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TAX FEATURES

www.taxfoundation.org June/July 2000 Volume 44, Number 6

Foster to Leave Tax Foundation for Staff of Rep. Phil Crane

J.D. Foster, Ph.D., executive director and chief economist of the Tax Foundation since 1993, has announced his departure for the staff of Rep. Phil Crane (R-IL). Foster will be legislative director and economic counsel to Rep. Crane, who is currently the second-ranking Republican on the House Ways and Means Committee, and chairman of its subcommittee on trade.

Foster's tenure at the Tax Foundation was marked by an expanded publications program. The Foundation's series of short reports on public finance, *Tax Foundation Special Report*, is now published ten times a year, and longer research papers are now published six times a year as *Tax Foundation Background Papers*. Two series begun by Foster are the *Tax Foundation Special Brief*, often featuring the text of testimony given before congressional committees, and *Extra Point*, a series of his short commentaries.

Under Foster's direction, Tax Foundation publications often featured research into fundamental tax reform, especially Social Security reform, excise tax reform, and international tax policy. On Social Security, several Tax Foundation reports addressed the program's long-term solvency problems, quantifying the declining returns that Social Security is providing to the nation's retirees.

On excise taxes, Foster and staff economist Scott Moody co-authored a proposal that federal excise tax reform would be an excellent complement to overall tax reform, especially as a way to ease the tax burden on the poor. A series of economic studies on individual excise taxes expanded on this theme.

J.D. Foster, Ph.D., seen here testifying before the House Ways & Means Committee in April, will join the staff of Rep. Phil Crane.

Foster wrote especially often on international tax issues, and greatly expanded the Foundation's international tax program. He led several delegations of congressional aides to Europe and Asia, and this year he included a trip to Latin America. His writings in international tax policy and economics have ranged from theoretical considerations of international capital flows to short commentaries on topical subjects like Subchapter F and the hot topic of the day, the Foreign Sales Corporation — the subject of his last Foundation message in this issue.

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The Estate Tax: Past, Present and Uncertain Future

Congress Votes to Bury the Estate Tax; President Promises Veto

The estate tax collected $28 billion in 1999, targeting the top two percent of estates and motivating sizable increases in charitable giving. Stated thus, it would not seem a likely candidate for repeal, but recent House and Senate action has brought the long controversial tax closer to the brink than it has been in over 70 years.

H.R. 8, the Death Tax Elimination Act, targets not only the estate tax, but also the gift tax and the generation skipping tax (GST). These three taxes comprise the unified transfer tax system. The federal transfer tax is unique in our tax system in that it is a tax on wealth.

As J.D. Foster explained in testimony before the House Ways and Means Committee in 1995, "The estate tax is not a tax on income, though it can influence the incentives to earn income; it is not a tax on consumption, though it can influence consumption; nor is it a tax on a particular activity. It is a tax on the net economic product of an individual after all other economic activity has concluded."[1]

In addition to taxing the wealth that decedents leave behind, the estate tax includes wealth transfers: wealth given from one living person to another (amounts over $10,000 are subject to the gift tax), and transfers to grandchildren or more distant descendants, which are subject to the GST.

The History of Transfer Taxes

For the first 119 years following their inception, transfer taxes were used only sporadically, in times of national emergency. They were levied on the wealthy, who were expected to make special sacrifices in times of crisis. The Stamp Act of 1797 marked the estate tax's first use: It was used to raise revenue for military purposes during a period of conflict with France.

It was repealed in 1802 and during the 19th century was enacted two more times in different forms, each time for a period of less than a decade, before becoming a permanent part of our tax system in 1916—just three years after the federal income tax came into being. The gift tax and GST were not added until later, mainly as backstops to close loopholes in the estate tax and prevent avoidance.

There have been numerous revisions in estate tax law in the ensuing 84 years, most of them attempts to correct some of the tax's perceived inequities or close loopholes. Congress enacted the federal gift tax in 1924, as a way of preventing people from giving large sums of money away in order to decrease the value of their taxable estates. It was repealed, then brought back as part of the Revenue Act of 1932.

Congress raised transfer tax rates during the 1930s in response to the Great Depression and the looming possibility of entry into WWII. As a result, transfer tax receipts soared, accounting for as much as 9.7 percent of all federal receipts during the late 1930s, the highest in the history of the tax.

