Abstract - The American Jobs Creation Act (AJCA) of 2004 eliminated the Extraterritorial Income provision (found to be an export subsidy), a change that improved economic efficiency and tax administration, as was likely the case with a number of tax shelter provisions. A provision allowing a special deduction from taxable income for manufacturing and certain other industries is likely to increase distortions and add complexity to the code. A temporary repatriation tax holiday for foreign source income is also likely to reduce revenue with little justification. Other foreign tax provisions are, however, more difficult to evaluate.

INTRODUCTION

The original purpose of the American Jobs Creation Act (AJCA), passed in 2004, was to eliminate the Extraterritorial Income provision (ETI) that had been found to be an export subsidy by the World Trade Organization (WTO). The ETI provision replaced the Foreign Sales Corporation (FSC) provision in an attempt to address WTO concerns, and the FSC was a replacement enacted in 1981 for the Domestic International Sales Corporation (DISC) provision in an attempt to address concerns of WTO’s predecessor organization, the General Agreement on Tariffs and Trade (GATT). Even after the replacement of FSC with ETI, there was a long delay in Congress reflecting the difficulty in getting the votes to repeal this provision that had become ensconced in the tax code. Some of the delay in enacting the bill also reflected the time to iron out differences between the House and Senate versions.

Towards the end of the revenue estimating horizon (2013), the permanent revenue gain from repealing the ETI was about $7 billion. However, the elimination of the ETI is only a small part of AJCA. This paper evaluates the major provisions of the bill, based on an efficiency standard, and classifies them as “good, bad or ugly,” or uncertain.

THE LAY OF THE LAND: IT’S NOT A DESERT OUT THERE

ETI was hardly the lone player in the 2004 tax drama; the provision eliminating the ETI was joined by, if not a cast...
of thousands, at least a cast of dozens. According to a line count of the Joint Committee on Taxation’s (2004) estimates measures there were 178 other tax changes in the corporate bill.

Obviously, it is impossible to assess 179 tax provisions, or even easily to characterize the bill. This section summarizes the major provisions of the bills judged by their revenue gains or loss. The AJCA cost $8.7 billion over the first five years (2005–2009) and was revenue neutral over ten years. This paper does not address a tobacco market revision included in the legislation paid for an assessment on tobacco companies.

The legislation contained both permanent and temporary provisions and had both revenue losers and revenue gainers. Estimates of the permanent provisions are provided for FY2013, to capture full phase-ins. For temporary provisions, choosing a particular year would be misleading, so these numbers are presented over several years.

Table 1 lists the major permanent revenue gainers and losers in the bill. To provide some perspective, in that year the corporate tax is estimated to raise $307 billion.

As the table indicates, the major revenue raising provisions are the ETI repeal and a set of tax shelter provisions, both raising almost $7 billion. The provision restricting leasing arrangements between taxable and tax-exempt entities is the single largest tax shelter provision, accounting for about 60 percent of the gain. There were also some general anti-shelter restrictions involving penalties and some other substantive changes in the law, including a provision aimed at limiting corporate inversions that occur when companies move their headquarters abroad to reduce taxes.

The most significant revenue loser is the 9 percent deduction for income from production activities, which cost $11.5 billion. The second largest set of provisions reduced the tax burdens on income from foreign source investments—the final legislation contained 25 provisions in this area, with most changes permanent. Over 90 percent of the cost of the provisions affected the foreign tax credit. The largest provision (common to all bills) was a provision allowing foreign interest as well as domestic interest to be allocated between U.S. and foreign sources for purposes of determining the limit on the foreign tax credit, which accounted for $2.8 billion of the total. (Note that there is some interaction between provisions and these estimates assume each is changed independently.) The next largest single provision in the Senate bill was extended carryovers and carrybacks of the foreign tax credit ($1.4 billion) and in the House bill combining foreign tax credit baskets ($1.1 billion)—versions of both provisions (costing $1.0 billion and $1.1 billion respectively) were included in the conference report (although some other provisions were not). Other international provisions with significant revenue losses contained in the final legislation were a provision recharacterizing domestic losses ($0.9 billion) and a provision repealing the 90 percent limitation on foreign tax credits under the alternative minimum tax ($0.3 billion).

