems of many other countries effectively discriminate against U.S. ownership of subsidiaries in these countries because the credit does not extend to U.S. corporate investors. In these cases, U.S. multinationals are at a disadvantage as compared to host country corporations. Thus, it may be time to reconsider corporate integration in light of both domestic and international economic objectives.

CONCLUSION

In conclusion, we commend the Committee for holding this hearing. With the increased openness of the U.S. economy and the rise of global competition, it is now appropriate to review our rules affecting the foreign operations of U.S. companies in light of the current economic realities. Tax policy can no longer be made without taking full account of the tax systems used by other countries.

The National Chamber Foundation would be pleased to provide information or otherwise assist the committee as it reviews options to simplify and enhance the Internal Revenue Code's treatment of foreign source income.

Thank you.

U.S. International Tax Policy for a Global Economy

Executive Summary

PRICE WATERHOUSE
WASHINGTON NATIONAL
TAX SERVICE

Edited by:
Robert Allen Ragland
Chief Tax Counsel
National Chamber Foundation

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EXECUTIVE SUMMARY

Introduction

The role of the U.S. economy in global markets has changed dramatically since World War II. The critical relationship between the taxation of U.S. companies and U.S. economic interests has not, however, been addressed in light of the new economic realities. Thus, a thorough analysis of the implications of current economic conditions for U.S. international tax policy is now required. This paper is a step in that direction.

The paper explores the history of the present U.S. international tax system; discusses basic principles of international income taxation; compares the U.S. tax rules with those of other countries; examines economic changes in the U.S. and global economies during the postwar period; illustrates cases in which U.S. tax laws are more burdensome than those of U.S. competitor countries; and concludes with a discussion of options for tax reform ranging from modifications in the present system to basic structural changes.

Global economic change

The influence of the United States in the world economy has declined sharply in the postwar period. With the rebuilding of Europe and Japan and the transfer of technology to newly industrializing countries, the U.S. economy now accounts for a much lower share of world income, trade, and capital flows than it did after World War II (see Table E–1).

The relative decline in U.S. economic power can be illustrated by the changing role of the dollar. The dollar was the strongest currency in the world in the 1950's and the cornerstone of the postwar monetary system. By 1971, however, persistent U.S. inflation exceeding that of other major industrial countries had resulted in a collapse of the fixed exchange rate regime and a diminished role for the dollar.

Table E–1.—THE CHANGING U.S. POSITION IN THE WORLD ECONOMY

U.S. Trade Balance (percent of GNP)	1950–59	1980–89
Merchandise balance	0.7%	–2.2%
Service balance	0.1%	0.8%
Current account balance	0.2%	–2.0%
Index of openness [1]	6.7%	15.0%
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Share from foreign sources	5.1%	15.4%
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U.S. of world total	39.9%	28.5%
World Exports	1960	1988
U.S. share of world total	16.6%	12.0%
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U.S. share of outward direct investment	50.4%	31.5%
U.S. share of inward direct investment	9.4%	25.2%
World's 20 Largest Industrial Corporations (ranked by sales)	1960	1988
Number of U.S. headquartered corporations	18	9

[1] Merchandise exports plus imports as a percent of GNP.

Sources: For world and U.S. GDP, see World Bank, 1990 World Development Report, Table 3 pp 182–83. For world and U.S. exports see IMF, 1990, International Financial Statistics Yearbook 1990, pp 120–121. Otherwise, see tables in Chapter II.

The dramatic change in the U.S. economic role also can be Seen in the reversal of the U.S. international investment position. In the first three postwar decades, the United States was the world's largest lender of capital. By the 1980's, however, it had become the world's largest debtor. Over the last five years, the United States annually borrowed over $00 billion from abroad to finance its trade deficit. The deficit in trade and the net importation of capital both reflect a decline in the U.S. savings rate during the 1980's.

In the new international economic environment, Europe and the Pacific Rim rival North America as regional superpowers. The single European Community market in 1992 and the conversion of the Eastern European economies from Centrally planned to market-oriented economies will further expand European influence.

As the U.S. dominance in the world economy is diminishing, U.S. dependence on global markets is increasing. The value of international trade as a percentage of U.S. national income has doubled and foreign affiliates' share of total U.S. corporate earnings has tripled over the last four decades. International trade and investment are now major Contributors to national employment and income.

Relying on exports alone to penetrate foreign markets is not, in most cases, a viable strategy. International competitiveness frequently requires global manufacturing and marketing strategies to avoid tariffs and nontariff barriers, to reduce manufacturing and transportation costs, and to maximize the value of intangible assets (e.g., know-how, brand name, etc.). The critical importance of international operations to U.S. companies is illustrated by the fact that foreign affiliates now account for 30 percent of worldwide sales and 43 percent of reported (book) worldwide profits of U.S. multinationals.

Over the last 40 years, a variety of legislative proposals have been advanced which were intended to discourage U.S. investment abroad. Some argued that foreign investment adversely affects the balance of payments and reduces U.S. employment. Others argued that as the world's largest capital exporter, the United States could earn a monopoly rate of return by restricting outward investment.

These arguments have become thoroughly obsolete in the new international economic environment. First, under the current regime of floating exchange rates, U.S. investment abroad has no adverse effect on the balance of payments. Second, empirical analysis has shown that outward investment complements rather than substitutes for U.S. exports. In an increasingly open economy, discouraging U.S. companies from producing in low-cost locations will not protect U.S. jobs; instead these jobs will go to foreign-based multinationals with lower costs. Third, it has been estimated that eliminating foreign investment would reduce U.S. research expenditures by 12 to 15 percent, which would adversely affect future economic growth. Fourth, the notion that the U.S. economy has sufficient monopoly power to gain from a tariff on capital exports is at odds with the current economic reality.

Implications for U.S. international tax policy

When the United States overwhelmingly dominated the world economy, the adverse consequences of nonconforming tax rules were limited by the lack of major foreign competitors and the tendency for other countries to follow U.S. tax developments. With increased worldwide economic integration, however, differences among U.S. and foreign country tax rules are much more likely to interfere with international flows of capital, both portfolio and direct investment. When inconsistencies among tax systems interfere with decisions relating to location of operations, research, or financing, American companies often are the losers. Consequently, U.S. tax policy makers should strive to achieve greater harmony between the international tax rules of the United States and those of other countries.

Since the inception of the corporate income tax in 1913, U.S. international tax policy has attempted to balance the goal of achieving uniform treatment of domestic and foreign operations of U.S. companies (known as capital export neutrality) and the goal of maintaining international competitiveness, *i.e.*, comparable taxation of U.S.- and foreign-based multinationals. Beginning with the restrictions imposed on deferral of tax on reinvested foreign earnings in 1962, however, the pendulum of U.S. international tax policy has swung sharply in the direction of capital export neutrality and away from international competitiveness. In a number of cases, the pendulum has veered off the scale, and the United States has imposed higher taxes on foreign than domestic source income (*i.e.*, discriminated *against* foreign source income). With the serious economic challenge now posed by foreign multinationals, it is time for the pendulum to swing back to a greater emphasis on international competitiveness and to end discrimination against foreign source income.

Among significant substantive differences that impose U.S. tax costs on U.S. multinationals not imposed by other countries on their multinationals are:

(1) Foreign-headquartered multinational companies are permitted full deductions for their interest, research and other costs, while U.S. expense allocation rules effectively prevent the benefit of a full deduction for many taxpayers.

(2) Foreign governments allow tax deferral for a wider scope of foreign subsidiary operations.

(3) The United States imposes a minimum tax on foreign income when foreign income is a high percentage of total income often resulting in double taxation.

(4) The United States fragments its foreign tax credit into different lines of business income while other countries either exempt broad categories of foreign business income or permit a simpler foreign tax credit calculation which does not require the computation of multiple limitations which raise the total tax burden on foreign source income.

(5) The United States imposes added, non-productive costs on its multinationals through the complexity of the U.S. rules for taxing foreign income.

Consideration also should be given to conforming certain U.S. rules that depart from international norms for taxing foreign source income and are detrimental to the competitive position of U.S. multinationals. Particular attention should be focussed on rules that are not "harmonizable," *i.e.*, that would cause international double taxation even if other countries adopted the U.S. standard. For example, the allocation of state and local tax expense against foreign income results in double taxation even if other countries were to adopt the U.S. rules (because the United States does not allow foreign state and local government taxes imposed on foreign parent corporations to reduce U.S. source taxable income). The United States should begin by unilaterally reviewing such nonharmonizable rules. Ultimately, greater international conformity might be achieved through the use of multilateral agreements regarding such matters as transfer prices, accounting rules, and withholding taxes.

The case for conformity is particularly strong where a U.S. tax rule is not harmonizable, departs from the practices of virtually all other major industrialized nations, and discriminates against foreign source income. For example, the U.S. interest allocation rules result in double taxation of foreign source income and depart from international norms. Conforming to the international practice would allow U.S. multinationals to compete on a more level playing field with foreign-based multinationals and generally would not create an advantage *vis-a-vis* purely domestic corporations (since they are not exposed to international double taxation).

Case study analysis

Case study examples developed for this report illustrate the lack of harmony of certain U.S. rules and the discrimination against foreign business activities of U.S. companies. The cases provide comparisons of the varying tax burdens that result when the same operations are conducted by foreign affiliates of parent corporations based in the United States and six other major industrial countries: Canada, France, Germany, Japan, the Netherlands, and the United Kingdom. In particular, the examples focus on the unique U.S. rules for interest and other expense allocations, the expansive subpart F rules that apply to U.S. multinationals, the deemed paid foreign tax credit rules, and the impact of the separate foreign tax credit limitation for dividends from noncontrolled foreign corporations (the "10–50 basket").

The situations presented are not isolated examples. The facts are based on the average characteristics of U.S. corporations engaged in manufacturing and trade as reported by the IRS. Comparative tax computations are made for a representative corporation which performs manufacturing operations in Italy and sells to Europe through a sales subsidiary in Switzerland.

In these case study examples, the U.S. multinational incurs a significantly higher effective tax rate on foreign income than would a similarly situated multinational headquartered in any of the six comparison countries (see Table E-2). The higher effective tax rate for the U.S. multinational, a differential ranging from four to ten percentage points, is tantamount to a surtax that multinationals headquartered in the other countries do not bear.

Table E-2.—CASE STUDY ANALYSIS

Parent Corporation Headquarters	Effective Tax Rate on Foreign Income
United States	35.2%
United Kingdom	29.3
Japan	29.5
Netherlands	28.6
France	25.1
Germany	31.8
Canada	31.1
Average (excluding U.S.)	29.2

Source: See Table III-1.