The next big change came in 1976, with the Tax Reform Act of 1976. This Act created the GST, which imposed a tax on and curtailed the popular avoidance method of setting up trusts for grandchildren or subsequent generations; eased restrictions on hard-hit small businesses and family farms; and united some provisions of the gift tax and estate tax by replacing their separate exemptions with a unified tax credit.

These changes were intended to ensure that gifts given during the benefactor's life were added to the value of his estate and therefore subject to the same tax rates as the rest of his estate. The transfer of a decedent's estate to his heirs is, in a sense, simply his final gift.

Throughout the 1980s and '90s, further changes were made in transfer tax law. The most recent significant changes were products of the 1997 Taxpayer Relief Act, which, among other things, increased the effective exemption of the unified credit from $600,000 to $625,000 and will continue to increase it each year until 2006, at which point all estates with a taxable value (gross assets plus lifetime gifts, less allowable deductions) of under one million dollars will be exempt from the tax (see Figure 1.) The current exemption is $675,000, equal to a unified credit of $220,550. The 1997 Act also included a new exclusion for certain family-owned businesses.

A Hypothetical Estate Tax Return

Figure 2 provides an illustration of how and when the tax is applied, using the example of a taxpayer who died with an estate valued at $7 million. His estate claims four deductions: charitable contributions, estate planning, spousal bequest, and funeral expenses. (There are several other potential deductions, including unlimited debts and mortgages, executors' commissions, and land donated for the purpose of conservation.)

After the deductions are subtracted, gifts over ten thousand dollars are added to the value of the estate, with the first ten thousand dollars exempted. This gives us the value of the adjusted taxable estate: $6,030,000. (If this value were under $675,000, the estate would not be taxed.) Next, the tax is calculated: the first ten thousand dollars is taxed at 18 percent, the next ten thousand at 20 percent, and so on, until the three million dollar mark. (See Figure 3.) At that point, the amount above three million dollars is taxed at 55 percent, the highest statutory rate. (See notes in Figure 3 about estates larger than $10,000,000). The unified credit is then subtracted. The credit exempts from taxation the amount of money under the filing limit, i.e., the credit of $220,550 is equal to the tax that would be owed on $675,000, using this rate

[1] *Tax Foundation Special Brief: The Gift and Estate Tax and Economic Performance* by J.D. Foster, Ph.D., February 1995, 8pp.

schedule. This leaves a total tax of $2,736,750, approximately a 39 percent average effective rate.

The Problem of Tax Complexity

From this one simplified example, it is easy to see how paying estate taxes can become extremely complicated, especially with large estates and many deductions. This complexity is considered by many to be a good reason for repeal, for two reasons. First, complexity, in and of itself, is a sign of bad tax law. The tax code should be as easy to understand and as simple to comply with as possible. Second, the myriad rules and deductions create a number of loopholes that cost the government revenue and give advantages to people with large estates that can afford to have accountants and tax lawyers provide elaborate estate planning, the cost of which is deductible. The costs of complying with the estate tax—taxpayers' cost plus the government's enforcement cost—certainly run into the billions of dollars and, according to critics, undermine any argument for keeping the tax.

Figure 1: Estate Tax Filing Requirements

Year of Death	Filing Requirement or Applicable Exclusion	Unified Applicable Credit Equivalent
1997	$600,000	$192,800
1998	$625,000	$202,050
1999	$650,000	$211,300
2000–2001	$675,000	$220,550
2002–2003	$700,000	$229,800
2004	$850,000	$287,300
2005	$950,000	$326,300
After 2005	$1,000,000	$345,800

Source: Tax Analysts

Figure 2: Example of an Estate Tax Return Filed in 2000

GROSS VALUE OF ESTATE	$7,000,000
DEDUCTIONS	
Charitable bequest	$175,000
Estate planning	$100,000
Spousal bequest	$1,000,000
Funeral expenses	$5,000
Total deductions	$1,280,000
TAXABLE ESTATE	$5,720,000
GIFTS	$320,000
ADJUSTED TAXABLE ESTATE	$6,030,000
TAX	
First $3,000,000 taxed at various rates	$1,290,800
Next $3,030,000 taxed at 55%	$1,666,500
Subtotal	$2,957,300
APPLICABLE UNIFIED CREDIT	$220,550
TOTAL TAX (tax minus credit)	$2,736,750
AVERAGE EFFECTIVE FEDERAL ESTATE TAX RATE	39.1%