Table 2 reports the temporary revenue gainer and losers. In this case, because of

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<th>Table 1</th>
<th>PERMANENT REVENUE GAINERS AND LOSERS, GAIN AND LOSS IN FY2013 (Billions of Dollars)</th>
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<tbody>
<tr>
<td>Revenue Gainers</td>
<td>Gain</td>
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<tr>
<td>Repeal ETI Provision</td>
<td>6.8</td>
</tr>
<tr>
<td>Tax Shelter and Related Provisions</td>
<td>6.8</td>
</tr>
<tr>
<td>Excise Taxes</td>
<td>1.1</td>
</tr>
<tr>
<td>Miscellaneous Revenue Raisers</td>
<td>0.4</td>
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</tbody>
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Source: Estimates from Joint Committee on Taxation (2004).
The 2004 Corporate Tax Revisions as a Spaghetti Western: Good, Bad, and Ugly

The unevenness of the revenue effect, the provisions are reported as the averages over budget horizons. The temporary gainer is an extension of custom fees. The most significant temporary revenue loser was a one-year exclusion for 85 percent of certain repatriated dividends from foreign subsidiaries of multinationals. Another significant temporary provision extended the expanded limit on expensing of investment in equipment for small businesses. The legislation also contained a temporary provision allowing state and local sales tax deductions for itemizers in lieu of the state income tax deduction, a provision that will primarily benefit itemizers in the eight states with a sales tax but without a broad based state income tax. The final bill also contained a provision allowing the expensing of certain costs of producing films.

ASSESSMENT OF PROVISIONS: THE STANDARD OF EFFICIENCY

In discussing which provisions were “good,” and which were “bad” or “ugly,” one needs a standard of assessment. That standard for purposes of this paper is efficiency, which can encompass not only a good provision that reduces tax distortions (and a bad one that magnifies them), but also includes administrative and compliance costs. An otherwise desirable provision that creates an administrative nightmare cannot be considered wholly good, and a bad provision that does so can become a very ugly provision indeed.

Administrative and compliance costs are important to consider in a number of the major provisions of the legislation.

Whether the provision gains or loses revenue is not considered part of the efficiency criterion for characterizing the provisions although, given both the short term and longer run fiscal pressures facing the country, a good provision that also raises revenue might be seen as especially good, while a good provision that loses revenue comes at a price.

Finally, any change produces windfall gains and losses; this effect, unless it could be easily avoided, does not figure into the assessment, but it was inevitably part of the political calculus. Indeed, it was the concerns about the loss of the ETI provision and its effects on certain firms that caused such a delay in passing the legislation. In this assessment, however, the viewpoint is one of the benefits and costs to the nation as a whole.

Not all provisions will be considered in this discussion, and in particular the changes in customs fees and excise taxes will not be addressed. But there is an attempt to cover the important income tax provisions, as judged by revenue effect.

THE “BEST” OF THE “GOOD”: ELIMINATING THE PROVISION WITH THREE NAMES (DISC, FISC, ETI)

Using these criteria, the hands down winner for a good change is the elimination of the ETI provision. While recognizing that this provision was important to

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**TABLE 2**
TEMPORARY REVENUE Gainers AND LOSers, AVERAGE ANNUAL COST (Billions of Dollars)

<table>
<thead>
<tr>
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<tr>
<td>Extension of Customs Duties</td>
<td>1.5</td>
<td>1.0</td>
</tr>
<tr>
<td>Lower Tax On Repatriations</td>
<td>-2.0</td>
<td>-3.3</td>
</tr>
<tr>
<td>Small Business Expensing</td>
<td>-1.4</td>
<td>-0.1</td>
</tr>
<tr>
<td>State and Local Tax Deduction</td>
<td>-0.5</td>
<td>-0.3</td>
</tr>
<tr>
<td>Depreciation, Film and Broadcasting</td>
<td>-0.3</td>
<td>(1)</td>
</tr>
<tr>
<td>Energy Sunsets</td>
<td>-0.4</td>
<td>(1)</td>
</tr>
<tr>
<td>Other Sunsets</td>
<td>-1.8</td>
<td>-0.5</td>
</tr>
</tbody>
</table>

Source: Estimates from Joint Committee on Taxation (2004).
(1) Less than $50 million.
certain companies and their employees (the factor that made it so difficult to eliminate), from an overall social viewpoint a subsidy for exports makes no economic sense. Not only does it distort trade, it subsidizes prices paid by foreigners with the tab borne by the FISC, and therefore the American people. It distorts and gives away resources. In a study on tax expenditures where the “dirty dozen” most questionable tax expenditures were listed, export subsidies were at the top of the list, and rightfully so (The Century Foundation, 2002). Of course, there are actually two export provisions; the other provision, the title passage rule, has a similar magnitude of revenue loss to the ETI provision. (The title passage rule allows significant income from exports to be allocated to foreign sources for purposes of the foreign tax credit limit).

