



4-1-1995

The GATT and VAT: Whether VAT Exporters Enjoy a Tax Advantage under the GATT

Christopher Deal

Follow this and additional works at: <https://digitalcommons.lmu.edu/ilr>



Part of the [Law Commons](#)

Recommended Citation

Christopher Deal, *The GATT and VAT: Whether VAT Exporters Enjoy a Tax Advantage under the GATT*, 17 Loy. L.A. Int'l & Comp. L. Rev. 649 (1995).

Available at: <https://digitalcommons.lmu.edu/ilr/vol17/iss3/5>

This Notes and Comments is brought to you for free and open access by the Law Reviews at Digital Commons @ Loyola Marymount University and Loyola Law School. It has been accepted for inclusion in Loyola of Los Angeles International and Comparative Law Review by an authorized administrator of Digital Commons@Loyola Marymount University and Loyola Law School. For more information, please contact digitalcommons@lmu.edu.

THE GATT AND VAT: WHETHER VAT EXPORTERS ENJOY A TAX ADVANTAGE UNDER THE GATT

I. INTRODUCTION

The General Agreement on Tariffs and Trade ("GATT")¹ prohibits countries from refunding income taxes to exporters.² In contrast, refunds of value-added-taxes ("VAT") are permitted. Advocates of a U.S. VAT argue that this distinction gives an advantage to countries who rely primarily on VAT to collect revenue.³ In 1971, the United States attempted to counter the alleged imbalance with the Domestic International Sales Corporation ("DISC").⁴ The DISC comprised a set of tax incentives by which the United States could decrease the income tax burden on its exporters.⁵ In 1984, the United States abandoned the DISC and replaced it with the Foreign Sales Corporation ("FSC") following lengthy struggles with its trading partners, who alleged that the DISC scheme violated the GATT.⁶ U.S. trading partners

1. General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. 5, 55 U.N.T.S. 194 (entered into force Jan. 1, 1948). The GATT has been amended several times since 1947. An official version of the amended GATT is contained in 4 CONTRACTING PARTIES TO THE GENERAL AGREEMENT ON TARIFFS AND TRADE, BASIC INSTRUMENTS AND SELECTED DOCUMENTS (1969) [hereinafter GATT, BISD].

2. GATT, BISD, *supra* note 1, at 31, 71.

3. Rep. Sam Gibbons (D-Fla.) suggests that the introduction of a value-added-tax (VAT) in the United States would help to ensure a "level playing field" with overseas competitors and would promote the United States' international competitiveness. Sam Gibbons, *A Proposal for a New Revenue System for the United States Incorporating a Value-Added Tax*, 93 TAX NOTES TODAY, Mar. 11, 1993, Doc. No. 98-46, available in LEXIS, Fedtax Library, TNT File, at *9. For a full discussion of the Gibbons proposal, see William H. Morris, *A 'National Debate' on VAT: The Gibbons Proposal*, 60 TAX NOTES 1259 (1993). For Gibbons' most recent comments on his VAT proposal, see Sam Gibbons, *Gibbons' Testimony at Bipartisan Commission Hearing on Entitlement and Tax Reform*, 94 TAX NOTES TODAY, Oct. 6, 1994, Doc. No. 198-36, available in LEXIS, Fedtax Library, TNT File.

4. Revenue Act of 1971, Pub. L. No. 92-178, at §§ 501-507, 85 Stat. 535 (codified as amended at I.R.C. §§ 991-997 (1988 and Supp. 1994)).

5. Robert E. Hudec, *Reforming GATT Adjudication Procedures: The Lessons of the DISC Case*, 72 MINN. L. REV. 1443, 1443 (1988).

6. See Hudec, *supra* note 5. The Foreign Sales Corporation was created as a provision to the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1986).

subsequently objected to FSC provisions that forgave approximately \$10-12 billion in deferred taxes owed by U.S. exporters.⁷

Much of the debate surrounding the DISC, the FSC, and current attempts to introduce a VAT in the United States implicitly assumes that countries using a VAT enjoy an advantage over their counterparts relying on income taxes.⁸

This Comment analyzes whether countries using a VAT system actually enjoy such an advantage under the GATT. First, the VAT and the GATT restriction on the refund of direct taxes to exporters are discussed. Second, the DISC and the FSC schemes and current efforts to introduce a VAT in the United States are examined. Third, the U.S. tax system and a potential advantage enjoyed by imports is discussed. Finally, the relative "effective" direct tax burdens of the United States and its competitors are compared to see if VAT countries actually enjoy any advantage under GATT. In order to compare effective tax burdens, this Comment uses a hypothetical manufacturer in the United States and compares his tax burden with a foreign manufacturer. The comparison is limited to three VAT countries: France, Germany, and the United Kingdom.

This Comment concludes that based on available data, the GATT's distinction between indirect and direct taxes may give foreign exporters in VAT countries a tax advantage over the United States.

II. THE GATT FRAMEWORK

A. *What is a VAT?*

A VAT is a "consumption tax" levied on sales of goods and services. A VAT is computed by taxing the value added to a good at each stage of production,⁹ normally at a flat rate.¹⁰ In con-

7. Hudec, *supra* note 5, at 1443.

8. See Gibbons, *Proposal*, *supra* note 3, at *8-9.

9. James M. Bickley, *How Much Revenue Could a U.S. VAT Yield?*, 60 TAX NOTES 1273 (1993). For example, if A uses inputs valued at \$100 in order to create a product sold to B for \$200 and a VAT rate of 10% is in effect, A is liable for 10% of the \$100 value added to the inputs or \$10. For a more complete description of the VAT process, see Joseph Isenbergh, *The End of Income Taxation*, 45 N.Y.U. TAX L. REV. 283, 333-34 (1990).

10. Many countries use multi-tiered VAT rate dependent on the type of goods on which the tax is levied. For example, France uses a two-tier system. Article 278 of the French Tax Code applies a 5.6% tax rate to certain foods, lodging establishments, meals

trast, a corporate income tax is levied only on a corporation's net profits.¹¹

VAT producers may generally offset taxes levied on intermediate stages of production with VAT collected from downstream purchasers in order to prevent the double taxation of the same value-added.¹²

Proponents of a U.S. VAT frequently tout its simplicity and revenue-raising possibilities.¹³ Other justifications for a U.S. VAT are that it encourages savings¹⁴ and does not discriminate between capital and non-capital goods or goods and services.¹⁵

Critics often focus on VAT's regressive nature by arguing that a greater percentage of income is spent on consumption as income levels fall.¹⁶ For example, assume *A* earns \$20,000 per year and spends \$15,000 a year on living expenses such as food, clothing, and rent. If a 10% VAT rate is in effect, he pays \$1,500 dollars a year in taxes, 7.5% of his income. *B* earns \$100,000 a year. If his living expenses are the same, the \$1500 per year paid to the government would only constitute 1.5% of his income. For *B* to pay the same percentage of his income as *A*, he would have to spend \$75,000 a year.¹⁷

served in company restaurants, camping establishments, entertainment, transportation fees, medicines, and books. Code Général des Impôts [CGI] art. 278 *bis* (Fr.). An 18.6% rate applies to any good or service that is not specifically enumerated by the statute. CGI art. 272 *bis*. Manufactured goods do not as qualify for the reduced rate and are taxed at the higher VAT rate.