The higher effective tax rate for U.S. companies results from three sources. First, a U.S. multinational cannot avoid allocating interest and other expenses to foreign source income. Because many U.S. multinationals have excess foreign tax credits, the allocated expenses effectively are rendered nondeductible, a form of double taxation that the other multinationals do not suffer. Second, unlike other countries, the subpart F rules deny a U.S. multinational the benefit of deferral where a base company is used to reduce foreign taxes. This increases the income on which a U.S. multinational is subject to current tax over that amount on which the other multinationals are currently taxed. Third, the U.S. rules for claiming a "deemed paid" foreign tax credit essentially produce more U.S. taxable income from a foreign operation than an otherwise identical domestic operation. This occurs because the United States, unlike other countries, requires the deemed paid credit to be based on earnings and profits rather than (foreign) taxable income.

The final example describes how U.S. tax rules discourage participation by U.S. multinationals in foreign joint ventures that they do not control. The U.S. rule requiring a separate foreign tax credit limitation for dividends from each noncontrolled section 902 corporation results in a competitive disadvantage relative to multinationals of other countries in the use of joint ventures. These joint venture arrangements are increasingly important vehicles for spreading risk and penetrating new markets such as Eastern Europe.

Options for change

A number of broad policy principles are suggested by the findings of this study. These include: (1) taxing foreign source income in a nondiscriminatory manner; (2) maintaining lower U.S. corporate tax rates adopted in the 1986 Tax Reform Act; (3) permitting U.S. companies operating abroad to reduce foreign taxes on their active business operations (without adverse U.S. tax consequences); (4) amending U.S. foreign tax rules to achieve greater harmony with international norms; and (5) reducing the complexity and compliance costs of U.S. tax rules.

The study contains an extensive discussion of options to modify particular tax rules consistent with the above-mentioned policy principles. These options include:

- Generally permitting deferral for the following types of active business income: base company sales and services income where there is no direct reduction in the U.S. tax base; oil-related income; and financial services income for those taxpayers actively engaged in the financial services business on a worldwide basis.
- Restoring a *de minimis* exception to anti-deferral rules that is based on a meaningful percentage of gross income.
- Restricting foreign tax credit limitations to two primary categories: active business income and passive portfolio income, with special limitations for high withholding tax interest and U.S. source income. The need for separate limitations for active banking (and other financial services income) and shipping income merits further consideration; if retained, the financial services category should be broadened to encompass all related income from the conduct of the business.
- Eliminating the separate foreign tax credit limitation for noncontrolled section 902 corporations and allowing look through based on a simplified approach, *e.g.*, using gross income of the foreign corporation as measured by financial statements or the foreign tax return; eliminating the special rules applicable to foreign oil and gas income; eliminating the 90 percent limitation on the use of foreign tax credits against the alternative minimum tax; and allowing an election with respect to the high withholding tax interest separate limitation to apply the 1985 House bill approach, with modifications that would allow a deduction for the non-creditable amount and that would make the calculation by aggregating all loans whose interest bore a five percent or greater withholding tax.
- Reflecting foreign borrowings in the allocation and apportionment of interest expense; allowing a U.S. corporation, borrowing on its own ability, to allocate and apportion its interest on the basis of its assets (including the assets of any lower-tier subsidiaries); reconsidering present interest expense allocation rules as applied to finance companies operating in a conglomerate group; and providing for an equitable allocation of research expenses.
- Providing symmetrical treatment of domestic and foreign income and expense including domestic loss recapture.
- Reviewing and revising U.S. tax laws to facilitate participation by U.S. taxpayers in international joint ventures.
- Encouraging the extension of foreign country corporate/shareholder tax integration relief to U.S. direct investment.

Alternatives to the present system of taxing foreign source income

The study also examines more fundamental alternatives to the present U.S. tax system in the form of: (1) foreign income exemption systems, like those found in the tax laws of Canada, Germany, France, and the Netherlands; and (2) worldwide tax consolidation of income of U.S.-controlled foreign affiliates with their U.S. parents, as proposed in 1978. The first option would move the tax system in the direction of source-basis taxation and capital import neutrality while the second option would move the system towards a more comprehensive residence-basis taxation and, in some respects, capital export neutrality.

The current U.S. rules for taxing foreign source income reflect a balance between these different approaches. The tax systems of other countries differ in emphasis, but most reflect a compromise between source and residence taxation. Moving the tax rules sharply in either direction, and away from the current hybrid system, does not appear necessary to achieve the broad policy principles outlined in this paper. Indeed, either of these options would present many of the same issues that must be resolved under existing law, *e.g.*, transfer pricing, allocation of expenses, taxation of royalties and portfolio income.

As a result, there is little assurance that either option would necessarily produce a simpler and more internationally harmonized tax system as compared to undertaking a more modest repair of the current hybrid system. Moreover, unilateral implementation of an exemption system may not be acceptable without increased coordination between U.S. and foreign income tax systems. Thus, modification of the current tax system is more likely, at least in the short run, to achieve important tax policy objectives.

Alternatives to the present system of taxing domestic income

In an increasingly open economy, tax rules that are considered "domestic" can also have important international ramifications. Consequently, the paper concludes with a brief examination of two aspects of U S. domestic tax policy which depart from the conventions of other major industrialized countries: (1) the heavy U.S. reliance on income tax revenues and the absence of a national consumption tax; and (2) the absence of any mechanism for relieving double taxation of corporation dividends at the corporate or shareholder levels.

Unlike the other members of the Group of Seven and 20 of the 23 Organization for Economic Co-operation and Development (OECD) member countries, the United States does not have & national sales tax. From the standpoint of international trade, however, studies have shown that the adoption of a value-added tax in the United States would not, by itself, affect U.S. competitiveness. Any potential trade benefit depends upon inducing an increase in net national savings which have fallen from 7.3 percent of GNP in the 1950's to 2.9 percent in the 1980's. Savings might be increased if the revenues from a national sales tax were dedicated to reduction of the federal budget deficit or to reducing taxes on income from capital.

Unlike the other members of the Group of Seven and over two-thirds of the OECP member countries, the United States does not have any mechanism for relieving the double taxation of corporate dividends. Moreover, the shareholder credit systems of many other countries effectively discriminate against U.S. ownership of subsidiaries in these countries because the credit does not extend to U.S. corporate investors. In these cases, U.S. multinationals are at a disadvantage as compared to host country corporations. Thus, it may be time to reconsider corporate integration in light of both domestic and international economic objectives.

PREPARED STATEMENT OF JOHN G. WILKINS

Mr. Chairman and Members of the Committee: I am pleased to have this opportunity to consider the U.S. tax structure in the context of those of three of our major competitors, Japan, Germany, and the United Kingdom. I thank the Committee for inviting me to share my views.

I am Director of Tax Policy Economics and a partner in the international accounting firm, Coopors & Lybrand. Prior to 1990, I was the senior advisor to the U.S. Treasury Assistant Secretary for Tax Policy and I held tax policy positions in the Department of the Treasury without interruption since 1966. My last major assignment in government was serving as acting Assistant Secretary for Tax Policy during the early months of the Bush Administration. Prior to my leaving government service I was vice chairman of the Committee on Fiscal Affairs of the Organization for Economic Cooperation and Development (OECD) and from 1975 until last year I was chairman of an OECD subcommittee that is devoted to improving tax statistics, international tax analyses, and international comparisons of tax structures. A part

of my testimony draws upon findings of a recent study by that group entitled *Taxing Profits in a Global Economy, Domestic and International Issues.*

I am appearing today on my own behalf and not as a representative of any Coopers & Lybrand client.

INTRODUCTION

I applaud the Committee's examination of the tax aspects of competitiveness, but I would urge Committee members to place the information that they are receiving today in perspective. Taxes account for only about 3½ percent of total costs of all corporations filing Federal income tax returns. That is not to say that taxes are unimportant, just that they are only one of many significant costs borne by businesses and but one of the determinants of competitiveness. This is underscored by the fact that it is difficult to attribute to tax law the sometimes dramatic differences in economic performance among the major trading partners that this hearing is focusing on. To illustrate this point consider Japan, which has the highest effective marginal corporate tax rate, which relies the least on savings-rewarding consumption taxes, and which has the fastest growing overall tax burden as measured by the share of gross domestic product (GDP)[1] going to taxes. Yet, as the statistics in Table 1 demonstrate, Japan has outpaced the United States, the United Kingdom, and Germany—by as much as two to one—in real growth over the past twenty years and has produced net national savings dual to 19.9 percent of GDP. Germany had a distant second 11.4 percent savings rate. The United Kingdom's rate was 5.8 percent and the United States trailed them all at 5.6 percent. Only in the growth of employment does Japan lose out to the United States—by a margin of a 2.1 percent annual average growth for the United States versus a 1.1 percent new jobs rate for Japan.

Nonetheless, taxes do remain a critical factor in making investment decisions. The trend around the globe is away from investment controls, foreign exchange controls, and other nontax barriers. As these impediments disappear, differences in the way countries tax capital income generally, and corporate profits in particular, are among the few remaining barriers to the efficient international allocation of capital. As a result, tax considerations play an increasingly important role in companies' decisions about where to invest, how that investment is financed (with debt, new equity, or retained earnings), and where funds are raised.

In this regard, tax competition between nations is real. I witnessed firsthand the concern of our European trading partners when the United States cut its tax rates in 1981 and 1986. After the 1986 reforms, policymakers abroad were deeply concerned that low rates would make the United States a virtual tax haven compared with the countries of the European Community (EC). Even when typical state and local income tax rates are included, the 1986 Act slashed the top U.S. corporate income tax rate from 49.5 percent to 38.3 percent—a 23 percent cut. At the time this tax cut was enacted, the average corporate rate for EC countries was 46.4 percent.

Time and again, European Finance Ministry officials expressed the opinion that these low U.S. tax rates could never remain at the levels established. However, these same officials acknowledged that if, for some reason, their predictions were wrong and the U.S. income tax rates did remain low, they would have no choice but to follow suit. Now, nearly six years after enactment, the legacy of the 1986 Act is undisputed: U.S. income tax rates remain among the lowest of the industrialized nations; and, true to their words, almost all of our European competitors embarked upon tax rate cuts of their own once it became apparent that U.S. policymakers were committed to maintaining low rates. In fact, of the 12 EC member countries, all but two have lowered their corporate income tax rates. Following the move of the United States, the EC countries lowered their corporate income tax rates about 12½ percent, from a 1986 average of 46.4 percent to a 1991 average tax rate of 40.6 percent. While the U.S. corporate tax rate was roughly three points higher than the European rate before the 1986 Act, it is now roughly two points lower.