Some form of the ETI export provision has been in the tax law for more than 30 years. It was proposed in the late 1960s primarily as a way to deal with a short run balance of payments problem when the U.S. still had fixed exchange rates. Even then, one should question the adoption of a permanent tax measure to deal with a short-run problem. But by the time the export provision was adopted, in 1971, we were headed towards flexible exchange rates but had not formally adopted them. Within two years, however, the U.S. moved to this flexible system, which obviated the original purpose of the provision.

In the then Joint Committee on Internal Revenue Taxation’s blue book (1972) giving the reasons for change, another reason is mentioned: the ability of firms to manufacture abroad through foreign incorporated subsidiaries. A beneficial treatment for export activities would bring the tax treatment closer to that allowed for manufacturing abroad. Of course, this change favors both producing abroad and producing for export relative to domestic provision for domestic consumption.

Interestingly, when the issue of repealing the ETI arose, arguments were made to also move to a territorial system, whereas an approach to bring the treatment of domestic and foreign manufacturing for export (a concern expressed in 1971) would have been to move in the opposite direction, towards current taxation of active income of foreign incorporated subsidiaries of U.S. firms. Whether this proposal reflected a misunderstanding of the economic effects or simply that revenue gains from repeal of the ETI were to be returned to multinationals is not clear.

The export subsidy, as with any provision that singles out a particular activity for preferential treatment, also complicated tax administration. DISC and its successors were implemented through the creation of a special export subsidiary, and required a complex set of rules to define and allocate deferred eligible income.

Whether the reasons for enactment were bad or good, the provision stayed in the tax law through two earlier challenges by world trade groups. The GATT challenged DISC in 1981, which led to FSC; the WTO challenged FSC in 1999 which led to the adoption of ETI in 2000 and an almost immediate challenge leading to a new finding in 2001. An additional three years were required to repeal it. Essentially a provision enacted to deal with a short term problem arising from fixed exchange rates stayed in the tax law for over 30 years and through three challenges from world trade institutions—a lesson in the politics of tax policy.

THE “WORST” OF THE “BAD” OR “UGLY”: THE PRODUCTION ACTIVITIES DEDUCTION

Just as the repeal of the ETI is an obvious candidate for good policy, the production activities provision is an obvious candidate for bad policy. At least part of the motivation for the provision was to
help firms that had been harmed by the repeal of the ETI, although, as the revenue estimates above indicate, the $11.5 billion cost of the production activities deduction was $4.7 billion in excess of the gain from the ETI. In the aggregate, firms got back about 70 percent more than they lost—although clearly some firms obtained considerably more than they lost and others considerably less.

The tenacity with which the export provision persisted in the tax law should be a lesson in the risks and outcomes of enacting such special provisions to deal with perceived short-run problems, and the production activities deduction joins a host of other troublesome provisions enacted in the same fashion (the most notable one of all being percentage depletion, whose roots can be traced back as an aid to the war effort in 1918). Indeed the story of the adoption of the production activities provision is eerily reminiscent of the original development of DISC. The original objective that made the provision so broadly appealing was to aid manufacturing, which was in a slump at least with respect to employment—yet another short-run concern addressed with a permanent tax provision. Moreover, many economists argued that decline in manufacturing jobs was due to productivity gains—not really an issue that needed to be remedied.

The initial proposal, however, had bipartisan support and gained popularity quickly although many tax professionals and some Members of Congress voiced reservations about the provision (Rojas, 2004). After enactment, the IRS commissioner expressed concerns (Rojas, 2004) and Senator Grassley (Stamper, 2005) has also indicated that this provision might need to be reconsidered.