11. See I.R.C. §§ 61-64 (1988). The U.S. corporate income tax applies graduated rates of taxation to companies with higher earnings. I.R.C. § 11 (1988 & VI Supp. 1994). Companies with net earnings over ten million dollars pay a 35% on all earnings. *Id.*

12. Isenbergh, *supra* note 9, at 333.

13. Gibbons, *Proposal, supra* note 3, at *2. In addition to being easier to administer, compliance with VAT is frequently considered "cheaper and easier" for the taxpayer. Morris, *supra* note 3, at 1261. Not only is less time spent by the taxpayer, but fewer accountants and lawyers are needed to determine a taxpayer's liabilities. *Id.*

14. It is commonly assumed that indirect taxes such as VAT and sales taxes encourage savings by discouraging consumption. See Isenbergh, *supra* note 9, at 331 ("It makes intuitive sense to tax those things we want less of and to refrain from taxing things we want more of. Increasingly, consumption is the only thing we've plenty of.").

15. Morris, *supra* note 3, at 1262.

16. See *id.* at 1264 ("Perhaps the central criticism of any VAT is that it is a regressive tax."). For a complete discussion of the regressiveness issue, see Perry D. Quick, *The Politics of the Value-Added Tax: Distribution Issues*, 93 TAX NOTES TODAY, June 22, 1993, Doc. No. 135-72, available in LEXIS, Fedtax Library, TNT File.

17. *But see* Morris, *supra* note 3, at 1264 ("While in any one year, those on a lower income will spend more of their income than middle- and higher-income earners, if one takes a longer view of the lifetime income and consumption cycle, then most middle-

B. The GATT

Article XVI:4 of the GATT forbids countries from using subsidies to aid exporters.¹⁸ Signatories to the GATT must "cease to grant either directly or indirectly any form of subsidy on the export of any product . . . [which] results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market."¹⁹ An interpretive note states "the exemption of an exported product from duties or taxes borne by the product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy."²⁰ The GATT is interpreted as prohibiting the refund of direct income taxes because the note only mentions the permissibility of indirect tax refunds.²¹

The theory behind the disparate treatment of direct and indirect taxes is that producers shift the cost of indirect taxes forward to the consumer but that direct taxes are absorbed by the producer.²² Relieving the direct tax exporter of the tax burden constitutes a subsidy because the price of the product sold abroad is cheaper than the price of the same product sold domestically.²³

For example, if A, an exporter in a direct tax system, is taxed \$1 on a \$9 good, he will absorb some or all of the cost of the tax himself, resulting in a price between \$9 to \$10. If A charges \$9.50 in the direct tax system country but receives a rebate of the tax for

income families also will spend all of their income over a 'lifetime.'").

18. GATT, BISD, *supra* note 1, at 31.

19. *Id.*

20. *Id.* at 71.

21. See Oliver Oldman & Alan Schenk, *The Business Activities Tax: Have Senators Danforth & Boren Created a Better Value Added Tax?*, 94 TAX NOTES TODAY, Dec. 19, 1994, Doc. No. 250-33, available in LEXIS, Fedtax Library, TNT File, at *9 n.36.

22. See *id.* ("The GATT rules reflect prevailing views that sales taxes [and] VAT are shifted forward and are borne by the consumers, while income and payroll taxes are borne by owners and shareholders and employees."); see also Isenbergh, *supra* note 9, at 333 ("Any person who consumes the goods (and therefore does not add value) cannot perforce turn them over again, and therefore cannot be reimbursed. The ultimate consumer, thus, bears the final nonrefundable burden of the VAT."); Gerard M. Brannon, *Does VAT Provide a Balance of Trade Advantage?*, 30 TAX NOTES 1387, 1388 (1986) ("[T]here is a consensus among economists that (a) the income tax is not shifted; (b) a VAT would be passed forward in prices. . .").

23. Ronald D. Sernau, *The Foreign Sales Corporation Boondoggle*, 71 CORNELL L. REV. 1181, 1185 n.24 (1986).

his exports, the cost of his product abroad would be lower than \$9.50.²⁴ The GATT considers this to be a subsidy.²⁵

Conversely, the price of a product sold by an indirect producer abroad will be the same as the domestic price.²⁶ The GATT assumes that in an indirect tax system, the price of the good remains constant—the consumer merely pays the tax when purchasing the product.²⁷ The *actual* price of the good will be \$9 whether sold domestically or abroad.²⁸

The forward-shifting theory is not universally accepted; some commentators suggest that direct tax benefits are shifted forward like indirect taxes, and some suggest indirect taxes are not completely shifted forward.²⁹ The incidence of the VAT may fall on manufacturers, consumers and laborers alike.³⁰ The tax is not borne only by goods and services but is rather “a proportionate tax on the factors of production—that is, a tax on labor and capital services.”³¹

24. *Id.*

25. *Id.* (“The GATT theory rejects the proposition that prices decrease because American manufacturers pass their tax savings forward.”).

26. *Id.*

27. *Id.*

28. *Id.*

29. *See id.* at 1184 (“Modern economic theory establishes that the GATT distinction between direct and indirect taxes is artificial. Economists generally agree that exporters in indirect tax jurisdictions do not fully shift tax savings forward to consumers. Similarly, economists contend that exporters shift some direct tax benefits forward.”); *see also* Morris, *supra* note 3, at 1261 n.10 (stating that the contention that VAT taxes are completely absorbed by the consumer “assumes a very inelastic demand curve that seems far from certain.”).

30. *See* Cliff Massa & David G. Raboy, *The Canadian Value-Added Tax: Does Anybody Care?*, 89 TAX NOTES INTERNATIONAL, Oct. 25, 1989, Doc. No. 43-58, available in LEXIS, Fedtax Library, TNT File, at *10.

31. *Id.* In their discussion of the incidence of value-added taxes, Massa and Raboy take the tax base of the corporate income tax and incrementally increasing the tax base to that of the VAT by removing the common CIT deductions such as payments on capital, fringe benefits and other business expenses, allowing for full loss offset instead of the current depreciation deduction system, and repealing the income cap on payroll taxes and shifting their full cost to the employer. *Id.* No increment individually shifts the costs of the tax forward to the consumer and, viewed collectively, there is no reason to treat the incidence of the VAT as any different from that of the CIT. *Id.* The VAT base is also decreased to that of the CIT with similar results. *Id.* Thus, there is no justification for treating the incidence of the VAT and the CIT differently. *Id.*

Some commentators have suggested that the extent to which a U.S. VAT would shift forward in prices would depend on the monetary policy adopted by the Federal Reserve Bank. *See, e.g.* Charles E. McLure, Jr., *State and Local Implications of a Federal Value-Added Tax*, 38 TAX NOTES 1517, 1524 (1988); Brannon, *supra* note 22, at 1388.