Figure 3: Unified Transfer Tax Rate Schedule

Taxable Amount	Rate of Taxation	Taxable Amount	Rate of Taxation
$0 – $10,000	18%	$500,001 – $750,000	37%
$10,001 – $20,000	20%	$750,001 – $1,000,000	39%
$20,001 – $40,000	22%	$1,000,001 – $1,250,000	41%
$40,001 – $60,000	24%	$1,250,001 – $1,500,000	43%
$60,001 – $80,000	26%	$1,500,001 – $2,000,000	45%
$80,001 – $100,000	28%	$2,000,001 – $2,500,000	49%
$100,001 – $150,000	30%	$2,500,001 – $3,000,000	53%
$150,001 – $250,000	32%	$3,000,001 and over	55%
$250,001 – $500,000	34%		

Notes: Because of the exclusions (see Figure 1 above), the first nine brackets are untaxed. Taxable estates above $10,000,000 gradually lose the benefits of the exclusion and the graduated rates by paying a surtax of 5 percent on amounts between $10,000,000 and $17,184,000.

How Important Is the Estate Tax to the Federal Revenue Stream?

The most popular argument for keeping the estate tax is the most obvious one: maintaining federal revenue. Transfer taxes, however, have generally not accounted for a large portion of federal tax receipts. Throughout the 1980s and 1990s they accounted for about one or one and a half percent of revenue. The percentage has never been higher than about 9.7 percent, when the Great Depression and potential entry into WWII led Congress to hike tax rates.

The Joint Committee on Taxation estimates that H.R. 8 would reduce federal revenues by $28 billion annually during the period from 2001 to 2005. This number is not universally agreed on, however, and some say that important considerations have been overlooked. For example, the estate tax hurts the economy by reducing people's incentive to accumulate and save wealth. People are less motivated to save and invest if they know that a large portion of their wealth will be taken by the government upon their death. Instead, they are likely to spend or give away their money, thereby reducing savings and capital formation. In some cases, they make large, tax-deductible donations to charity in order to keep their wealth out of government coffers.

While the activities of many charitable organizations are socially desirable, money thus disposed of lowers the income tax base; that is, in the hands of a tax-exempt charity, the money will not bring in any revenue for the federal government, while if it

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Why America Needs the Simplified USA Tax Act

by U.S. Rep. Phil English (R-PA)

The American tax system is a Frankenstein's monster, terrorizing the individual taxpayer and casting a cold shadow over the productive sectors of the U.S. economy. It is much too complicated and riddled with obvious inequities. It punishes savings and investment, reducing economic growth and burdening domestic industry struggling to remain competitive in the global marketplace.

I introduced the Simplified USA Tax Act, H.R. 134, because I want to reform the American tax system in a way that is sensible to the average citizen and that passes the test of time. Not only do we need a tax system that is fair and understandable, we need one that is stable. As bad as the current system is—and I am one of its severest critics—the last thing Congress should do is to enact reform that is so radical and experimental that Congress will need to revamp it again in a few years.

I want to reform the American tax system in a way that is sensible to the average citizen and that passes the test of time. Not only do we need a tax system that is fair and understandable, we need one that is stable. As bad as the current system is—and I am one of its severest critics—the last thing Congress should do is to enact reform that is so radical and experimental that Congress will need to revamp it again in a few years.

The Simplified USA Tax is revolutionary in that it addresses the strongest points of concerns with the current system while at the same time addressing concerns about the equity of other tax reform proposals being considered. The Simplified USA Tax is based on principles I feel are vital to any meaningful reform:

- Imposing a simple tax on individuals and businesses to encourage efficiency;
- Ensuring that income is taxed only once;
- Saving taxpayers time and money through simplification;
- Establishing trade equity for American products;
- Taking the double tax burden off of savings — so as not to discourage individuals from saving;
- Providing incentives for investment in physical capital and human capital;
- Including an accommodation with respect to the Social Security payroll tax—the most regressive tax of all.

The Simplified USA Tax Act contains a new and better way of taxing corporations and other businesses that will allow them to compete and win in global markets in a way that exports American-made products, not American jobs.

All businesses, corporate and non-corporate, are taxed alike at an 8 percent rate on the first $150,000 of profit and at 12 percent on all amounts above that small business level. This proposal treats all businesses alike whether they are corporate or non-corporate, capital intensive or labor intensive, large or small. For the first time in history, businesses would be provided a credit for the Social Security taxes that they pay.