The original target was manufacturing, but coverage spread, with the final bill including not only manufactured products but products grown or extracted, along with domestic film and energy production (other than sexually explicit productions), construction, and engineering and architectural services. The deduction was broadly applied to taxpayers, including pass-through entities and cooperatives, although a restriction to 50 percent of wages eliminates the coverage of sole proprietorships without employees (which might include many farmers). According to tax expenditure estimates, about a quarter of the benefit is received by individuals. The deduction is not treated as a preference under the alternative minimum tax and is phased in over six years.

In a letter dated September 22, 2004 to Mark Prator and Patrick Heck, responding to a query about the similar (although slightly different) Senate version of the provision, the Joint Tax Committee indicated that three quarters of the benefit would have gone to corporations, 12 percent would have gone to Subchapter S firms (smaller incorporated firms that elect to be treated as partnerships) and cooperatives, 9 percent would have gone to partnerships, and 4 percent to sole proprietorships. Based on the revenue estimates ($3 billion for 2006) and projected corporate tax receipts of $249 billion for that year, the implication is that around a third of corporate activity qualifies. Once the provision is fully phased in, the overall corporate effective tax rates would fall by about 3 percent, with the individual rate falling somewhat less. Since about a third of investment is financed by debt, a third of the capital stock is invested in owner-occupied housing, and about a fifth of the capital stock is invested in unincorporated business, which would be less affected; the reduction in the overall economy-wise tax rate would be less than 2 tenths of a percentage point or a reduction of slightly over 1 percent with a current overall capital income tax rate of around 30 percent. Thus the change is not a large one.

The beneficial treatment given to income from these activities will encourage
more investment in manufacturing and other production activities and less in sales and services. It will also encourage more equity investment in the affected sectors.

The provision rates bad marks for two reasons. First, it is largely a provision that increases distortions between different investments and, even for those margin it improves, there are other ways to provide benefits in a more neutral fashion. Secondly, and in this case perhaps more importantly, the administrative and compliance cost of this provision could pose a significant problem.

Efficiency Issues: Deadweight Losses

One effect of the provision is to subsidize domestic production. Is this effect desirable? Under a common standard used by economists to judge world wide economic efficiency (which suggests that U.S.–owned capital is allocated most efficiently when rates of return are equated in both places) the direction of change depends on the extent to which foreign source income is undertaxed relative to U.S. income (as it is in low tax countries) or overtaxed (as it is in high tax countries). If the objective is to maximize U.S. economic welfare, however, it is better to encourage domestic investment in large part because taxes on returns to domestic investment accrue to the U.S. Treasury, while taxes on returns to foreign source investment may largely accrue to foreign governments. (This analysis assumes that foreign governments do not retaliate against U.S. policies to discourage capital outflow). Even if the domestic incentive were considered desirable, however, it would be better to provide a benefit that is more uniform across industries.

Had rate cuts been restricted to corporations, the distortion between corporate and non–corporate sectors would have decreased, but with the provision applying to both corporate and noncorporate investment, there is little gain. Moreover, the most significant sector to which the deduction applies, manufacturing, is virtually entirely corporate in any case, and there can be little misallocation of capital between the corporate and noncorporate sectors in the first place. (Evidence of this distortion is too much non–corporate capital; if there is virtually none in an industry, the distortion between corporate and non–corporate production is virtually non–existent).

There may be some gain in reducing the distortion between debt and equity for the corporate sector. But such a gain could also be made by an overall corporate rate cut.

The provision produces a new distortion, however, one that favors the defined “production” activities of manufacturing, extraction, agriculture, energy production, construction, and film–making.

Administrative Issues

Carving out a special tax provision for a particular industry will create some significant administrative costs: in the definition of the favored activity, the allocation of income for diversified firms, and in the definition of domestic as opposed to foreign production.

No definition of the favored activity can be drawn that will not give rise to some disputes about what activities are or are not eligible. Consider, for example, manufacturing. State experience with manufacturing exemptions is instructive in showing the types of disputes that may arise. For example, cases in past years dealt with whether the mixing of paint in a retail store was manufacturing, how to determine the extent to which newspapers involve manufacturing (the printing of the paper is manufacturing, but what about the gathering and processing of content?), and the extent to which activities such as broadcasting, on–site pizza dough making in a restaurant, brewing beer for a
brew pub, and blending sand qualified as manufacturing. (These cases were provided by Matt Tomalis of the Federation of Tax Administrators.)