Compared with the other three countries that are the subject of this hearing, the U.S. corporate statutory tax rate had been less than 1 percentage point below the U.K.-Germany-Japan average in 1986 (50.4 percent) but is now nearly 9 points lower than that average (46.8 percent). During this period, the U.K. rate was lowered from 35 percent to 34 percent; Germany's rate was dropped from 61.7 percent

[1] Gross domestic product (GDP) measures the value of all goods and services produced *within a country,* even if foreign-owned resources are employed. By comparison, gross national product (GNP) measures the value of all goods ad services produced *by a country,* even if some producing resources are located abroad. Most international comparisons employ the GDP concept.

to 56.5 percent; and the rate for Japan was lowered from about 55 percent to 50 percent when corporate taxes at all levels of government are included.[2]

DETERMINANTS OF COMPETITIVENESS

Many factors influence the ability of U.S. firms to compete in the global economy. Taxes are growing in importance as many nontax barriers to trade and investment flows are eliminated. However, infrastructure, income, wealth, and nontax subsidies all affect the ability to compete and are part of the competitiveness equation.

Infrastructure. The whole climate in which a business operates helps shape costs that determine ultimate profitability. Components of the domestic infrastructure, which generally result from a degree of government spending or support, and which make investment attractive to a global firm include:

- Economic and political stability;
- Well-developed and reliable transportation and communications networks;
- Good public and affordable private education;
- Sound banking, legal, and accounting systems; and
- Unrestricted repatriation of profits without exchange controls.

Laws, regulations, and taxes designed to protect the environment are a new component of the infrastructure that can add significant costs to the production of many goods.

Population Characteristics. In addition to infrastructure, investment will be attracted to well-educated labor pools and rich consumer populations. Obviously, the sheer number of potential consumers is also critical.

Subsidies and Incentives. Economists persuasively argue that the highest living standard can be obtained for a given set of resources only when markets are free to allocate those resources. This advice has been well-heeded by the new governments of Russia, the other independent states in the former Soviet Union, and the Eastern European countries in transition from centrally planned to market economies. Subsidies, like most taxes, reduce economic efficiency by distorting savings, investment, and consumption choices. Subsidies or special taxes on production may be appropriate in those few cases in which the marketplace cannot correctly allocate resources.

- One example is where producers cannot realize full returns on their investments, as may be the case of research and development (R&D) expenditures that generate technical knowledge for the benefit of all. In such situations governmental tax relief or nontax subsidies for R&D may be appropriate because they could improve upon the free-market allocation of capital and other productive resources.
- Another example is where producers do not pay (and consequently consumers are not charged) the full costs of production, as may be the case of a production process that generates toxic waste. In such situations some believe that government regulations or taxes on the particular production process may be appropriate because they, too, could improve upon the market allocation of resources.

Among the four countries being examined today, nontax subsidies to various sectors appear in the form of grants, loans at favorable interest rates, and equity participation by government. Data through 1988, the most recent year for which comparable figures are available, show that the use of subsidies relative to GDP in Japan, the United Kingdom, and the United States appears to have leveled off or declined.

In 1988, the United States devoted only 0.6 percent of GDP to government subsidies to business and industry. These subsidies represented less than 25 percent of total corporate income tax collections (see Table 2). Japan was 50 percent higher—but still relatively low—with 0.9 percent of GDP spent on subsidies to business, representing 12 percent of corporate income tax collections. In the United Kingdom, subsidies represented a much larger share: they equalled 1.3 percent of GDP and about 32 percent of corporate tax collections. By comparison, Germany paid out a huge 2.3 percent of GDP in subsidies to businesses. In total these subsidies exceeded by 15 percent the total German corporate income tax for 1988.

OVERALL TAX BURDENS

Tax burdens vary among the industrial countries according to the relative size of government and how that government is financed. Among the four countries being

[2] Among the four countries, only the United Kingdom does not have a local government corporate income tax.

compared today, the overall tax burden ranges from a low 30.1 percent of GDP for the United States up to 38.1 percent of GDP for Germany in 1989, the latest year for which internationally comparable data are available. (See Table 1.) Japan, with tax revenues of 30.6 percent of GDP is very close to the United States, and the United Kingdom, with taxes running 36.5 percent is close to Germany. As shown in Figure 1, the Japanese relative tax burden has reached the level of the United States only in recent years. Since 1970, the U.S. tax burden has fluctuated within a very narrow range, running no lower than 28 percent of GDP and no higher than 30 percent. In contrast, the Japanese burden has increased in every year but one (1975) from 19.7 percent of GDP in 1970 to a current (1989) high of 30.6 percent. The increase in the overall tax burden for Japan is attributable primarily to roughly dual increases in income taxes and social security taxes. Both Germany and the United Kingdom experienced very modest increases in the overall tax burden, with tax revenues remaining a fairly constant share of GDP since 1976 for Germany and since 1981 for the United Kingdom.

Major sources of revenue to finance government vary considerably among the four countries. The way countries finance government is relevant to the economists' argument that income taxes distort choices by favoring income used to consume by taxing it only once and disfavoring income put into savings by taxing that income when it is earned and then taxing the subsequent return on it. By this argument, greater reliance on consumption taxes is a pro competitive choice because more income will be saved to finance investment for future growth.

Figure 2 shows that *at the central government level* Germany relies on income taxes (both individual and corporate) only half as much as any of the other countries, receiving only 20 percent of all central government tax revenues from them. By contrast, the United States collects 55 cents of every federal government revenue dollar from income taxes. For both Japan and the United Kingdom income taxes are no more than 44 percent of central government revenue. Noticeably, the United States relies significantly more on income taxes and significantly less on consumption taxes than do any of the other three countries.

This narrow focus on taxes levied by central governments, however, is very misleading. Figure 3 shows that more than a third of all taxes in the United States are levied by state and local governments. Moreover, according to a new Coopers & Lybrand survey, 92 percent of U.S. businesses expect state and local taxes on business to increase over the next three years, particularly the corporate income tax. Germany, also a federal country, raises nearly 31 percent of tax revenues through non-central governments and Japan raises about 26 percent at lower levels of government. The United Kingdom, a unitary country, raises only 11 percent of its government revenue at the local level. Figure 4, which shows how the four countries raise revenues when all levels of government are combined provides a very different view than Figure 2. Whereas the United States ranked highest in its reliance on income taxes and lowest in its reliance on consumption taxes at the central government level, when taxes levied at all levels of government are combined, Japan, rather than the United States, is now shown to rely the most on income taxes and the least on consumption taxes.

TAXES PAID BY BUSINESS

The OECD has identified the main set of direct taxes paid primarily by business as being the corporate income tax, property taxes (other than those paid by households), taxes on corporate net wealth, and the employer share of social security taxes. (Indirect taxes on consumption have not been attributed to business.) By this measure, each of the four countries raises between 9 and 12 percent of GDP from business taxes, with Japan at the high end of this range and the United States at the low end. Over the last two decades, U.S. business taxes have varied very little as a share of GDP—remaining around 9 percent. Both Germany and the United Kingdom have experienced slight increases, from about 8 percent of GDP in 1970 to about 10 percent in 1989. By contrast, the figures on Table 3 show a steady increase in business taxes as a share of GDP for Japan—starting around 7.5 percent of GDP in 1970 and moving up to 12 percent by 1989.

According to this analysis, businesses pay a fourth or more of total tax revenues in each of the four countries. (The fraction would run even higher if some portion of sales taxes were assumed to be paid by business.) As shown on Table 1, business taxes account for more than 39 percent of all tax revenues in Japan, 30 percent in the United States, 28 percent in the United Kingdom, and 25 percent in Germany.

Apart from the employer share of social security taxes which most agree fall on labor in the long run, the corporate income tax remains the principal tax on business that falls on capital and hence has a direct impact on competitiveness. Cor-

porate income taxes as a share of GDP range from a low of 2.1 percent in Germany up to 7.5 percent in Japan. The U.S. corporate tax runs 2.6 percent of GDP and the U.K. corporate tax is 4.5 percent of GDP. (See Table 1.)

In both Germany and the United States, the largest business tax is social security contributions paid on behalf of employees. In the United Kingdom and Japan, the corporate tax is the largest tax paid by business. Business property taxes are significant only in the United States and the United Kingdom. Only one country—Germany—reports a tax on corporate net wealth but revenues from that tax amount to only 3 percent of all business taxes paid in Germany and are only about one-seventh as great as corporate profit tax revenues.

HOW TAX RATES SHOULD BE EVALUATED

Twenty years ago government policymakers had no choice but to examine the tax codes of their trading partners in order to determine whether or not their own taxes were competitive. Because countries have established very different sets of tax rules to meet their own objectives, such examinations proved to be highly inadequate. Today, policymakers have new tools of analysis and are able to make meaningful comparisons of effective marginal tax rates that affect actual business decisions.

Average Tax Rates. Although statistics on government revenues are readily available through the OECD and the International Monetary Fund, average rates of corporate income tax cannot be compared among countries because there is no internationally accepted measure of corporate profits. Corporate tax revenue as a fraction of GDP is frequently substituted for an average rate of tax on corporate profits; however, this measure fails to show the relative tax burden on similarly situated corporations because the fraction of GDP accounted for by the corporate profit tax base can differ among countries and change over time. Moreover, this average tax rate is not relevant to investment decisions, which are made at the margin.

Statutory Tax Rates. As shown in Table 4, the statutory corporate tax rate in the United States is calculated to be 38.3 percent when deductible state and local taxes averaging 6.5 percent are included with the Federal 34.0 percent rate.[3] This places the United States next to lowest among the four countries, second only to the United Kingdom, which has a 34 percent statutory rate. Germany's 56.5 percent statutory rate is the highest, followed closely by Japan's 50 percent.[4] Statutory tax rates are readily available but all too often paint a misleading picture of relative tax burdens because definitions of income, allowable deductions, and tax credits vary considerably from country to country. It is difficult to account precisely for differences between statutory and effective marginal tax rates on new investment; however, reasons why effective marginal tax rates on investment are considerably lower than statutory rates are clear. Among the important factors that modify the statutory rate to create a lower effective rate in most countries are:

- Indexation of and reserves for inventories;
- Integration of corporate and personal taxes;
- Depreciation allowances;
- Investment credits and other special investment tax incentives; and
- The treatment of debt financing.

Thus, a high nominal tax rate may not necessarily mean a high effective marginal tax rate.