The GATT distinction becomes blurred if indirect taxes are at least partially absorbed by the producer, or if the direct tax producer's lower overseas price is not the result of a subsidy but rather the result of the producer passing his tax savings forward to the consumer.³² In other words, the GATT distinction may unfairly punish exporters in direct tax jurisdictions in either of two ways. First, if direct taxes are shifted forward to the consumer, disallowing the border tax adjustment may place the exporter's goods at a disadvantage in the export market because the good's price still retains a direct tax component and is consequently more expensive than domestic goods.³³ Second, if indirect taxes are partially absorbed by the producer, the border tax adjustment may constitute a subsidy by allowing a rebate greater than the amount of tax passed forward to the consumer and consequently renders the price of the indirect tax exporter's goods cheaper than domestic goods in the export market.³⁴

The introduction of the DISC³⁵ and the subsequent introduction of the FSC³⁶ suggest Congress believed the GATT distinction was false.³⁷

32. Sernau, *supra* note 23, at 1181-84.

33. *Cf.* McLure, *supra* note 31, at 1525 (stating that the use of the GATT border adjustment by U.S. exporters that would result from the replacement of the CIT with the VAT could, if direct taxes are passed forward, "unshift" the price component passed on in American exports).

34. *See* Sernau, *supra* note 23, at 1184 n.26 (citing KENNETH DAM, *THE GATT LAW AND INTERNATIONAL ECONOMIC ORGANIZATION* 214-15 (1970)).

35. *See infra* discussion at Part II.A.

36. *See infra* discussion at Part II.B.

37. Sernau, *supra* note 23, at 1185 ("Congress accepted the modern view that no appreciable difference exists between the impact of direct and indirect taxes on prices . . . [and] designed the DISC legislation's benefits to equalize American exporters with foreign counterparts exporting from countries providing indirect tax refunds and exemptions.").

The DISC legislation was also a reaction to the use of "tax-havens" by certain European countries that the U.S. believed constituted a subsidy under Article XVI of the GATT. Hudec, *supra* note 5, at 1447. The United States used the latter justification in its defense of the DISC legislation during the GATT proceedings described below; however, the "long standing complaint about . . . the accepted practice of remitting value-added and other such taxes on exported goods and of imposing such taxes on imports, received almost equal attention during the process of [DISC's] enactment. *Id.* at 1447 n.15.

III. Congressional Attempts to "Level the Playing Field"

A. *Domestic International Sales Corporation (DISC)*

The DISC was enacted in 1971 as a device to reduce income taxes and "level the playing field" for U.S. exporters.³⁸ Although modified in 1976,³⁹ the DISC survived through 1984 and is still available for small exporters.⁴⁰

U.S. trading partners objected to the DISC as a violation of the GATT's prohibition against subsidies; the European Community brought a lawsuit in 1972 to enjoin the United States from using the DISC program.⁴¹ The U.S. reaction to the European suit was to bring counter-complaints against the Netherlands, Belgium, and France, which alleged that the DISC program merely mirrored tax structures already in place in these countries.⁴²

The DISC was controversial not only within the GATT community but also within the United States itself.⁴³ A Carter administration official declared that it would take a "miracle" for

38. *Id.* at 1446. The DISC sought to increase exports by decreasing taxes on U.S. exports. A parent company would establish a domestic subsidiary, known as a DISC, solely for the purpose of avoiding taxes. The DISC was not required to have any assets or employees. I.R.C. §§ 991-993 (1982). The parent company would sell goods to the DISC, which would then sell the goods abroad. Half of the profits would be distributed to the parent company and taxed normally. *Id.* Taxes on the other half were deferred as long as the profits remained undistributed and remained with the DISC. *Id.* The tax-free deferral was the mechanism by which exports were encouraged. Although in theory only a deferral, exporters eventually began to treat the plan as a complete tax exemption. Hudec, *supra* note 5, at 1446.

39. The DISC program was modified to allow only tax benefits for the volume of exports exceeding a specified amount computed over a four-year base period commencing seven years before the exporter was entitled to the deferral. I.R.C. §§ 991-993 (1982). Hudec estimates that under the previous version of DISC, a corporation could defer taxes on approximately 25% of its profits, while under the modified version, it is only able to defer 17-18% of its profits. Hudec, *supra* note 5, at 1447.

40. Sernau, *supra* note 23, at 1181. Small exporters must now pay interest on the taxes deferred by the program. *Id.*

41. Hudec, *supra* note 5, at 1443. The various complaints and counter-complaints, collectively known as the DISC case, were litigated for over 12 years ending "with an outcome that satisfied almost no one." *Id.*

42. *See id.* at 1445. The counter-complaints also served a political purpose by "assuring Congress that the Administration was vigorously defending United States Interests." *Id.* at 1457. The strategy of filing counterclaims may have been devised before the actual complaints themselves were discovered. *Id.*

43. James L. Rowe Jr., *DISC's seem likely to die in Carter Tax Revision Package*, WASH. POST, July 24, 1977, at G1.

the program to survive the administration.⁴⁴ The Treasury Department argued that the program had not proven to benefit trade whatsoever.⁴⁵ Commerce Secretary Frank Weil noted, however, that 85% of the nation's exports went through the DISC's and, while conceding that the overall effect could not be measured, Weil stated that the program was "bound to do something."⁴⁶

B. *The Foreign Sales Corporation*

The Foreign Sales Corporation provisions of the Deficit Reduction Act of 1984 attempted to appease U.S. trading partners; most importantly, the provisions were directed at the EC countries, by eliminating the bulk of the DISC program while still retaining tax incentives for U.S. exporters.⁴⁷ The provisions replaced the DISC with the FCS⁴⁸ and, more significantly, relieved DISCs of approximately \$10-12 billion in deferred taxes owed under the program.⁴⁹ European trading partners maintained that the relief violated the GATT's prohibition against subsidies.⁵⁰ Additionally, Europeans were "convinced that Congress' forgiving the \$10 billion plus [was] simply concrete evidence that they [were] correct in calling DISC an illegal export subsidy all along."⁵¹

44. *Id.*

45. *Id.*

46. *Id.*

47. Sernau, *supra* note 23, at 1181.

48. While the DISC system did not require the DISC subsidiary of the parent corporation to have any assets or employees, and was thus purely a creation on paper, the FCS requires the subsidiary to incorporate in either the United States possession, other than Puerto Rico, or a country with which the United States had an exchange of information agreement. I.R.C. § 922 (1988). In addition, the subsidiary must establish a foreign presence by establishing an office outside the United States. *Id.* There are also foreign-management and foreign-economic-presence requirements. *Id.*; see also Sernau, *supra* note 23, at 1190-91.