A second, and perhaps more serious problem arises. Many firms operate in manufacturing and in other types of business as well. They may be firms with some amount of vertical integration (e.g., operating related wholesale and retail sales, or finance, businesses). Firms may also operate different types of businesses, an approach that reduces risk. And some activities may have a manufacturing and a non-manufacturing element. These different businesses may be branches of the same entity, or may be separately incorporated affiliates. Because of the variety of activities, one cannot simply allow any firm that engages in manufacturing to take a deduction for its taxable income without allocating income to the manufacturing activity. In many cases, neither firms nor the IRS have existing experience in allocation of income and deductions across activities.

This problem of allocation of income has been a serious and longstanding problem in our international tax system, where, because we do not currently tax foreign source income and do not allow unlimited foreign tax credits, firms have an incentive to allocate income to the areas that minimize their tax liability. Two methods are used to achieve this effect. First, when domestic and foreign entities buy products from each other, taxable income will be affected by the intercompany price charged—an issue referred to as transfer pricing. Tax rules require an arm’s length price (the price that would be charged by related parties) but this arm’s length price is observable only if the items are traded in a general market and in many cases such comparables do not exist. Secondly, the firm can attempt to allocate deductions and other payments, such as interest, rents, royalties, and overhead costs, in a way to minimize taxable income in high tax jurisdictions. A great deal of time and effort on the part of taxpayers, the Internal Revenue Service, and the courts is devoted to adjudicating these issues.

Finally, defining domestic production is a challenge because the provision applies to items manufactured in “significant” part in the United States.

The Treasury has already issued some preliminary regulations (Notice 2005–14), which may resolve some uncertainties. For instance, it provides a safe harbor for a minimum amount of U.S. input for the income to be qualified as domestic. But there remain many uncertainties and the degree of the burden on tax administration will not become completely clear until disputes actually arise and are negotiated or adjudicated.

**TAX SHELTER PROVISIONS: CANDIDATES FOR THE “GOOD”**

The tax shelter and related provisions are lengthy and complicated, but on the whole appear to be the kinds of changes that close loopholes, eliminate unintended benefits and are generally necessary to enforce the tax system. The largest one by far, accounting for over 60 percent of the $6.8 billion revenue gain, was the set of increased restrictions on leasing arrangements between taxable and tax exempt entities. There are also provisions explicitly directed at tax shelters that account for another 10 percent (including increased penalties and reporting requirements as well as substantive changes) and a number of miscellaneous but important revenue raisers (such as disallowing donated vehicles where deductions far exceed the amount received by the charities). Not as important in terms of revenue gain but having high visibility was the issue of corporate inversions—basically circumstances where firms moved their headquarters abroad to take advantage of tax havens. The bills imposed restrictions and penalties on these firms that
may have been necessary to prevent a stampede of inverted firms (although public disapproval was also helping to limit this practice).

Absent from the final bill were two provisions that had been considered earlier that were perhaps somewhat more controversial. One of them was codifying the economic substance doctrine, which had been an important provision in the Senate bill. There was considerable disagreement about the desirability of this legislation, with the current administration opposing it, but the prior one supporting it. This issue may be reconsidered, however. The IRS recently lost several tax cases and in one the fact that Congress did not act to codify the doctrine was cited by the judge in finding for the taxpayer (Gary and Stratton, 2004). And there are certain to be some changes that would strengthen the government’s position (such as requiring both a subjective test of intent and an objective test of outcome).

The other provision, in a 2003 version of the House bill, was a provision to further restrict earnings stripping—reducing U.S. tax with debt or other deductible payments to related firms, an important feature of corporate inversion techniques. Earnings stripping is an issue not just with inverted firms, but with U.S. subsidiaries of foreign parent firms in general. Because of the potential for abuse, the current tax code has a restriction on deductibility of interest for thinly capitalized U.S. firms (with more than 60 percent of assets held in debt and with more than 50 percent of earnings paid in interest)—restrictions that would have been tightened. This provision was not in the final legislation but would have been a significant change.

THE ONE TIME DIVIDEND REPATRIATION RELIEF: A CANDIDATE FOR “BAD”

Another provision that would fall into the questionable category is the provision allowing a one–time tax holiday on most of the tax paid on repatriation dividends. Under current law, earnings of foreign subsidiaries of U.S. firms are not taxed until the dividend is remitted to the U.S. parent (repatriated). This deferral provision encourages investment abroad in low tax jurisdictions (jurisdictions with taxes higher than the U.S. tax would receive no tax advantage because U.S. tax would be eliminated via the foreign tax credit). Once an investment is made, however, there is an incentive to retain profits abroad. The provision allows a one time deduction for 85 percent of dividends during a single year.