Effective Tax Rates. Global businesses always have known that *effective,* rather than *statutory,* tax rates on investment help determine (a) whether or not they would make an investment, (b)in which country they would place it, and (c) how and where they would finance it. Unfortunately, policymakers have not always had access to effective marginal tax rate information on an internationally consistent basis in order to evaluate the U.S. corporate income tax against those of our principal competitors.

An important step toward identifying effective marginal tax rates is the calculation of actual rates of tax that would apply in an illustrative situation, such as a direct investment of $1 million. This illustration can be made for a "model firm" operating in each of a number of different countries. The principal benefit of this kind of analysis is that tax investment incentives and special deductions or credits that

[3] State and local taxes must be included in international comparisons because corporations in unitary countries like the United Kingdom essentially face only central government taxes while corporations in other countries, such as the United States, face both central government and state and local government taxes.

[4] The rate on distributed profits can sometimes differ. In Germany, distributed profits are taxed at a statutory rate 12.2 percentage points lower than the 56.5 percent rate on retained earnings.

apply to the investment will be counted—and not just the nominal tax rate. The main analytical drawback to this approach is that only a limited set of assumptions can be made regarding the "typical" investment and consequently the model firm may not closely resemble corporations actually doing business in any of the countries being studied.

This drawback is surmounted by a methodology adopted in the OECD study (*Taxing Profits in a Global Economy, Domestic and International Issues*) on the role of corporate income taxes in international competitiveness. This methodology involves converting the model firm approach into a "real world" example by carrying out each effective marginal tax rate calculation many times over—each time varying a critical assumption and applying weighted averages to the results to paint more accurate pictures of the tax situations facing multinational enterprises. The study considers the various ways in which direct investments in manufacturing are made and financed. The tax on investments in three different types of assets is calculated. For each asset, three means of financing the investment are considered. Since a different tax results for each possible combination of asset investment and financing approach, an overall effective marginal tax rate is calculated as a weighted average of the various results. The weights are drawn from the actual experience in each country studied—or as an average of all of these countries.

For example, among the OECD member countries, 50 percent of direct investment in manufacturing goes into machinery and equipment, 28 percent represents buildings and structures, and 22 percent is inventory. On average, investment is financed from the following sources: retained earnings, 55 percent; borrowing, 35 percent; and new equity, 10 percent. According to calculations made by the OECD, almost all countries' tax structures favor investments in equipment over investments in other types of assets. This bias was found to be true also for the United States, despite repeal of the investment tax credit and the 1986 depreciation changes.

As shown by the figures in the second column of Table 4, the overall weighted effective marginal corporate tax rate on domestic direct investment in the United States (including deductible state and local corporate income taxes) is estimated to be 13.8 percent, substantially lower than the statutory rate of 38.3 percent. Even with this dramatic drop, the United States remains second lowest in both statutory and effective rates relative to the other three competitors.

As is evident from Table 4, the relative gap between United States and foreign tax rates is dramatically changed from the situation involving only statutory rates. Importantly, the range of marginal tax rates is substantially reduced: whereas *statutory* marginal corporate income tax rates for the four countries have a range of 22.5 percentage points, from 34.0 percent to 56.5 percent, the range of *effective* marginal corporate income tax rates is only 11.2 percent, or half the spread for the statutory rates. Germany, which has the highest statutory rate at 56.5 percent, has the lowest effective rate at 10.7 percent. Even though Japan's 50 percent statutory rate drops to a 21.9 percent effective rate, it emerges with the highest effective marginal corporate tax rate of the group.

INTERNATIONAL INVESTMENTS

An attribute of the "real world" methodology for calculating effective marginal tax rates on new investment is that it also can be employed to examine cross-border investments by firms operating in the global economy. The recent OECD study did this by considering direct investment in the manufacturing sector of each OECD member country by multinational firms resident in each other country.

The tax calculations associated with the "real world" method measure the tax on investment by a subsidiary, assuming the actual mix of assets acquired: machinery, structures, and inventory. The calculations also assume that investment by the subsidiary in the source country could be financed by retained earnings of the subsidiary, borrowing from the parent, equity participation by the parent, or some combination of the three. In the two cases where the parent helps provide financing for the investment, funds coming from the parent are, in turn, raised according to the actual mix of debt, new equity, and retained earnings applicable in the parent's country of residence.

The data generated by this "real world" approach permit comparisons of the effective tax rate on purely domestic investment with rates on (a) cross-border investments by U.S. -based multinational enterprises (MNEs) into other countries and (b) cross-border investments by foreign-based MNEs into the United States. The data also permit examination of the impact of income tax treaties on the effective tax rates faced by both outbound U.S. MNEs and inbound foreign MNEs. Two findings resulting from these analyses are noteworthy.

Domestic and International Investments. Results from the study suggest that domestic direct investment in manufacturing generally is taxed more lightly at the margin than either inbound investments by foreign MNEs or outbound foreign investments made by U.S. MNEs. In both the inbound and outbound cases, the effective marginal corporate income tax rate represents the combined net tax of both the resident and source country on the parent and the subsidiary. Because these calculations allow for no "leakage" from inefficiencies in tax administration and collection practices and from legal opportunities for tax reduction in the case of international transactions, they may overstate the actual tax rate differences MNEs face on their cross-border investments in practice.

The Impact of Tax Treaties. Bilateral tax treaties have a very large impact on the effective tax rate results that would apply in their absence. Each of the four countries examined today has a wide network of bilateral income tax treaties, including treaties with one another. As expected, in every case, the treaty produces a sharp reduction in effective marginal corporate income tax rates that would otherwise exist. On average, the overall effective marginal rate of tax on cross-border investments involving the four countries is lowered roughly one-third by bilateral income tax treaties.

CONCLUSIONS

Competitiveness & Economic Performance. Taxes are not the only determinant of competitiveness, however, taxes are increasing in importance as other barriers to international capital flows are being eliminated. Differences in economic performances logged by the United States and the three other countries being discussed at this hearing cannot be explained by differences in tax regimes alone.

- Over a long period of time Japan has outpaced the others in real growth, yet has the fastest rising overall tax burden, the greatest reliance on income taxes and the least reliance on consumption taxes, and has the highest effective corporate income tax rate on direct investment.
- The United States has led in employment gains and also relies heavily on income taxes and lightly on consumption taxes.

State and Local Taxes. Policymakers must not exclude state and local taxes when evaluating tax policies for competitiveness.

- Non-central government taxes count for only 11 percent of the overall tax burden in the United Kingdom but more than one-third in the United States—and U.S. businesses expect those taxes to grow according to a new Coopers & Lybrand survey.
- Because both the mix of tax and the rate of tax differs by level of government, central government tax analysis, used alone, can lead to wrong answers.

Business Taxes & Subsidies. Taxes paid by business—by one measure—are highest in Japan and lowest in the United States. On the other hand, of the four countries examined, U.S. business and industry is the least subsidized by government. Germany is the most subsidized.

Statutory vs. Effective Rates. Statutory corporate tax rates can be particularly misleading as barometers of competitiveness among the countries studied.

- Germany has the highest *statutory* tax rate of 56.5 percent (on retained earnings) but the lowest *effective* marginal tax rate of 10.7 percent.
- The United States has the second lowest (next to the United Kingdom) *statutory* tax rate and the second lowest (next to Germany) *effective* corporate marginal tax rate.

Treaties & Foreign Taxes. Treaties have helped reduce effective marginal tax rates on international investments and have narrowed the range of rates businesses face. Nonetheless, businesses investing abroad still must compete with foreign-based multinationals which pay tax on foreign-source income under sometimes very different rules.

- Expansion of our treaty network as other countries have done would be a positive step, even if that requires abandoning our blanket policy against tax sparing in order for U.S. businesses to compete successfully against others in developing countries.
- A competitiveness litmus test for a U.S. multinational enterprise would compare the taxes it pays on foreign income in country "X" with the taxes that a Japanese, British, or German MNE would pay on foreign income earned in country "X" rather than with the taxes that the U.S. MNE pays on U.S. income.

Table 1
Taxes and Economic Performance in Germany, the United Kingdom, Japan and the United States

Indicator	Germany	United Kingdom	Japan	United States
Taxes as a Percent of GDP, 1989[1]				
All Taxes	38.1%	36.5%	30.6%	30.1%
Percentage Point Change Since 1970	5.1%	-0.4%	10.9%	0.8%
Corporate Income Tax	2.1%	4.5%	7.5%	2.6%
Percentage Point Change Since 1970	0.2%	1.2%	2.3%	-1.2%
Other Business Taxes	7.6%	5.7%	4.5%	6.5%
Percentage Point Change Since 1970	1.6%	1.1%	2.2%	1.4%
Share of Total Tax Revenue, 1989[1]				
Total Business Taxes	25.4%	27.9%	39.1%	30.1%
Corporate Income Tax	5.5%	12.3%	24.4%	8.5%
Other Business Taxes	19.9%	15.6%	14.7%	21.6%
Consumption Taxes	24.5%	29.3%	10.9%	14.2%
Economic Performance				
Average Annual Growth in Real GDP, 1970-90[2]	2.4%	2.2%	4.3%	2.8%
Average Annual Growth in Employment, 1971-1990[3]	0.3%	0.5%	1.1%	2.1%
Average Net National Saving Rate, 1971-1990[4]	11.4%	5.8%	19.9%	5.6%

Coopers & Lybrand
Tax Policy Economics

July 21, 1992

[1] Source: Derived from OECD, *Revenue Statistics of OECD Member Countri· · 1960-1990*. Business taxes refers to taxes paid primarily by business — corporate income tax, prope taxes other than those paid by households, taxes on corporate net wealth, and the employer share of social security taxes.
[2] Source: Derived from OECD, *National Accounts 1960-1990*, Main Aggregates, Volume 1.
[3] Sources: Derived from OECD, *OECD Economic Outlook Historical Statistics 1960-1990* and *OECD Economic Outlook*, 51, June 1992.
[4] Source: Derived from OECD, *National Accounts 1960-1990*, Main Aggregates, Volume 1.