The Simplified USA Tax Act contains a new and better way of taxing corporations and other businesses that will allow them to compete and win in global markets in a way that exports American-made products, not American jobs.

This will represent a major tax cut for small businesses.

All costs for plant, equipment and inventory in the Unites States would be expensed in the year of purchase. All export sales income is exempt, as is all foreign-source income, and all profits earned abroad can be brought back home for reinvestment in the United States without penalty.

Because of a 12 percent import adjustment, all companies that produce abroad and sell back into U.S. markets will be required to bear the same tax as companies that both produce and sell in the United States. In effect, we import tax base from abroad so that the tax burden on our citizens is reduced without reducing the revenues to the federal government. This is a major annual tax reduction on the American economy.

The creation of a border adjustable tax is the prominent feature of this proposal. The recent World Trade Organization ruling that the U.S. foreign sales corporation (FSC) regime is an illegal export subsidy is clear and convincing evidence why the United States should adopt an internationally competitive tax

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Phil English is a member of the House Ways and Means Committee.

system. This time bomb, if the European Union retaliates, could have a devastating effect on American companies. FSC was originally made necessary only because the U.S. maintains an archaic worldwide tax system which taxes foreign source income and because the U.S. taxes export income.

The WTO ruling provides Congress with the unique opportunity to level the playing field of export taxation, eliminate the tax motive for runaway businesses rather than simply searching for a short-term fix. The looming October first deadline for compliance makes the likelihood of Congress considering and passing a border adjustable tax system bleak. However, I firmly believe that regardless of whatever tinkering is done to FSC in the upcoming weeks and months, the U.S. will face similar situations again and again until Congress and the Administration work together to give American companies a tax system that allows them to compete in the global marketplace.

However, it is crucial to understand that there will not be corporate tax reform without individual tax reform. The Simplified USA Tax Act provides a progressive individual rate tax paid by individuals when they receive wages, interest, dividends and other income. The centerpiece of the individual tax is the elimination of the double taxation

be simpler and nothing could give people a better opportunity to save — especially young people. Because only new income earned after enactment of the Simplified USA Tax can be put into the USA Roth IRA, young people starting to move into their higher-earning years are the ones who will benefit the most for the longest time.

The tax code should give everyone the opportunity to keep what they save, and if they wish, to pass it along to suc-

For the first time in history, businesses would be provided a credit for the Social Security taxes that they pay. This will represent a major tax cut for small businesses.

on income that is saved. The tax code must give Americans a fair opportunity to save part of their earnings.

In my tax reform proposal, USA stands for "Unlimited Savings Allowance." Everyone is allowed an unlimited Roth IRA in which they can put the portion of each year's income they save after paying taxes and living expenses. After five years, all funds in the account may be withdrawn for any purpose and all withdrawals — including accumulated interest and other earnings and principle — are tax free. Nothing could

ceeding generations. Therefore, the federal estate and gift taxes — the death taxes — would be repealed under my proposal.

Under a new tax code, tax rates will be lower, especially for wage earners who must now pay both an income tax and a 7.65 percent FICA payroll tax on the same amount of wages. At present, the *USA Tax* starts out with quite low rates — 15 percent at the bottom, 25 percent in the middle, and 30 percent at the top. Then, these rates are reduced even further by allowing wage earners a full tax credit for the 7.65 percent Social Security and Medicare payroll tax that is withheld form their paychecks under current law. I do not propose to repeal the payroll tax because to do so would imperil Social Security, however, a credit is allowed for it and when that credit is taken into account, the rates of tax on workers' wages are very low — in the 7 percent to 17 percent range for nearly all Americans. These rate reductions occur even while maintaining the financial base of the payroll taxes.

Under this proposal, everyone gets a deduction for the mortgage interest on their home and for the charitable contributions they make. In addition, the Simplified USA Tax Act allows for a deduction for tuition paid for college and post-secondary vocational education. The annual limit would be $4,000 per person and $12,000 for a family.

Generous personal and family exemptions are also allowed under this proposal. On a joint return, the family exemption is $8,140 and there is an additional $2,700 exemption for each member of the family. Therefore, a married couple with two children pays no tax on their first $18,940 of income.