49. The ultimate irony of the FCS provisions was that they were contained in a deficit reduction act. See Hobart Rowen, *The Great Tax Grab*, WASH. POST, July 5, 1985, at A21 ("The callousness of the \$10 billion to \$12 billion giveaway in DISC . . . takes the cake . . . [i]t seems that when the corporations and their tax lawyers go to work in earnest, the public gets ripped off.").

50. Stephen M. Kotran, *Of DISC's and FSC's*, 24 TAX NOTES 8 (1984).

51. *Id.*

C. Proposals to Introduce a VAT

Representative Sam Gibbons (D-Fla.), the Chairman of the House Ways and Means Committee before the recent midterm elections, recently proposed the introduction of a VAT to replace, or at least supplement, the current income tax system.⁵² The VAT is not a new addition to the ongoing debate over the restructuring of the U.S. tax system. Another Former Chairman of the House Ways and Means Committee, Representative Al Ullman (D-Ore.), had advocated introduction of a U.S. VAT in 1980, but the debate dissipated with his defeat that same year.⁵³

Retired Senators David Boren and John Danforth recently proposed the introduction of a "Business Activities Tax," which closely resembles a European style VAT system.⁵⁴ Other proposals include "sales-subtraction business tax" by Senator William Roth (R-Del.), proposed in 1985, and a "sales-subtraction business alternative minimum tax," introduced in 1985.⁵⁵ In 1993, Senators Sam Nunn (D-Ga.), and Pete Dominici (R-N.M.), co-chaired the Strengthening of America Commission, which issued a report recommending a VAT.⁵⁶

Gibbons advocates the subtraction method⁵⁷ over the credit-

52. Gibbons, *Proposal*, *supra* note 3. Former Treasury Secretary Lloyd Bentsen, however, recently told reporters "I know of no plans to move toward a value-added—none." *White House Has No Plans to Move Toward Value-Added Tax, Bentsen Says*, BNA Management Briefing (Oct. 28, 1994), available in LEXIS, Nexis Library, Curnews File.

53. For a discussion of Ullman's proposal, see L. Hart Wright, *Personal, Living or Family Matters and the Value Added Tax*, 82 MICH. L. REV. 419 (1983). Representative Al Ullman's advocacy of a VAT may have result in his 1980 defeat. See Morris, *supra* note 3, at 1260.

54. For a complete discussion of the proposal, see Oldman & Schenk, *supra* note 21.

55. *Id.* at *2.

56. *Id.* Some commentators have also proposed the adoption of a U.S. VAT. See, e.g., Isenbergh, *supra* note 9, at 335 (proposing the adoption of a 25% VAT to replace current payroll and income taxes).

57. See Oldman & Schenk, *supra* note 21, at *3. The subtraction method subtracts the sum of all the inputs used by a manufacturer or a service corporation from the total value of all taxable sales. This figure is then multiplied by the VAT rate to arrive at the tax owed. See Morris, *supra* note 3, at 1262. If A purchases \$100 in inputs and makes \$200 in sales and a 10% VAT rate exists, he is liable for the VAT rate multiplied by the value added (\$100), or \$10. The subtraction method is favored by Gibbons because it is better suited towards the taxation of services, would not require new accounting systems, and would in general impose less compliance burdens. *Id.* Gibbons argues that the transition to a subtraction method would be easier for the IRS. The credit invoice method, however, is preferable for audit reasons because taxpayers are given an incentive to keep accurate

invoice method⁵⁸ for calculating VAT.⁵⁹ In addition, Gibbons' proposal, and nearly every proposal for a U.S. VAT, embraces the "destination principle" approach to VAT.⁶⁰ Under the destination principle, VAT is only charged at the point of sale.⁶¹ Imports are taxed upon entry into the United States, while exporters are not only exempted from VAT on the final sale but are entitled to a refund of previously paid VAT.⁶² Use of the destination principle is central to the notion of "leveling the playing field."⁶³

Although citing numerous reasons for introduction of a VAT,⁶⁴ one of Gibbons' primary arguments in favor of a U.S. VAT is that it "give[s] our companies and workers a fair chance

records in order to receive a tax refund, and the resulting paper trail makes it easier to detect fraud. Sernau, *supra* note 23, at 1184.

58. Morris, *supra* note 3, at 1262.

59. Most VAT countries use the credit-invoice method. See Bickley, *supra* note 9, at 1273 ("The nearly universal method of calculating VAT is the credit-invoice method.").

Taxes previously paid by a manufacturer are subtracted from the taxes collected on its sales. Thus, if A pays \$20 in taxes purchasing its inputs of \$100, receives \$10 in taxes from sales of \$200, and a 10% VAT rate is in effect, A would receive a refund of \$10. For a more complete discussion and illustration of the credit-invoice mechanism, see Isenbergh, *supra* note 9, at 333-34.

60. See Morris, *supra* note 3, at 1268.

61. See *id.*

62. Oldman & Schenk, *supra* note 21, at *9. All countries that impose a VAT use the destination approach. *Id.* The refund is accomplished by "zero-rating" exporters, which entitles the exporter to a refund of VAT already paid. A VAT "exemption exempts the final sale but does not allow for a refund of previously paid VAT." *Id.* at *13.

A typical example of a VAT "zero-rating" refund is included in the French Tax Code. Articles 256, 262, and 263 of the CGI provide exporters with a "recapture mechanism" for VAT already paid and an exemption for the final sale as long as it is proven that the goods were actually exported. See Cambell & Philippart, *Business Operations in France—Taxation, Tax Mgmt.* (BNA), *Foreign Income Portfolios*, No. 961, at A-102 (1993). For a discussion of similar provisions in the German tax code, see Dr. Juergen Killius & Radler R. Bezenberger, *Business Operation in Germany—Taxation, Tax Mgmt.* (BNA), *Foreign Income Portfolios*, No. 962, at A-63 (citing USTG § 4 *et seq.* (1980)).

63. See Morris, *supra* note 3, at 1268. If the destination principle is used, United States exports remain tax-free but imports are taxed at a normal VAT rate, thus resulting in a boost to United States exports, and simultaneously imposing a larger tax burden on imports.