Table 2
Total Business Subsidies and Corporate Income Tax Revenue as a Percent of GDP, 1988

Country	Total Business Subsidies[1]	Corporate Income Taxes[2]
United States	0.6%	2.5%
Japan	0.9	7.5
United Kingdom	1.3	4.0
Germany	2.3	2.0

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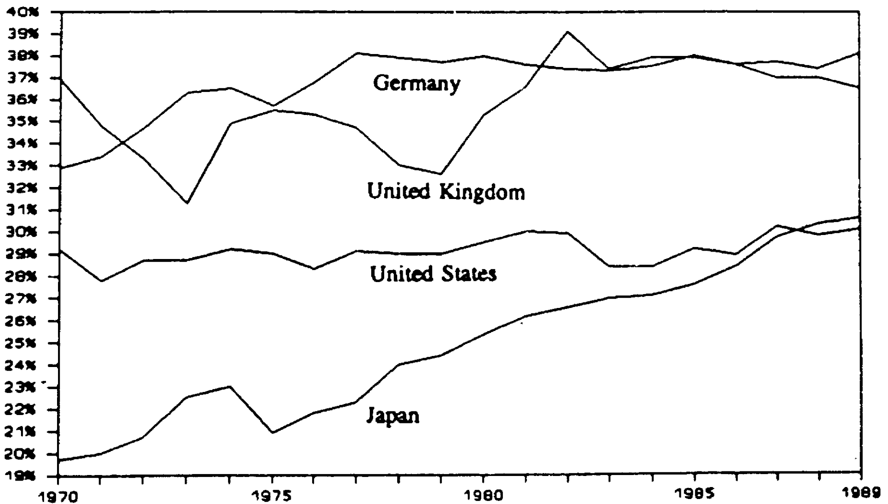
Tax Policy Economics

July 21, 1992

[1] Source: OECD, *OECD Economic Studies*, Autumn 1990, Table 2, p. 43.
[2] Source: OECD, *Revenue Statistics of OECD Member Countries 1965-1990*, Table 12, p. 78.

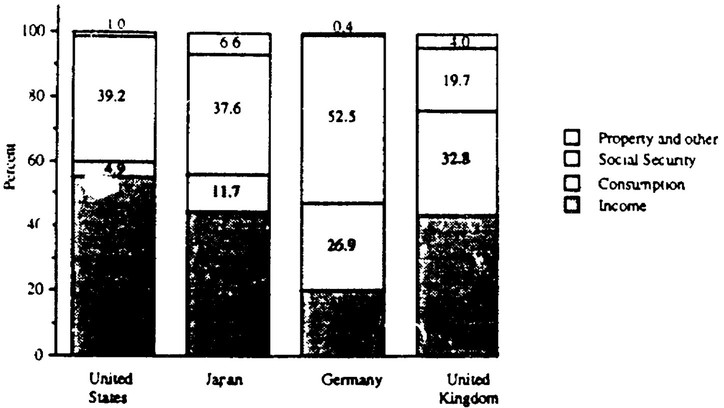
Figure 1
Total Tax Revenue as a Percent of GDP



Source: OECD, *Revenue Statistics of OECD Member Countries 1965-1990*, Table 3, p. 73.

Figure 2

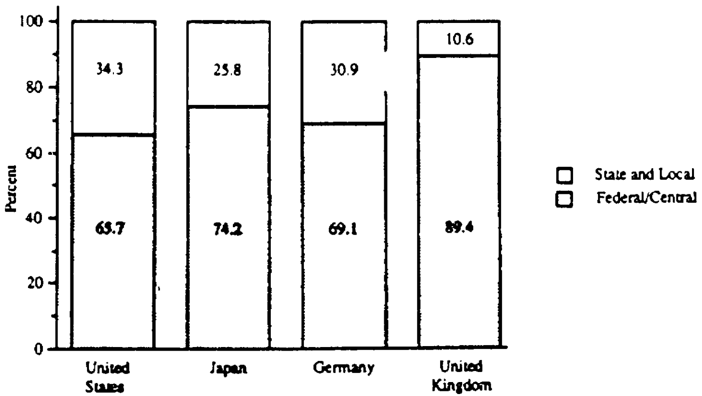
Central Government Tax Revenue Sources, 1989



Source: Derived from OECD, *Revenue Statistics of OECD Member Countries 1965-1990.*

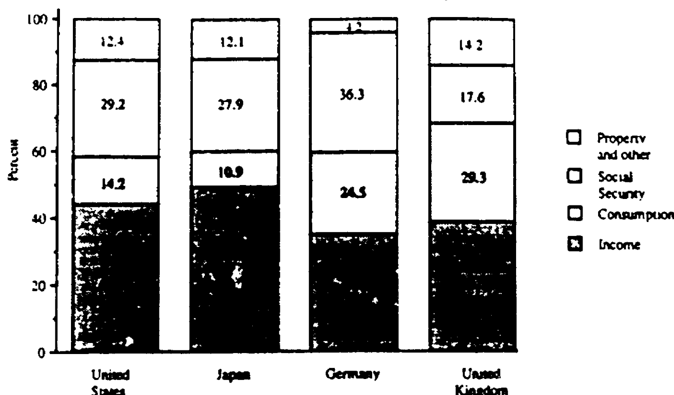
Figure 3

Share of Total Tax Revenue by Level of Government, 1989



Source: Derived from OECD, *Revenue Statistics of OECD Member Countries 1965-1990.*

Figure 4
Sources of Tax Revenue
All Levels of Government Combined, 1989



Source: Derived from OECD, *Revenue Statistics of OECD Member Countries 1965-1990.*

Table 3
Taxes Related to Business Activities
as a Percent of GDP

Country	1970	1975	1980	1985	1989
Japan	7.5%	7.5%	9.4%	10.1%	12.0%
United Kingdom	8.0	8.5	8.5	10.5	10.2
Germany	7.9	8.9	9.8	10.1	9.7
United States	8.8	9.2	9.1	8.6	9.1

Coopers & Lybrand
Tax Policy Economics

July 21, 1992

Source: OECD, *Revenue Statistics of OECD Member Countries 1965-1990*, Tables 36, 45, 50, 60, and 61, pp. 90, 111-113, 124-126, 147-151. Business taxes refers to taxes paid primarily by business — corporate income tax, property taxes other than those paid by households, taxes on corporate net wealth, and the employer share of social security taxes.

Table 4
Statutory and Effective
Corporate Income Tax Rates, 1991

Country	Statutory Tax Rates[1]	Effective Tax Rates[2]
Germany	56.5%	10.7%
Japan	50.0	21.9
United States	38.3	13.8
United Kingdom	34.0	15.3

Coopers & Lybrand
Tax Policy Economics

July 21, 1992

[1] Source: OECD, *Taxing Profits in a Global Economy*, Table 3.14, p. 71.
[2] Derived from OECD, *Taxing Profits in a Global Economy*, Tables 4.3 and 4.4, pp. 99-100. Assumes no personal taxes, average OECD member country inflation of 4.5 percent, and average OECD member country assets and financing weights.

COMMUNICATIONS

The Committee on Finance of the United States Senate

Hearing
on

The Competitiveness of the U.S. Tax System

Testimony

on behalf of

The Independent Petroleum Association of America

The Domestic Petroleum Council

The National Stripper Well Association

The California Independent Petroleum Association

The Rocky Mountain Oil and Gas Association

The Permian Basin Petroleum Association

The Texas Independent Producers and Royalty Owners Association

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The Oklahoma Independent Petroleum Association

The Independent Petroleum Association of New Mexico

The New Mexico Oil and Gas Association

The Louisiana Association of Independent Producers and Royalty Owners

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The Illinois Oil and Gas Association

The North Texas Oil and Gas Association

West Central Texas Oil and Gas Association

The Kansas Independent Oil and Gas Association

The Energy Consumers and Producers Association

Submitted
by
Craig G. Goodman

The Committee on Finance of the United States Senate

Hearing on The Competitiveness of the U.S. Tax System

May 12, 1992

Mr. Chairman, members of the Committee, my name is Craig Goodman, and I am pleased to submit this testimony on behalf of the numerous organizations listed on the front cover of this testimony. These organizations collectively represent the vast majority of independent oil and gas producers, large or small, operating in the United States today. Because of the unique significance of crude oil both to the U.S. and world economies, we believe our comments on the competitiveness of the U.S. tax and fiscal system are important to the long-term economic well-being of the United States as well as to its competitive position in the global economy.

New research[1] indicates that over the last three decades, the U.S. tax code has been reformed in a manner that produces numerous regressive and anti-competitive impacts. The most onerous impacts occur because of the conflicting structure of the regular and the alternative tax systems and because of overly complicated and restrictive capital and non-capital investment cost-recovery provisions. Additional anti-competitive impacts have been created by higher taxes on capital and income from capital, artificial allocation rules, foreign and domestic "ring-fence" and exploration-loss-recapture rules, and rules which effectively bar cost recoveries or tax certain income twice. Each of these structural impacts increases both the costs and risks for U.S.-based taxpayers to do business anywhere in the world. Importantly, no country in the world penalizes new investment capital - - except the United States!

The majority of those represented by this testimony do business solely or primarily in the United States, many by patriotic preference, some by operational necessity. Yet, the cumulative effects of the changes to the U.S. tax code since the inception of tax reform have become so onerous that the statistically average U.S. geological prospect is no longer a competitive use of capital for a majority of U.S.-based producers. In essence, the U.S. tax code is encouraging the depletion of America's resource base and is placing U.S.-based producers at severe competitive disadvantages, both domestically and internationally.

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[1] **Impacts of U.S. tax reform on investments in depletable assets:** *The Microeconomic Impact of the U S Tax System on Domestic Petroleum Extraction, A Quantitative Analysis of the Post-Tax Reform System of Take in the United States*, Goodman, Gordon and Youngblood, 1990. *The Impact of the Omnibus Budget Reconciliation Act of 1990 on Investments in Domestic Petroleum Extraction*, C. Goodman, 1991; **Impacts of U.S. tax reform on investments in depreciable assets:** *Economic Report of the President*, January 1989 (Washington, D.C.: U.S. Government Printing Office), p.92; *An Analysis of the Alternative Minimum Tax: Equity, Efficiency, and Incentive Effects*, A. Lyon, 1991; *AMT Depreciation How Bad is Bad*, Arthur Andersen, 1991; *Approaches to Efficient Capital Taxation Leveling the Playing Field vs Living by the Golden Rule*, Goulder and Thalmann, National Bureau of Economic Research Working Paper #3559 December 1990; *Tax Neutrality and Intangible Capital*, Fullerton and Lyon, National Bureau of Economic Research Working Paper #2430, November 1987.

Tax Reform and U.S. Capital Depletion Policy

Over the last twenty years, political concerns about equity and efficiency have motivated a "reform" of the U.S. system of income taxation. This reform has come primarily in the form of slower cost recoveries in the regular tax code and the creation of a new form of taxation called the alternative minimum tax (AMT). Contrary to traditional principles of income taxation, at the margin, the incidence of this new tax falls directly on capital itself rather than on the income generated from that capital. Consequently, the various tax reform acts between 1969 and 1986 have increased substantially the economic impact of U.S. income taxation on virtually all U.S. investments.