For too long the tax code has been a needless drag on the economy. That is not very wise and certainly not fair to those Americans whose living standards are lower because of it. For years, the tax code's complex inanities have been the source of confusion and ridicule. It is high time that we restore people's faith in the integrity and competence of their tax system, and, in the process, take a major step toward restoring people's confidence in the good character of their government.

Fundamental tax reform must be a priority of the next administration if America is to maintain its economic preeminence. The Simplified USA Tax Act offers a clear model for how bipartisan tax reform could be a catalyst for economic growth, savings, investment and tax simplification for all Americans.

The Tax Foundation invites a national leader to provide a "Front and Center" column each month in Tax Features. *The views expressed are not necessarily those of the Tax Foundation.*

Estate Taxes

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remains in the estate, it will be subject to a high rate of income tax and will eventually fall to taxpaying heirs. Some proponents of the tax, however, argue that its ability to motivate people to make charitable contributions is a valid reason to keep it.

The estate and gift tax also encourages taxpayers to give monetary gifts to people whose tax rates are lower than their own, thus decreasing federal revenue. Taxpayers may distribute $10,000 ($20,000 for married couples) each year, tax free, to any person. The donor is likely to have a high individual income tax rate, while the recipient, often a child or grandchild, is likely to have a lower rate. Therefore, the money brings in less tax revenue than it would have if it had remained with the donor.

The Effect of the Estate Tax on Entrepreneurs

Entrepreneurs, critics contend, are affected by an additional disincentive: the disincentive to invest in capital. There is less incentive to earn and accumulate wealth if a taxpayer knows that the more she earns, the greater the government's share will be, and there is less incentive to start a business if a taxpayer knows that she cannot leave all of it to her heirs and that it might have to be sold after her death to pay the tax, possibly at a time when the market for the business's assets is down.

A 1994 Tax Foundation study examined the effect of the estate tax on entrepreneurs, to determine the extent to which knowledge of the estate tax discourages people from starting a business, working hard and accumulating wealth.[2] The study used a model that showed that the estate tax has "roughly the same effect on entrepreneurial incentives as a doubling of income tax rates."

For example, suppose the estate of an entrepreneur with a non-corporate business is worth $5.2 million dollars at the time of her death in 1994. The estate is then subject to an effective estate tax rate of 44.34 percent. This is a powerful disincentive: In order to create an equally powerful disincentive in the absence of an estate tax, we would have to raise this business-woman's effective individual income tax from 37 percent to over 68.21 percent, nearly doubling it. Entrepreneurs create jobs and opportunities and provide services and products that are in demand; they should not be discouraged from being as productive as possible.

Some supporters of the tax argue that it is good luck, not hard work, that leads to a person inheriting part of another's estate or being born into a wealthy family, and it is far more fair to tax an inheritance than to tax income, which involves hard work. The counter-argument is that wealth is originally accumulated because of hard work, and the person who accumulates it should have the right to decide how it will be distributed after his death. He has earned, saved, and paid taxes on his income his whole life, and he should be able to distribute the final product as he sees fit. It is irrelevant whether the recipient deserves such good luck; that is for the benefactor to decide, not the government. An additional counter-argument is that the contents of most of the taxpaying large estates (worth $20 million or more) are business assets, such as closely held stock, farm assets, and limited liability partnerships. This wealth, therefore, is very likely the product of a lifetime of hard work by farmers and entrepreneurs—first generation wealth, rather than inherited wealth.[3]

These are just some of the arguments relating to a sense of social justice or fairness. One of the original justifications for the tax was that it would prevent wealth from becoming concentrated in the upper socioeconomic strata, in the hands of a few extremely wealthy families. Leaving aside the question of whether this was a valid social justification at the time, it is not a valid economic justification now: Today's economy has solved this problem as "new money" dwarfs "old money" in size and number of fortunes more every year.

Proponents of repeal also argue that the estate tax places an unfair burden on small family-owned businesses and family farms, which do not always have the liquid assets to pay the tax and may instead opt to sell or break up the business. The 1997 Taxpayer Relief Act did provide an additional exemption for these businesses, but it is extremely difficult for businesses to meet the complex, strict standards necessary to qualify for the exemption. Some critics argue that the estate tax is unduly burdensome to families in yet another way: the death of a family member, they say, is not an appropriate time to require grieving relatives to pay taxes.