Use of the "origin principle," whereby exports are taxed and imports are exempted, would only make sense in a country with a large trade surplus—more revenue could be generated by taxing imports. A country-by-country approach is, of course, ideal: exports to countries with whom a trade surplus is maintained would be taxed while imports from countries with whom a trade deficit is maintained would be taxed. See *generally id.*

64. Some of the reasons cited by Gibbons include: (1) increased productivity, (2) increased savings and investment, and (3) savings resulting from the ease of determining and paying taxes. *Id.*

to compete. Other countries, including most of our principal international competitors, already use a VAT, which automatically exempts their exports from tax."⁶⁵ The notion that the VAT will increase the international competitiveness of U.S. firms is common among many U.S. VAT advocates.⁶⁶

The introduction of a retail sales tax or VAT alone could only improve the U.S. trade balance if VAT taxes are not completely forward shifted.⁶⁷ Partially or completely replacing the corporate income tax (CIT) with a VAT could produce trade advantages if either direct taxes are forward shifted or indirect taxes are not.⁶⁸ If direct taxes increase prices but are not border adjusted, it may be advantageous to switch to the an indirect tax which may be permissibly rebated under the GATT because the reversal of the "mismatch" may result in lower prices for the exported good.⁶⁹

In addition to largely ignoring the prevailing views on the forward shifting of direct and indirect taxes, the argument that the U.S. is at a competitive disadvantage does not take into account the fact that VAT countries also levy direct taxes.⁷⁰

Whether VAT exporters actually enjoy a tax advantage over American exporters depends largely on two factors. First, the extent of any advantage given by the GATT distinction between direct and indirect taxes. Second, whether any advantage given to VAT countries is offset by the direct tax burden imposed on exporters in VAT countries. The discussion that follows focuses on the second proposition by contrasting the direct tax burdens in the United States and in three VAT countries. Before comparing the relative tax burdens, a brief discussion of the taxation of U.S. exports and imports is presented.

65. *Id.*

66. See Brannon, *supra* note 22, at *1 ("There has been a spate of discussions of a direct consumption tax, emphasizing that switching to such a tax would produce a valuable balance of trade advantage for the U.S.").

67. McLure, *supra* note 31, at 1524; *see also* Gilbert E. Metcalf, *Value-Added Taxation: A Tax Whose Time Has Come?*, 9 J. ECON. PERSP. 121, 130 (1995) (asserting that a destination style VAT would have no effect on the balance of trade).

68. *See, e.g.* McLure, *supra* note 31, at 1525.

69. Brannon, *supra* note 22, at 1389.

70. *See, e.g.*, Sernau, *supra* note 23, at 1184 ("This note divides the world into indirect and direct tax jurisdictions for illustrative purposes. Most countries use both forms of tax.").

IV. U.S. INCOME TAXES

A. Introduction

U.S. corporations are taxed on all worldwide income.⁷¹ Foreign corporations are only taxable in the United States on sources of income "connected with the conduct of a trade or business within the United States,"⁷² or on gross income derived from U.S. sources but not "effectively connected" to a trade business in the United States.⁷³

B. The Foreign Tax Credit (FTC)

Although a U.S. corporation's worldwide income is taxable, tax credits, or deductions for certain categories of taxes,⁷⁴ may be used to offset taxes paid in foreign countries.⁷⁵ Section 901 avoids the problem of double taxation. Section 901 allows a tax credit to citizens and domestic corporations for the amount of any "income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country."⁷⁶

The section 901 credit is limited to the amount of foreign taxes actually paid.⁷⁷ Otherwise, a taxpayer who pays more in foreign taxes than his corresponding liability in the United States could use the extra foreign tax paid to offset income unrelated to the taxpayer's foreign activities.⁷⁸

71. I.R.C. § 1 (1988).

72. *Id.* § 871(b).

73. *Id.* § 871(a). Such income is taxed at a flat rate of 30%. *Id.*

74. A credit operates as a dollar-for-dollar reduction on an individual's tax liability. A deduction only partially offsets an individual's liability. For example, if *A* owes \$10 to the IRS and receives a credit of \$1, he will have to pay \$9 in taxes. If he is only entitled to a deduction, the deduction merely reduces his taxable income. If *A* has \$100 of income and is in a 40% tax bracket, he will be taxed at 40% of \$99.

75. See generally *id.* §§ 901-904 (1988).

76. *Id.* § 901(a) (1988).

77. *Id.* § 904.

78. For example, *A*, a U.S. exporter, earns \$100 profit on goods in France and pays \$50 in taxes to the government of France. The IRS would have imposed only \$30 in taxes. If the tax credit is not limited, *A* could offset \$20 against income unrelated to his activities in country *X* or use it as a loss.

C. The Source Rules

The rules that determine whether income is derived from sources within or without the United States—the sourcing rules—are established in sections 861-65 of the Internal Revenue Code.⁷⁹ These rules determine whether a U.S. or foreign corporation's income is taxable and, for U.S. corporations, whether any taxes owed in the United States may be offset with a foreign tax credit.

The general “sourcing” rule is that income from the sale of personal property by a U.S. citizen is sourced within the United States.⁸⁰ In actuality, the rule is swallowed by its exceptions. Sale of goods transactions are not governed by section 865(a) because section 865(b) exempts income from the sale of inventory property⁸¹ from the general rule of section 865(a). Instead, sourcing is determined by sections 861(a), 862(a)(6), and 863(b).⁸²

Section 861(a)(6) applies to purchases of inventory in the United States and their sale outside of the United States and vice-versa.⁸³ The place of sale is determinative of the source of income.⁸⁴ The key to determining where a product is sold under section 861(a)(6) is to determine where the sale occurs.⁸⁵ The “place of sale” is defined as the “place where rights, title, and interest of the seller in the property are transferred to the buyer.”⁸⁶ The sale occurs where the title passes except “in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance.”⁸⁷ In these cases, the Treasury considers factors such as the place of negotiations, the place of execution of the agreement, the place of

79. *Id.* § 865 (1988).

80. *Id.* § 865 (1988).

81. Inventory property is defined in § 861(i)(1) as personal property as defined by section 1221 of the IRC. *Id.* § 861(i)(1). Section 1221's definition is interpreted to include pure selling activities and not sales resulting from the culmination of a manufacturing process. JOSEPH ISENBERGH, *INTERNATIONAL TAX* 137.

82. I.R.C. § 865(b) (1988).

83. *Id.* § 861(a)(6) (1988).

84. 2 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 70.6.3 (1991).

85. Treas. Reg. § 1.861-7(c) (1957).

86. *Id.*

87. *Id.*

payment, and the location of the property when determining whether the transaction was arranged to avoid taxation.⁸⁸

The "title passage" or "place of sale" principle has significant consequences for foreign importers and U.S. exporters. A foreign importer can structure a transaction so that title passes in the foreign country and escape taxation on the manufacturing component of a transaction.⁸⁹ U.S. exporters can structure transactions to generate foreign source income⁹⁰ and, consequently, foreign tax credits.⁹¹ Attempts to blatantly manipulate the place of sale rule, however, through the use of overseas subsidiaries may encounter a number of difficulties. First, the place of sale may be recast if the principle purpose of the structure of the transaction is tax avoidance.⁹² Second, attempts to manipulate the prices and profits attributable to foreign source and U.S. income may pose section 482 problems.⁹³ Third, attempts to

88. *Id.*

89. Problems arise if the foreign manufacturer has an office or other fixed place of business in the United States because of taxation treaties between the United States and its trading partners. See Francene M. Augustyn, *A Primer for Incorporating Under the Income Tax Laws of France, Germany, or the United Kingdom*, 7 J. INT'L L. BUS. 267, 315 (1985). Some of the income from the manufacturing component could be attributed to the permanent establishment. *Id.* It is assumed that the foreign manufacturer in this paper does not have a permanent establishment in the United States. See also Treas. Reg. 1.864-7 (defining office and fixed place of business).