However, no industry is more negatively affected by these tax policies than the U.S. petroleum industry, especially those taxpayers whose income is derived primarily from domestic wellhead revenues - - America's independent producers. Virtually every major expenditure that keeps a U.S. petroleum firm from liquidation is now subject to alternative minimum taxation. These new tax policies were enacted in response to events that occurred in the early 1970s.

As a penalty for the foreign embargoes and price spikes of the 1970s, time-honored rules allowing recovery of sufficient funds to replace depleting reserves were eliminated for more than 70% of all U.S. oil and natural gas production. Remaining cost recoveries were also drastically restricted. Provisions enacted as part of the Tax Reform Act of 1986 (TRA) virtually repeal traditional drilling cost recoveries (IDC [illegible]ensing) and reverse many other historical tax policies intended to maintain, enhance or replace domestic production and reserves. Today, significantly less than 30% of U.S. petroleum production qualifies for less than one-half of the traditional allowance for capital depletion, if and only if multiple limitations are met.

Modern U.S. capital depletion and investment recovery policies have virtually ignored the collapse of the post-tax-reform markets for crude oil and natural gas[2]. These policies also undermine recent "clean air" legislation which is intended to promote new environmental investments[3] and to encourage greater utilization of abundant U.S. natural gas reserves.

New research on the AMT also suggests that it is somewhat disingenuous to call this new form of taxation a "minimum tax". On the margin, the impact of the AMT is more in the nature of a "maximum tax" or a "tax penalty" than a "minimum tax".

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[2] The Budget Reconciliation Act of 1990 did recognize and reverse slightly the long-term negative trend in U.S. capital depletion policy; however, it did not neutralize the severe competitive disadvantages of the AMT on the majority of U.S.-based producers. See *The Impact of the Omnibus Budget Reconcili[illegible] Act of 1990 on Investments in Domestic Petroleum Extraction*, supra note 1.

[3] See *Counterproductive Economic Policy: The Regular and Alternative Minimum Tax Treatment of Pollution Control Equipment*, J. McCallum, (Washington, D.C.: American Council for Capital Formation Center for Policy Research, April 1991).

U.S. taxpayers must always pay the higher of either regular tax liability or AMT liability in any given year. To avoid being labeled a "direct tax on capital", thereby passing constitutional muster, a credit for AMT payments is provided to those taxpayers that pay regular income taxes in the future.

However, the majority of U.S. oil and gas producers are currently AMT taxpayers. Moreover, producers that attempt to avoid liquidation by drilling to replace depleting reserves are likely to remain subject to the the AMT in the future. Consequently, these producers never fully recover the capital they must invest to continue operating because AMT credits are not available to them. Those lucky enough to use AMT credits still never fully recover their investment capital after the time-value of money is considered.

The current U.S. definition of "taxable income", which now includes drilling costs and asset depletion, represents a major departure from the historical structure of the U.S. system of income taxation as well as from its constitutional underpinnings.[4] In the U.S. today, a long-term AMT producer is no longer guaranteed a return of, much less a return on, new drilling capital.[5]

We submit that the United States no longer can afford flawed capital depletion and investment recovery policies. New estimates of the federal tax revenues lost by these policies exceed $1.1 trillion[6]. Moreover, the failure to provide timely and adequate cost recoveries places U.S.-based independent producers at a severe competitive disadvantage domestically, and places U.S.-based multinationals at a severe competitive disadvantage internationally.[7]

New capital depletion and investment recovery policies must allow U.S.-based taxpayers to earn competitive, risk-weighted, after-tax returns of and on both depletable and depreciable capital. The evidence presented in this testimony demonstrates persuasively that such policies will increase U.S. economic activity, employment, income tax collections, U.S. social wealth, and improve our trade balances. We also believe that our testimony provides strong evidence that continuation of current capital depletion and recovery policies will only further erode U.S. economic strength, U.S. world-market share, U.S. petroleum production and the standard of living for all Americans. America's independent petroleum producers urge this Committee to revise U.S. tax policies consistent with the recommendations included at the end of this testimony.

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[4] See *U.S. Petroleum Income Taxation: 1890-1990*. Oil and Gas Tax Quarterly, vol. xxxix, (Dec. 1990).

[5] *Ibid.*, at p. 306, *et seq.*

[6] See Goulder and Thalmann, *supra* note 1.

[7] **For international comparisons.** See *Taxation Effects on the Competitiveness of U.S. Oil and Gas Investments: Promoting Stability in the 1990's*, Flaim, Gordon and Hemphill, 1989; *U.S. International Tax Policy for a Global Economy*, Price Waterhouse, 1991; *The International Competitiveness of the U.S. Petroleum Licensing System*, R. Gordon, 1988; *U.S. and Canadian Tax and Fiscal Treatment of Oil and Gas Production*, C. Goodman, Working Paper, U.S. Department of Energy, May 1989; GAO/GGD-90-75, July 1990, at pages 97-110; *See also* testimony of The American Petroleum Institute, July 17, 1991. **For domestic comparisons,** *see supra* notes 1, 3 and 4.

The primary focus of this testimony is the competitive disadvantages imposed by the U.S. tax and fiscal (take) system on U.S.-based taxpayers that compete against other U.S. or foreign-based taxpayers operating within the United States. Many of the anti-competitive impacts of the U.S. take system occur because its structure imposes an economic burden on the capital invested to find new oil and natural gas reserves as well as on the revenues generated from the sale of these assets.

By increasing tax liability "up-front", before income is generated, investment capital and its time-value are lost to higher taxes. Consequently, both the cost of capital and the amount of risk sustained by U.S.-based taxpayers are higher. At current price levels, average field sizes, and well depths, the resulting financial burdens imposed on the majority of U.S.-based producers exceed 100% of the total expected social worth[8] of new oil and gas investments.

Since the OPEC-controlled price collapse of 1986, virtually every major non-OPEC producer of crude oil other than the United States has reduced the economic impact of their take systems on new petroleum investments.[9] Failure of U.S. policies to incorporate the post-tax-reform realities of the world petroleum markets has placed U.S.-based producers at a severe competitive disadvantage both domestically and internationally.

Most of the anti-competitive impacts of the U.S. take system occur because:

(1) a U.S.-based taxpayer is subject to both regular and alternative minimum taxes while its U.S. competitor is subject only to regular taxes;

(2) a U.S. taxpayer is subject to both regular and alternative minimum taxes while its foreign-based competitor is only partially subject to U.S. regular taxation; or

(3) a U.S.-based taxpayer is fully subject to the regular U.S. tax system while its foreign-based competitor is only partially subject to the U.S. tax system.

The anti-competitive impacts demonstrated in the following charts apply to the vast majority of the domestic petroleum industry. As mentioned, a majority of U.S.-based oil and natural gas producers pay both regular and alternative

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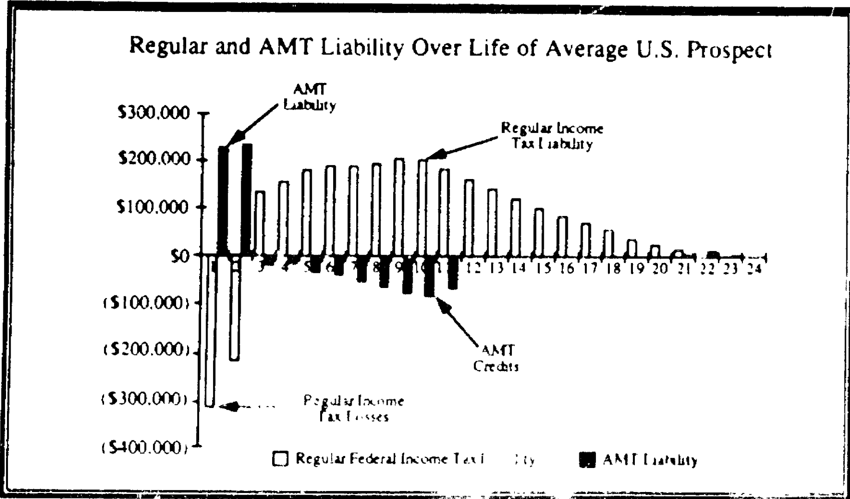
[8] "Social worth" which is synonymous with "social wealth", is the value of crude oil or natural gas produced minus the costs of finding it, producing it and getting it to market. In economic terms it is the actual wealth added or the net revenues generated by an investment, before multiplier effects. Total claims or financial burdens are the sum of all payments by the taxpayer to landowners, state and federal governments. The charts in this testimony do not include payments for state and local income and property taxes or indirect overhead expenses. Policies that take more than the social worth of an investment render that investment unprofitable, and discourage substantial wealth creation.

[9] *See generally* note 7 *supra*

minimum taxes, yet compete against other U.S. taxpayers paying only regular income taxes or foreign-based taxpayers only partially subject to regular U.S. income taxation.[10] The following chart demonstrates the difference in the timing of income tax liability between the regular U.S. system and the alternative U.S. system.



This chart shows both the regular income tax liability and the added burden of the AMT on the statistically average U.S. geological prospect. As can be seen AMT liability occurs during the first two years because the taxpayer is investing money in new drilling over this period. For regular tax purposes, drilling costs are treated as an expense. For AMT purposes, however, a substantial portion of these investment dollars are treated as "taxable income".

As is also shown, it takes an AMT taxpayer approximately 11 years to recover the "up-front" AMT tax that results from a new drilling investment. Contrary to the intent of the law, recovery of the "up-front" AMT payment is not guaranteed. Only if the taxpayer eventually becomes profitable enough to pay regular taxes is a credit provided to recover the "up-front" AMT tax on drilling capital.[11] *Under this structure the taxpayer lends the government money, interest free by paying taxes before income is earned, and gets paid back only if he is sufficiently profitable.* Experience has shown that for many independents, the AMT credits are not available or are unusable, and the AMT thus becomes a direct tax on the capital invested to maintain and replace America's depleting oil and gas reserves.