On the other side, supporters of the tax argue that its progressivity is reason enough to keep it: The estate tax is paid by only the wealthiest two percent of estates. Not surprisingly, states with high per capita incomes also rank high on the list of dollars paid in estate taxes: Connecticut, New York and Florida are first, second and third, respectively, in per capita estate tax payment. Progressivity alone, however, is not a valid reason for keeping a particular tax; there are other ways to maintain or gain progressivity in the tax code, critics argue.

Supporters of the tax maintain that it can be reformed, and there are currently many proposals for reform. However, opponents argue that there have been too many failed attempts at reform already and the law is so complicated that the only logical solution is a repeal.

H.R. 8 would gradually phase out transfer taxes by the year 2010. The unified credit would first be changed to a tax exemption of $675,000 in 2001 and would gradually be increased to one million dollars in 2006. Full repeal would occur in 2010. The bill passed the House on June 9 in a vote of 279-136 and passed the Senate on July 14 in a vote of 59-39, not enough votes to override the veto President Clinton has promised. Even if it is vetoed, however, the sponsors of H.R. 8 are promising this will not be the last we hear of the issue.

— Alicia Hansen

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[2] *Tax Foundation Background Paper #9,* "An Analysis of the Disincentive Effects of the Estate Tax on Entrepreneurship" Patrick Fleenor and J.D. Foster, Ph.D. June 1994. 23pp.

[3] *A History and Overview of the Estate Tax,* Patrick Fleenor, January 1994. 18pp.

Going Bananas Over the FSC

Most Americans have never heard of Foreign Sales Corporations (FSC). Even many trade and tax people had only a general notion about FSCs before the World Trade Organization (WTO) ruled the FSC violated the anti-subsidy provisions of the WTO and the ruling was upheld by an appellate body.

Briefly, the FSC is a device built into the tax code to reduce some of the U.S. corporate income tax burden on U.S. exports. One way to think about the FSC is that it operates as a modest rebate of income tax akin to the Value-Added Tax (VAT) export rebates many of our trading partners enjoy.

Many U.S. trading partners, and particularly many Europeans, have groused for years that the FSC was not really kosher tax policy and probably violated the international trading rules as laid out in the General Agreement on Tariffs and Trade and, subsequently in the WTO. However, the problem was modest enough as the Europeans saw it not to warrant a major trade row. They were also somewhat concerned that if they raised a stink over the FSC, the U.S. might try to put the VAT's border tax adjustments (BTAs), i.e. its export rebates and import levies, on the table in a future trade round.

What happened? Why did the Europeans suddenly raise the issue? One reason is they got the acceptability of their BTAs codified in the last WTO round, putting them in a very strong defensive position on that score.

But the real reason seems to be all about bananas, with a touch of beef hormone. The U.S. won the last two trade disputes with the Europeans brought before the WTO. These dealt with beef hormones, (the Europeans don't like them), and bananas, about which the Europeans proved to be quite discriminating. The problem was not that the U.S. won these cases, but that after winning the banana case the U.S. Administration pounded its chest in loud self congratulation like the louts that infest British soccer stadiums. Bad form.

No one likes to be shown up, least of all Sir Leon Brittain, the European Union Trade Commissioner. Sir Leon lost the beef and banana cases and wanted revenge after the Americans behaved so badly. Acting largely on his own initiative, which is supposed to be a no-no in EU circles, Sir Leon launched his challenge against the FSC. Not wanting to appear out of the loop the European governments quickly fell in line in support of the challenge.

J.D. Foster, Ph.D.
Executive Director & Chief Economist
Tax Foundation

For its part, the U.S. thought it had a gentleman's agreement dating back two decades and re-affirmed during negotiations to create the WTO that the FSC would not be challenged. Apparently no one thought to have the gentleman's agreement included in the official WTO agreement. Thus, initially, the FSC challenge surprised the U.S. government, and it was stunned when the decision went for the Europeans. Now the U.S. is scrambling to decide what to do to avoid trade sanctions against U.S. exports that could easily run in the tens of billions of dollars.

Interestingly, most Americans involved with the issue quickly decided the Europeans really weren't all that interested in FSC. Americans presumed the Europeans wanted leverage for something else. Perhaps they wanted the U.S. to give way on beef and bananas. In fact, most people involved were hoping a little horse trading was all the Europeans were after because they did not see a sure-fire way to create a FSC-like device that would pass WTO muster.