90. Title to inventory property is purchased in the United States and is passed outside the United States; the profits from the sale are thus deemed foreign source income. I.R.C. § 862(a)(6) (Supp. 1993); see also Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 32 n.57 (1993).

91. See Caroline A. Krass, *A Guide to the Source of Income Rules for the Sale and Purchase of Inventory Property*, 45 TAX LAW. 857, 858-89 (1992). The tax credit rules assure that the U.S. exporter exporting to a country with a lower rate of taxation pays the same rate of taxation as a domestic producer. *Id.* Excess tax credits may be credited towards other taxable years. *Id.*

92. See *infra* text accompanying note 88.

93. One of the goals of section 482 was to address the problem of corporations hiding profits from U.S. taxation by false intercompany pricing. See Joseph R. Gauche, *Section 482: Past and Present Significant Section 482 Litigation*, in TRANSFER PRICING AND THE FOREIGN OWNED CORPORATION 119 (1991) ("[The purpose of section 482 is to] prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'), and in order to clearly reflect the true tax liability.") (quoting H.R. REP. NO. 2, 70th Cong., 1st Sess. 16-17 (1927)).

In cases where two or more organizations are indirectly or directly owned by the same interest, section 482 allows the Secretary to "distribute, apportion, or allocate gross income . . . among such organizations . . . if he determines that such distribution . . . is necessary in order to prevent evasion of taxes or to clearly reflect the income of any such organizations." I.R.C. § 482 (1988).

retain profits at the overseas subsidiary level, and thus receive a deferral of taxation, could result in the recharacterization of the profits as distributions to the shareholders under the controlled foreign corporation rules.⁹⁴

Inventory produced within the United States and directly sold in a foreign country or inventory produced in a foreign country and directly sold in the United States are deemed to have both foreign source and U.S. source components.⁹⁵ Section 863(b) gives the Treasury the power to determine the formula for dividing foreign source and U.S. source income for manufactured goods.⁹⁶

The Treasury uses three techniques for determining the portion within the United States and without the United States.⁹⁷ Regulation 1.863-3 states that where a "producer regularly sells part of his output to wholly independent distributors . . . in such way as to establish fairly and independent factory or production price . . . the taxable income attributable to sources within the United States shall be computed . . . at the independent factory price so established."⁹⁸

In sum, if the producer is in the regular business of using a middleman to sell overseas, the profits gained in the sale to the middleman are used to compute the portion of profits attributable to sources within the United States in sales to its own overseas distributing branch.⁹⁹ The U.S. source component, or profit from the sale to the middleman is used to compute the U.S. source income in sales to its distributing branch.¹⁰⁰

Another method relies on the records of the manufacturer to determine the portion of profits attributable to U.S. source income.¹⁰¹ The regulation allows the taxpayer to calculate the source allocation on the basis of his own records if he "in good faith and unaffected by considerations of tax liability, regularly employs in his books . . . a detailed allocation of receipts . . . which

94. *See id.* §§ 951-967.

95. *Id.* § 863(b)(2); *see also* BITTKER & LOKKEN, *supra* note 84, at ¶ 70.6.3.

96. *Id.* ("[T]he portion of such taxable income attributable to sources within the United States may be determined by processes of formulas of general apportionment prescribed by the Secretary.")

97. *Treas. Reg.* § 1.863-3 (1957).

98. *Id.* example 1.

99. *Treas. Reg.* § 1.8633(b)(2) (example 1); BITTKER & LOKKEN, *supra* note 84, at ¶ 70.6.3.

100. BITTKER & LOKKEN, *supra* note 84, at ¶ 70.6.3.

101. *Treas. Reg.* § 1.863-3, example 3 (1957).

reflects more clearly than the processes or formulas herein prescribed the taxable income derived from sources within the United States."¹⁰²

The burden is on the taxpayer to prove that his records are more reliable than the method prescribed by the Treasury.¹⁰³ As a result, this method is infrequently used.¹⁰⁴

The final method uses a specific formula to divide domestic and foreign source income.¹⁰⁵ Taxable income is divided into two portions. One half is allocated to the place of sale and the other half is dependent on the portion of the taxpayer's property within and without the United States.¹⁰⁶ If a U.S. producer exports to foreign countries and does not produce goods overseas for sale in the United States, the sales half is entirely foreign source income.¹⁰⁷ If a foreign producer sells in the United States and does not sell goods manufactured in the United States to foreign countries, the sales half is entirely U.S. source income.¹⁰⁸

V. THE FOREIGN TAX BURDEN

A. Introduction

A foreign corporation is one created or incorporated under the laws of a foreign jurisdiction or a U.S. possession.¹⁰⁹ As discussed above, because of the passage of title principle it is fairly easy to overcome a portion of the taxation imposed on imports or for U.S. manufacturers to receive a tax credit for exports.¹¹⁰

102. *Id.*

103. *Id.*

104. ISENBERGH, *supra* note 81, at 177-81.

105. Treas. Reg. § 1.863-3T, example 2 (1957).

106. *Id.*

107. BITTKER & LOKKEN, *supra* note 84, at ¶ 70.6.3. For example, a U.S. producer makes a total profit of \$100 on the sale of manufactured inventory. Fifty dollars is assigned to the place of sale and because the producer does not produce goods overseas for sale in the United States, all \$50 is foreign source income. All the producer's property is located in the United States and thus the remaining \$50 is U.S. source income. If the United States imposes a 30% tax rate, the producer's U.S. tax liability would be \$30. If the foreign government imposes an additional tax of \$20 on the sale in the foreign country, the producer would receive a \$20 tax credit to be applied against the \$15 deemed foreign source income. The excess tax credit of \$5 could be applied to other years and the producer's total tax liability would be \$35.

108. *Id.*

109. I.R.C. § 7701(a)(4); *see also* BITTKER & LOKKEN, *supra* note 84, at ¶ 65.3.

110. *See infra* discussion at Part IV.C.

Imports are generally taxed if they are produced or bought in a foreign country and then sold or exchanged in the United States. Under GATT, any VAT taxes imposed on the transaction may be refunded when the goods are exported. In contrast, the U.S. manufacturer must pay at least a portion of his manufacturing profits to the United States because of the export sourcing rules. Furthermore, the refund of this type of direct tax is not permissible under the GATT rules.