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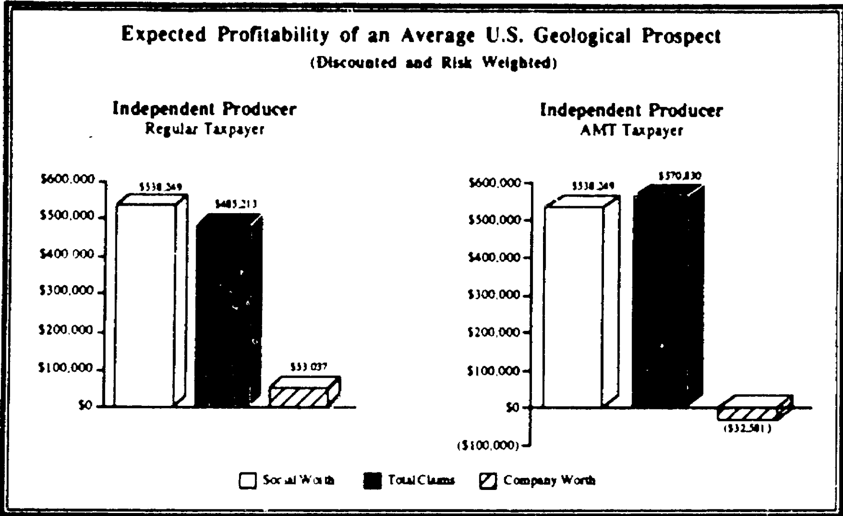
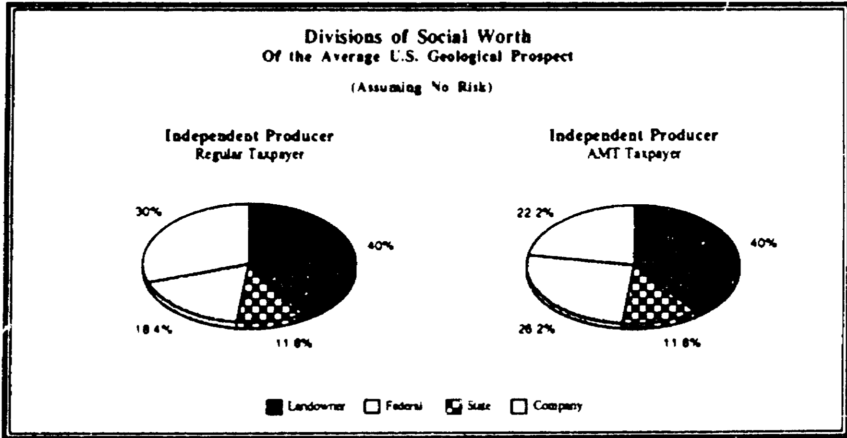
[10] For anti-competitive impacts of the U.S. take system on non-petroleum firms *see* notes 1, and 3, *supra*. For anti-competitive effects of the U.S. take system on petroleum firms *see* notes 1, 4 and 7, *supra*. *See also* testimony of The American Council for Capital Formation, June 6, 1991, and the testimony of The American Petroleum Institute, July 17, 1991.

[11] The statistically average U.S. geological prospect operated by a U.S.-based independent producer switches from AMT to regular tax-paying status in year three of the project assuming the taxpayer stops drilling.

Today, a regular taxpayer exploring for crude oil in the United States can expect a profit in an amount that is almost identical to the expected loss of a competing AMT taxpayer on the exact same investment. Shown below is a side-by-side comparison of the expected after-tax economics of an identical investment made by an AMT taxpayer and a regular taxpayer.

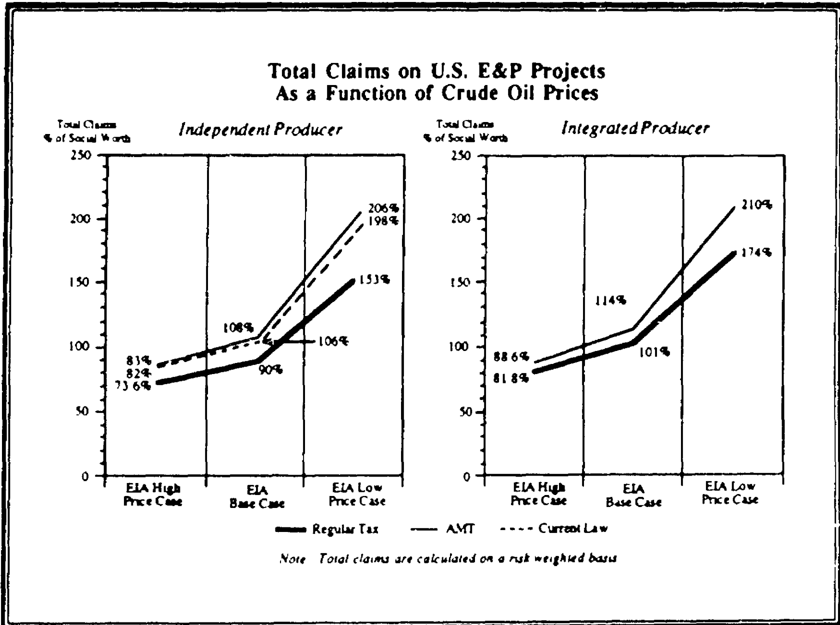


The revenues generated by this investment, if undertaken, would be divided in the manner shown in the following pie chart. As shown, when a taxpayer moves from a regular tax position to an AMT position, this investment is rendered unprofitable because the federal government's share of the net revenues generated from the investment increases over forty percent, from 18% to 26%.



Principles of tax neutrality require that the underlying economics of a project not be affected differentially by the tax code, however, both the bar and pie charts show that different taxpayers are treated very differently. Under current U.S. capital depletion and investment recovery policies, after-tax economics do not approach similarity until investments become far more profitable. In essence, on the margin, our tax system allows more-profitable taxpayers to make higher after-tax returns than less-profitable competitors, on the exact same investment.

The following chart shows that as crude oil prices decline, the percentage of the net revenues taken by the U.S. tax and fiscal system increases dramatically for every type of U.S. producer. The chart also shows that at any given price level, the after-tax return to an AMT taxpayer will always be lower than the return to a regular taxpayer, on the exact same investment. Consequently, U.S.-based taxpayers subject to the AMT cannot make a competitive rate of return on the statistically average U.S. geological prospect.



It should also be noted that AMT capital depletion and investment recovery policies have the same regressive economic impact when either revenues or profitability decline and as the costs of production increase.[12]

[12] For the regressive impacts as a function of total revenues and profitability. See *The Impact of Corporate Minimum Taxation on U.S. Petroleum Extraction*, C. Goodman, (Washington, D.C.: American Council for Capital Formation Center for Policy Research, April 1991).

These tax policies have also contributed to a marked decline in U.S. crude oil production. Since the Tax Reform Act of 1986, crude oil production in the United States has declined over 1.7 million barrels per day, despite interim price increases of more than 100 percent. Exploration and development in the United States, measured by the drilling rig count, footage drilled, reserves replaced, and seismic crew activity, remain near record lows.

This lost production alone equates to a measurable loss in wealth to U.S. society, before multiplier effects, of $160 billion to $250 billion[13], a loss in Federal and State revenues of more than $50 billion, plus hundreds of billions of dollars in S&L-related losses, trade deficits, increased military spending and economic multiplier effects. At $20 a barrel, the United States spends $60 billion dollars annually on imported crude oil. By 1995, the U.S. is projected to export over $100 billion a year in sorely needed capital just for this one vital commodity. Moreover, when the wealth effects derived from investments in depreciable assets are also considered, the negative impacts on the economy, the U.S. cost of capital and federal tax collections are stunning.[14]

International Impacts
of
U.S. Capital Depletion Policy

No other single commodity contributes as much to the wealth of nations as crude oil. According to a pre-tax-reform Joint Tax Committee survey, the U.S. petroleum industry as a group pays more taxes to both the U.S. and world governments than any other industry sampled: over [illegible] times more than the next highest taxpaying industry domestically, and over three times more than the next highest taxpaying industry worldwide.[15]

Historically, the sheer economic power of the United States has motivated other countries to model their tax codes around ours. In the last three decades, however, America's status in the world economy has declined dramatically. After decades of being the world's largest lender of capital, the United States is now the world's largest debtor nation. Over the last five years alone, the U.S. has been forced to borrow over $100 billion annually from abroad[16] just to finance its trade deficit, much of it related to the importation of crude oil.

During the evolution of U.S. tax reform, the United States has gone from an unparalleled economic superpower with a 40% share of the world's total production, to one of several regional economic powers fiercely competing for market share.

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13 See *The Microeconomic Impact of the U.S. Tax System on Domestic Petroleum Extraction, A Quantitative Analysis of the Post-Tax Reform System of Take in the United States*, supra note 1.
14 *See generally* notes 1 and 6 *supra*.
15 Industry samples of 1983 taxes paid attached. *See also* Joint Committee Print JSC-40-84, Nov. 28, 1984.
16 See *U.S. International Tax Policy for a Global Economy*, Price Waterhouse, 1991.

In the process, the U.S. has also lost more than 28% of its global-market share. During the same time, the U.S. share of the world's total direct investment has declined 38% while foreign direct investment in the United States has increased thirty-fold (3000%).

New research[17] concludes that both the recent slow-down in U.S. economic growth and the erosion of America's competitive position in world commerce can be related directly to the lack of neutrality and the long-term neglect of U.S. capital depletion and investment recovery policies which culminated in the Tax Reform Act of 1986. This Act increased taxes on both capital and income from capital, severely inhibited cost recoveries, created numerous inefficiencies from its lack of neutrality, and caused a substantial increase in the U.S. cost of capital. It is estimated that the federal government has lost more than $1.1 trillion in present value tax receipts over what would have been collected if the Tax Reform Act of 1986 had never passed.[18]

Over the same period, the U.S. foreign tax code has also severely limited the ability of U.S.-based firms to recover the costs of new capital investments both at home and abroad.[19] While the coalition represented by this testimony is concerned primarily with the anti-competitive impacts of capital depletion policies on U.S. investments, these same flawed policies are causing anti-competitive impacts internationally.

When the U.S. petroleum take system is compared to foreign systems, identical extraction investments earn higher after-tax returns elsewhere.[20] Recent comparative studies of the U.S. take system demonstrate remarkable anti-competitive impacts.[21] At virtually every level of geological risk and at any level of crude oil prices, an oil and gas investment in the United Kingdom will yield its investor a higher after-tax return than a similar investment would in the United States, solely because of the structure and operation of the U.S. take system.[22] A recent study completed under contract with the Argonne National Laboratories concluded that:

> *When compared to foreign systems, the U.S. system now in effect does not equitably share risk, favors large projects (which the U.S. has fewest of) is quite regressive over a wide range of price and cost assumptions and is inflexible, i.e. incapable of*

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[17] *See generally* note 1 *supra.*

[18] Goulder and Thalmann, National Bureau of Economic Research Working Paper #3559, *supra.*

[19] *U.S. International Tax Policy for a Global Economy, supra* note 15.