The crux of the ruling against the FSC is that it is an export subsidy because a taxpayer only qualifies for the FSC benefit to the extent goods and services sold through an FSC contain U.S. content. In response to the WTO ruling, the U.S. Treasury came up with a very clever solution. The U.S. would allow any U.S.-owned foreign corporation to qualify for the benefit if it made the appropriate election and if it the goods and services contained a sufficient amount of U.S. content. In effect, they expanded the universe of companies that could qualify for the benefit to include those foreign companies that purchased U.S. content-bearing goods abroad and resold them, possibly after some additional processing.

The Europeans said publicly they were quite surprised the Yanks came up with a proposal so quickly. In other words, they thought the U.S. was boxed in with nowhere to go. Deputy Treasury Secretary Stu Eizenstadt, the Administration's FSC point man, went over to present the proposal to his counterpart, EU Trade Commissioner Pascal Lamy. Unfortunately, Eizenstadt also let on that the U.S. attitude was "take it or leave it," which Mr. Lamy indicated was fine because they would leave it, thank you very much. Eizenstadt then backtracked, indicating there might be some wiggle room. Nothing like drawing a line in the sand and then erasing it as quickly as you can.

After a week of discussions with EU officials and other European government officials it is quite clear the EU wants only one thing — for the U.S. to be WTO compliant. They are not looking for a deal and they would rather not have to retaliate. For Europeans their attitude is remarkably direct: We expect the U.S. to comply with the WTO ruling. We are happy to discuss anything you like, but we are not negotiating anything despite Mr. Lamy's indication that the "door remains open." We think Treasury's proposed solution is a non-starter, but if you think it is WTO compliant take it to the WTO and let's find out.

It's anybody's guess whether the Administration's proposal will pass WTO muster. What is certain is the Congress has precious little time to act in any case. It is also certain that if the Congress does pass the Administration's proposal, the Europeans will challenge it under expedited review. Finally, it is certain that if the U.S. loses the challenge it is going to be in a very weak position, the Europeans will retaliate as long as the FSC remains in effect, and Sir Leon Brittain is going to be insufferably and deservedly smug.

TAX FEATURES©

Tax Features© (ISSN 1069-711X) is published 10 times a year by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia. Annual subscriptions to the newsletter are $15.

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Tax Foundation's International Tax Policy Seminar In European Capitals Addresses WTO Rejection of The U.S. Foreign Sales Corporation

The Tax Foundation led a delegation of senior congressional staff and corporate representatives to Berlin, Brussels, and Paris in May to discuss an array of tax policy issues, and particularly the World Trade Organization (WTO) dispute over the Foreign Sales Corporation (FSC).

As in previous years, the Tax Foundation was joined in sponsoring this event by the Organization for International Investment and the European American Business Council. This conference, a major part of the Tax Foundation's program, is an annual event that, along with our similar conferences to Asia and Latin America, seek to provide the congressional staff with an in-depth exposure to critical issues in international commerce and international tax policy.

Among American participants, there was clear bi-partisan support for the Treasury's position on the FSC.

Spurred by a complaint filed by the European Union, the WTO has ruled that the FSC provisions of the federal tax code violate the anti-subsidy provisions of the WTO agreement. The U.S. has until October 1, 2000, to alter its law to comply with the WTO to avoid significant retaliation.

Seeking a solution, the U.S.Treasury developed a possible FSC alternative that was quickly rejected by the Europeans. This trade dispute has raised a myriad of questions about the WTO, the motivations of the European Union, and what solutions might be available. During the Tax Foundation conference we explored each of these issues in depth. Perhaps the most striking aspects of these discussions were the clear bi-partisan support for the Treasury's position, the eagerness of the Europeans to discuss the matter, and their clear position that if the United States believes it has an appropriate remedy, it should take it to the WTO.

While the FSC dispute clearly dominated the discussions, other important issues did arise. For example, the U.S. delegation was particularly interested in the European efforts at tax harmonization and their efforts to discourage harmful tax competition.

Some members of the delegation suspected, and may continue to suspect, that some high-tax European governments define harmful tax competition as any other country's tax regime that is less punitive than its own. However, discussions in all three cities indicated that the operational meaning of harmful tax competition is any tax relief provision that is inconsistent with the basic structure of that country's tax system. Specifically, harmful tax competition does not refer to a country's tax rates.

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