Thus, the GATT distinction between indirect and direct taxes and the advantage given to foreign corporations and foreign subsidiaries of U.S. parents under the passage of title rule may favor exporters in VAT countries. It is this contention that is relied on by Gibbons and other proponents of a United States VAT. The premise is that American manufacturers are put at a disadvantage in international trade by the GATT's prohibition of direct tax refunds and the permissibility of indirect tax refunds. In addition to assuming that the VAT is not "forward shifted" or that direct taxes are forward shifted, many proponents of a U.S. VAT also assumes that VAT countries do not levy significant direct taxes; however, virtually every country uses a mix of indirect and direct taxes.¹¹¹ Even assuming that the GATT distinction does give VAT exporters an advantage, the use of direct taxes in VAT jurisdictions may partially offset any advantages under the GATT.

B. Foreign Tax Systems

Unlike the United States, which holds corporations liable for all worldwide income, the French tax system is based on the principle of territoriality: "the tax law is not applicable beyond French territorial limits."¹¹²

The French corporation¹¹³ is subject to the corporate income tax currently levied at 33 1/3%.¹¹⁴ Foreign business entities are

111. The United States already imposes indirect taxes such as the state sales tax. In fact, the sales tax operates much like VAT because it taxes the value of the good rather than the profits from a particular transaction. For a discussion of the differences between a retail sales tax and a VAT, see Massa & Raboy, *supra* note 30.

112. Augustyn, *supra* note 89, at 269. French territories are defined to include Metropolitan France, Corsica, and France's "overseas departments". *Id.*

113. The following business entities are subject to the French corporate income tax: the stock corporation, the limited liability company, and the limited partnership. *Id.* at 271.

114. CGI art. 219. In 1985, a flat rate of 50% was imposed on many business entities. See Augustyn, *supra* note 89, at 270. The lower rate may have been a reaction to the large tax cuts introduced in the United States by the 1986 reforms. John G. Wilkins, *Coopers*

subject to the French corporation income tax if they have a permanent establishment in France.¹¹⁵ A variety of exemptions and credits not relevant to this discussion are provided to French business entities.¹¹⁶

The German tax system imposes unlimited tax liability on residents and limited liability for non-residents.¹¹⁷ It is thus closer to the "worldwide profits" approach of the United States than to the territorial approach of France.¹¹⁸

The German corporation tax is currently levied at 45% percent.¹¹⁹ Entities subject to the German corporate income tax are the stock corporation, the limited liability company, and the partnership limited by shares.¹²⁰

Like the German system, the United Kingdom imposes liability on the worldwide profits of "resident" corporations and on the domestic source income of non-residents.¹²¹ Residency is not dependent on the place of incorporation but rather on the location of central management and control.¹²² Income tax treaties generally render the resident and non-resident's tax liability the

& Lybrand Director Testifies on International Competitiveness, 91 TAX NOTES TODAY, July 19, 1991, Doc. No. 152-37, available in LEXIS, Fedtax Library, TNT File at *4-5 (statement of John G. Wilkins before the Committee on Ways and Means U.S. House of Representatives Hearings on Factors Affecting U.S. International Competitiveness) ("Following the move of the United States, the EEC countries lowered their corporate income tax rates about 12 1/2 percent, from a 1986 average of 46.4 percent to a 1991 average tax rate of 40.6 percent.").

115. Augustyn, *supra* note 89, at 270. The definition of a permanent establishment is normally defined by treaty. *Id.* This Comment assumes that the definition is met.

116. Tax exemption is provided to corporations located in certain "enterprise zones" in France in order to encourage industrial investment in these regions. CGI art. 208 *quinquies* (I)(1) (1993). Tax exemption is also provided to new businesses formed after October 1, 1988. CGI art. 44 *sexies* (1993).

117. See Augustyn, *supra* note 89, at 273.

118. Like U.S. corporations, German corporations may be liable for certain types of foreign source income. Thus, a German manufacturer may be liable for profits on the retailing transaction in the United States; however, the manufacturing component of the transaction is most important to this discussion.

119. Perry D. Quick & Thomas Neubig, *Tax Burden Comparison: U.S. vs. the Rest of the G-7*, 65 TAX NOTES 1409, 1418 (1994). A thirty percent rate is levied on distributed earnings. *Id.*

120. Augustyn, *supra* note 89, at 273.

121. *Id.* at 274.

122. *Id.* The primary factor in determining central management and control is the location of directors' meetings. *Id.* at 237.

same.¹²³ The U.K. corporation is liable for thirty-three percent of its profits.¹²⁴

A significant difference between the three countries is France's reliance on the territoriality principle. The French manufacturer or American subsidiary can escape French taxation on the retailing component of the transaction; however, the existence of tax credit provisions in the United Kingdom and Germany render this difference less meaningful.¹²⁵ The total tax on the retailer is largely determined by the rate of U.S. taxation.

In contrast, the tax on the manufacturing component of a foreign or American subsidiary is determined by the host countries corporate tax rate.

C. Comparative Effective Tax Rates

There are a variety of methods of measuring comparative tax rates. Top statutory corporate tax rates fail to accurately measure comparative tax burdens because of differences in tax bases, but they may provide some indication of "a tax environment that is friendly or hostile toward high-income or business taxpayers within a country or state."¹²⁶ Top statutory corporate income tax rates are 33.3% in France, 45% in Germany,¹²⁷ and 33% in the United Kingdom.¹²⁸ The current top statutory rate in the United States is 35%.¹²⁹

Attempts to measure "effective" comparative corporate income taxes may be more accurate. One method compares

123. *Id.* at 276 ("Where a nonresident company is [taxable by treaty], the computation of liability on the chargeable profits of the permanent establishment corresponds generally that of a United Kingdom resident company.").

124. Quick & Neubig, *Tax Burden*, *supra* note 119, at 1418.

125. Augustyn, *supra* note 89, at 279 ("[T]his apparent advantage is minimized when it is recognized that worldwide taxing regimes generally allow for a credit or deduction for foreign taxes paid.").

126. Quick & Neubig, *Tax Burden*, *supra* note 119, at 1418 (table 8); *see also* Perry D. Quick & Thomas S. Neubig, *Enterprise Economics and Tax Reform: Working Papers Volume II, Comparing Tax Burdens*, 94 TAX NOTES TODAY, October 13, 1994, Doc. No. 201-45, available in LEXIS, Fedtax Library, TNT File ("The economic significance of a tax's burden depends on several distinct factors. First, what activities or objects are included in the tax base, and what—if any—activities or objects . . . receive special exemptions?").