[20] See: *Taxation Effects on the Competitiveness of U.S. Oil and Gas Investments: Promoting Stability in the 1990's,* Flaim, Gordon and Hemphill, 1989.

[21] *Ibid.* See also *The International Competitiveness of the U.S. Petroleum Licensing System,* and *U.S. and Canadian Tax and Fiscal Treatment of Oil and Gas Production,* Working Paper, U.S. Department of Energy, *supra.*

[22] *Ibid.*

> *automatically adjusting to changes in world oil markets. These conditions favor a flight of drilling capital abroad and are reflected by a radical downturn in domestic drilling activity, 75% fewer rigs operating in 1988 than in 1981.*[23]

Similar results were found in Canada after the OPEC price collapse. Immediately after the collapse, Canada provided cash grants for new drilling expenses, implemented tax and royalty holidays and numerous other take reductions to avoid damage to its natural resource base. Now, Canadian gas is flowing into the United States, putting U.S. producers at a double competitive disadvantage, one because of transportation rate disparities,[24] the other because of take disparities. With current concerns about competitiveness, clean air and the U.S. standard of living, we can no longer afford flawed capital depletion and investment recovery policies.

Recommendations to Improve the Competitiveness of the U.S. Tax System

Competition comes in many forms and forums. The competitiveness of a tax and fiscal system, however, is measured by its impact on the after-tax rate of return on capital invested domestically or internationally by businesses headquartered within its boundaries. Capital is a scarce resource that theoretically has no national boundaries and pledges its allegiance solely to a risk-weighted, after-tax rate of return.

As demonstrated by the charts on pages 5-7, rates of return are greatly affected by the economic burdens[25] governments impose on capital and the income generated from capital. On the margin, after the underlying economics of an investment are computed, government take policies will basically determine whether capital is competitively employed.

In Theory

In my personal opinion, eliminating completely the anti-competitive impacts of the U.S. tax code on both domestic and international investments, would require a significant restructuring of U.S. corporate income taxation. Essentially, it would

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[23] Flaim, Gordon and Hemphill, *supra* note 20.

[24] See *Statement of George Yates For The IPAA Before the House Subcommittee on Energy and Power Regarding Natural Gas Legislation on S 341, H R 779, H.R 1301 and H.R.1543*, June 5, 1991.

[25] There are many types of financial and non-financial economic burdens that are placed on new investments. Generally, these burdens take the form of taxes, levies, fees and royalties (take). However, non-financial economic burdens such as regulatory restrictions, barriers to market entry, and environmental restrictions also affect rates of return. Legislative and regulatory uncertainty, risk of appropriation, relative standards of living and the quality and education of available labor markets also enter into the equation. However, the scope of this testimony is limited to the competitiveness of the U.S. tax and fiscal system.

require a uniform/low-rate tax structure that allows immediate and complete cost recoveries without a distinction between expenditures for labor or capital and without a distinction between debt or equity sources of funds.

Such a tax structure would essentially eliminate the conflicting regular/AMT structure of current law and reduce the time it takes a U.S.-based taxpayer to recover new investments anywhere in the world. Since tax revenues from new investments would take several years to recover from the switchover, new, easily-identified, non-regressive, consumption-based taxes could be earmarked both to reduce the current deficit and to reduce and eventually eliminate the national debt before being phased-out. These measures would return both equity and efficiency to the U.S. system of capital and capital-income taxation. These measures would also increase the U.S. savings rate, and reduce the U.S. cost of capital.

In Practice

Within the next few years, the sheer magnitude of the losses in both social wealth and global-market share will likely force a revision in U.S. tax laws. Given recent political developments, these measures may not be as far off as originally thought. Given also the enormous wealth effects that inure to the benefit of U.S. society, however, it is realistic to consider revising the U.S. tax code to at least improve the competitiveness of investments within the United States and to improve conditions for U.S. companies that also must compete in the global marketplace.

Revising U.S. capital depletion and investment recovery policies, particularly those embedded in the AMT, is a realistic, extremely low-cost, high-yield policy option. The federal government can improve expected economics of new U.S. investments at virtually no "real" cost. Since the AMT imposes tax liability before income is generated, a change that shifts the tax burden back to the income and off of the investment doesn't actually lower the total taxes that would be paid over the life of the project, it merely collects the tax when it's due, not "up-front". By moving the tax from the investment capital to the project's income, the project becomes marginally profitable, thereby yielding disproportionately greater increments of wealth to U.S. society.[26]

Consequently, the most important tax policy recommendation of the U.S.-based independent petroleum industry is to eliminate the existing AMT tax penalties on drilling costs and asset depletion contained in Sections 56 and 57 of the Internal Revenue Code.

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[26] If U.S. tax policy renders the statistically average U.S. geological prospect marginally economic to an AMT taxpayer (75% of the domestic industry), the prospect would generate over $12.5 million in "actual" new wealth to U.S. society, of which $2.5 million would go to the federal treasury, and $1 million would go to the state treasury. Yet, this does not occur because the investor faces an expected loss solely because of the impact of the AMT. *See also* notes 1, 4, and 12, *supra*.

The following measures are also strongly recommended:

1. Shorten the recovery periods for new investments in depletable and depreciable assets for both regular and AMT taxpayers, and repeal artificial limitations on the use of percentage depletion.

2. Repeal the artificial exclusion of oil and natural gas exploration expenses from the existing research and experimentation credit, and reinstate an investment tax credit for selected energy and environmental investments.

3. Equalize the treatment of new and existing tax credits between the regular and AMT systems, and allow AMT credits to be used against any subsequent tax liability.

These measures, coupled with accelerated depletion allowances for "stripper" production and enhanced oil recovery investments, would allow investments made to properly manage our domestic resource base to be a competitive use of capital for a majority of U.S.-based producers. By overcoming past failures to foster competitive capital depletion policies, these measures would reduce existing competitive disadvantages for U.S.-based taxpayers that compete either in the United States or abroad. These recommendations will also increase U.S. economic activity and employment, lower budget and trade deficits, and increase U.S. social wealth.

Conclusion

In order for petroleum extraction firms to replenish their capital structure and in order for America to replenish its petroleum resource base, investments to maintain, enhance and replace America's depleting capital must be competitive with other investments. Taxing capital, and raising taxes as prices and profits fall is clearly contrary to the basic precepts of U.S. income tax policy. However, virtually every major expenditure that is now made to prevent the liquidation of U.S. oil and natural gas reserves is considered a "preference item" for which a tax penalty is incurred.

Unless U.S. capital depletion and investment recovery policies change to reflect the risks and realities of the modern crude oil market, the proven crude oil reserve base of the United States will continue its gradual liquidation. The U.S. independent petroleum industry urges Congress to remove the existing barriers to timely and adequate cost recoveries for investments to maximize America's depleting resource base. We submit that benefits from revising these antiquated policies to both U.S. society as well as to federal and state treasuries are quite significant and far exceed their costs.

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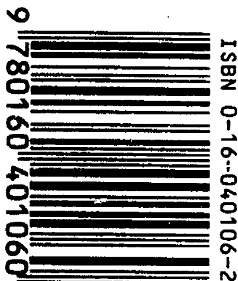

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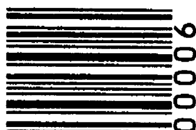

Global Income Taxes Paid by Industries Sampled in 1983

(Thousands of Dollars)

	U.S. income before tax	Foreign income before tax	Worldwide income before tax	Current U.S. tax expense	Current foreign tax expense	Current worldwide tax expense
Aerospace	3,287,418	373,107	3,660,525	459,337	201,611	660,948
Beverages	1,688,161	577,327	2,265,488	316,120	301,673	617,793
Broadcasting	1,081,109	209,552	1,290,661	199,818	79,957	279,775
Chemicals	1,164,100	3,416,300	4,580,400	(11,100)	2,433,900	2,422,800
Computers and office equipment	***6,842,475***	***4,972,408***	***11,814,883***	***1,796,917***	***2,702,044***	***4,498,961***
Construction	59,386	195,035	254,421	429	74,134	74,563
Electronics and appliance	**3,952,658**	**1,482,062**	**5,434,720**	**290,863**	**598,646**	**889,509**
Financial institutions	2,862,830	3,460,057	6,322,887	182,040	1,354,023	1,536,063
Food processors	3,810,004	1,309,634	5,119,638	987,286	511,118	1,498,404
Glass and concrete	605,401	180,435	785,836	105,754	85,754	191,[illegible]79
Instruments	2,256,478	659,639	2,916,117	739,600	330,291	1,069,891
Insurance	1,755,975	48,800	1,804,775	174,398	58,491	232,889
Investment companies	979,855	680,650	1,660,505	91,478	137,383	228,861
Metal manufacturing	(1,341,203)	16,600	(1,324,603)	25,396	40,300	65,696
Metal products	286,113	318,686	604,799	43,296	133,960	177,256
Mining	(485,812)	145,328	(340,484)	(18,861)	70,961	52,100
Motor vehicles	**5,759,186**	**1,281,402**	**7,040,588**	**202,308**	**527,330**	**729,638**
Paper and wood products	759,318	118,263	877,581	(3,846)	66,917	63,071
Petroleum	***19,255,863***	***22,171,133***	***41,426,996***	***4,094,087***	***13,303,397***	***17,397,484***
Pharmaceuticals	2,301,842	1,549,400	3,851,242	626,033	608,331	1,234,364
Retailing	**5,067,076**	**288,367**	**5,355,443**	**1,015,447**	**125,630**	**1,141,077**
Rubber	618,089	283,821	901,910	121,366	194,260	315,626
Soaps and cosmetics	2,027,044	513,380	2,540,424	720,699	266,857	987,556
Telecommunications	**11,072,260**	**127,117**	**11,199,377**	**530,913**	**96,978**	**627,891**
Tobacco	3,083,254	539,760	3,623,014	1,041,548	150,751	1,192,299
Transportation						
Airlines	(272,024)	169,123	(102,901)	(58,828)	4,464	(54,364)
Railroads	**2,164,765**		**2,164,765**	**71,899**		**71,899**
Trucking	1,283,557	7,824	1,291,381	442,768	4,278	447,046
Utilities (electric and gas)	**7,158,433**		**7,158,433**	**505,298**		**505,298**
Wholesalers	947,776	9,200	956,976	329,472	13,806	343,278
Average, All Companies	90,031,387	45,104,410	135,135,797	15,021,935	24,477,216	39,499,151

Source: Joint Committee Print JSC-40 84, Nov. 28, 1984