127. Thirty percent on distributed earnings. Quick & Neubig, *Tax Burden*, *supra* note 119, at 1418.

128. *Id.*

129. I.R.C. § 11 (1988 & VI Supp. 1994).

corporate tax revenues as a percentage of total tax revenues.¹³⁰ Another measure of corporate tax revenues as a percentage of total gross domestic product (GDP).¹³¹

Corporate income taxes generally account for a small percentage of overall government revenues in G-7¹³² countries and average 8.8%.¹³³ The United States relies less on corporate taxes to generate revenues; however, this percentage does not necessarily measure the actual burdens faced by U.S. corporations because a principal drawback of this measure is that changes in other sources of revenue may produce a change in the corporate percentage even if the corporate rates do not change.¹³⁴ U.S. corporate income taxes have declined as a percentage of revenues since 1970.¹³⁵ Similar declines have occurred in the G-7 countries.¹³⁶

As a percentage of Gross Domestic Product (GDP), the United States also stands in the middle of the G-7 countries. In 1988, corporate income taxes accounted for 2.5 percent of U.S. GDP, 2.3 percent of French GDP, 2.0% of German GDP, and 4.0% of U.K. GDP.¹³⁷ This measure, however, 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."¹³⁸

These methods also fail to account for the effects of the double taxation of dividends in the United States where taxes are imposed at the corporate level by the corporate income taxes and

130. Wilkins, *supra* note 114.

131. *Id.* at *15.

132. The G-7 stands for the group of 7 countries "considered the lead economies of the world" and includes Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. *Id.* at *5 n.3.

133. Neubig & Quick, *Tax Burden*, *supra* note 119, at 1415. U.S. corporate taxes account for 7.3% of tax revenues. French and German corporate taxes account for only 4.5% and 4.3% of revenues respectively while in the United Kingdom, corporate taxes account for 8.9% of revenues. *Id.*

134. See Wilkins, *supra* note 114.

135. Neubig & Quick, *Tax Burden*, *supra* note 119, at 1415-16. In 1970, corporate income taxes accounted for 12.7% of total tax revenues in the United States and 10.9% of G-7 revenues. *Id.* By 1991, these figures were 7.3% and 8.8% respectively. *Id.*

136. *Id.*

137. Wilkins, *supra* note 114, at *14. In addition, France and Germany "paid out nontax subsidies to businesses that exceeded the total income tax collected from corporations." *Id.* at *12.

138. *Id.* at *8.

at the shareholder level by personal income taxes.¹³⁹ In contrast, Germany, France, and the United Kingdom all allow some relief from double taxation by “integration” of the two taxes.¹⁴⁰ Germany and France allow for total integration.¹⁴¹

The integration is allowed at the shareholder level by providing the taxpayer with a credit for taxes previously paid by the corporation.¹⁴² The integration does not affect corporate income tax statistics because the integration occurs at the personal income tax level; however, comparing effective rates of effective taxation without any discussion of integration would be misleading—a corporation's profits are not only taxed by the corporate income tax but also when distributed.¹⁴³ A more accurate comparison of cross-country tax rates accounts for the effects of integration.

Some commentators suggest comparing effective tax rates made on new investments.¹⁴⁴ In 1991, the United States taxed domestic investment 37.5%. Germany's rate was only 15.3%, The United Kingdom's rate was 28.6% and France's rate was 31.5%.¹⁴⁵ These commentators conclude that while the United States has lower tax revenues as a percentage of GDP than many of its trading partners,¹⁴⁶ comparison of effective rates on new

139. Neubig & Quick, *Tax Burden*, *supra* note 119, at 1418.

140. *Id.*

141. *Id.*

142. *Id.*

143. *See id.* The double or even triple taxation of corporate profits, predictably, attracts much criticism. *See, e.g.* Wilkins, *supra* note 114, at *4 (stating that the lack of integration is one of the “critical problems” of the U.S. tax system).

144. *Id.* Comparing the effective rates on new investments reflects taxation on both new and old investments because “long lived assets such as machinery and structures are depreciated over multiple years.” *Id.* at *23. In addition, tax policy “generally can influence firms’ decisions on new, but not existing investments.” *Id.*

145. Another methodology suggested by Neubig and Quick uses combined corporate and individual income tax rates. Under this method, the United States places in the middle of the pack. In 1991, France had the lowest combined rate of 6.4%, Germany had a 13.2% rate, the United States had a 13.8% rate, and the United Kingdom had the highest combined rate of 14.7%. Neubig & Quick, *Tax Burden*, *supra* note 119, at 1418 (table 9).

146. *Id.* at 1410. U.S. tax revenues as a percentage of total GDP were 29.8% in 1991. Germany collected 39.2% of GDP, the United Kingdom collected 36.0% and France collected 44.2%. France's extremely high figure probably results from its heavy reliance on payroll taxes: France collects 40.1% of total tax revenues from payroll taxes. *Id.* at 1413. Payroll taxes have been ignored because it is unclear on whom the incidence of these taxes fall. *See id.* at 1421 (“International comparisons of tax rates on labor income do not address who bears the burden of labor taxes.”).

investments reveals that "the United States has one of the highest marginal tax rates on corporate capital income among the G-7 countries."¹⁴⁷ The average rate of U.S. taxation of inbound investment into the United States also supports Gibbons' assertions that the U.S. is at a competitive disadvantage with its competitors. While effective average tax rates on domestic investment are 37.5%, rates on inbound investment are only 36.7%.¹⁴⁸

VI. CONCLUSION

The studies on cross-country tax burdens suggest that if VAT taxes are not forward shifted or that direct tax benefits are forward shifted, there is some justification for Gibbons' assertion that U.S. corporations are at a competitive disadvantage with foreign competitors. The magnitude of this advantage is unclear because of the controversy surrounding the extent of forward shifting of indirect and direct taxes and the scarcity and uncertainty of the data surrounding comparative tax rates.

The partial replacement of the current corporate income tax system with a VAT style tax could offset any advantage or even give U.S. corporations an advantage by both lowering the direct tax burden and by giving U.S. corporations the opportunity to take advantage of the VAT refund. Any such advantage may be short lived. The advantage could be eventually offset by changes in exchange rates.¹⁴⁹ Furthermore, if seen as a blatant attempt to manipulate GATT rules, retaliation would be a possibility. In particular, VAT exporters could adjust their own corporate and VAT rates to compensate for the U.S. readjustment. As a result, although there are many strong arguments for a U.S. VAT, international competitiveness alone seems a poor justification.¹⁵⁰

Christopher Deal

147. *Id.* at 1422.

148. *Id.*

149. McLure, *supra* note 31, at 1525 ("[A]ny positive effect on competitiveness resulting from such a shift in tax policy would probably be temporary, lasting only until offset by adjustments in exchange rates."); Brannon, *supra* note 22, at 1389.

150. *See* McLure, *supra* note 31, at 1525 ("The uncertain and temporal benefits on international trade that might result from substituting a VAT for part of the corporate income tax or choosing it over other sources of additional revenues should not weigh heavily in the decision of whether to follow such policies.").