The provision was obviously beneficial to firms that had a lot of accumulated unrepatriated dividends that they desired to bring back home. But was it beneficial to the country? One argument made was that the provision would raise revenue because these dividends would never be brought home. The Joint Committee on Taxation did not concur with that view and projected a series of future revenue losses. And, in any type of steady state model where the rate of return exceeds the growth rate, profits could not accumulate indefinitely without eventually being returned.

As in the case of several other proposals, however, the major reason given for the provision was to stimulate the economy. In this case, the short run stimulus issue was addressed with a temporary provision.

The provision gets bad marks, however, primarily because it was unlikely to address this short run policy concern. Not only was the economy in recovery, but there was no reason, given the fungibility of money, that the repatriation would have a significant effect on U.S. domestic investment. To the extent that investment is determined by expected return, cash flow should be an unimportant, or at least secondary, consideration. And to top it off, the flow of capital into the U.S.
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is, absent a quick translation into physical investment, contractionary, not stimulative. The demand for dollars drives up the price of the dollar and contracts net exports. Thus, it is entirely possible that such a scheme, if it worked, would actually be contractionary. In any case, it is a poor choice for a stimulus.

The other problem with the temporary repatriation benefit is that it adds to the incentive to retain funds abroad in the future, as firms may hope for the temporary relief to be repeated in the future.

THE INTEREST ALLOCATION RULES FOR THE FOREIGN TAX CREDIT: UNCERTAIN

International provisions are always difficult for an economist to evaluate because, often, hidden behind the more obvious economic discussions are also complicated taxpayer compliance and administrative issues that are usually not quantified or even carefully spelled out (especially for a change that benefits taxpayers, whose interest groups are most likely to raise some simplicity issues). The interest allocation rule is likely to complicate tax administration. Were the economics such that it could be considered undesirable, it could be classified as “bad.”

But the economic evaluation is uncertain. Part of the uncertainty arises because of the existence of an unclear objective in the international arena. Moreover, the United States only controls its rules and not the rules of foreign jurisdictions, always raising the issue of the extent to which U.S. rules should take foreign rules into account in measuring income and setting policy.

There are two potential objectives U.S. tax policy might pursue internationally: the efficient allocation of worldwide capital (which suggests the tax system be neutral with respect to the allocation of capital around the world) and the maximization of U.S. social welfare which, in a system where the place of investment has the first right of taxation, suggests encouraging domestic investment, in part because the U.S. rather than the foreign country collects the taxes. If one did not have to be concerned about reducing U.S. tax receipts, capital export neutrality would be achieved by current taxation of foreign source income and an unlimited foreign tax credit. If one did not have to be concerned about retaliation, maximizing social welfare would require, at a minimum, that foreign income taxes be deducted rather than credited.

One policy objective that is often prominently featured in the discussion of international taxation is international “competitiveness,” and achieving this objective is often related to an objective called capital import neutrality and a territorial income tax system, where the U.S. does not tax foreign source income at all. But there is no economic objective that underlies this notion (as in the case of competitiveness among firms within an economy, which is required for efficient allocation of resources). A free market economy with free trade where the government has appropriately tended to market failures is, in general, the best we can do—subsidizing exports or subsidizing investment abroad can only do damage. (Taxing imports and taxing exports of capital could, in theory, improve U.S. welfare, although tax rates would be difficult to set and such a policy may fail if there is retaliation.) And capital import “neutrality,” which argues that all firms in a given country should pay the same tax, is not neutral at all (or efficient)—it encourages the migration of capital to low tax countries where such capital earns a lower social return.

The provision allowing worldwide allocation of interest for the foreign tax credit limit is responsible for $2.8 billion, almost half of the total $6.1 billion cost of foreign source income provisions. (The provision
does not contain a special subgroup election that was contained in some previous proposals that had a potential for developing into a tax shelter device. The U.S. taxes dividends of foreign subsidiaries and branch income currently, but allows a foreign tax credit. The credit is limited, however, to U.S. taxes that would otherwise be due. For firms in an excess credit position, and thus who cannot use all of their credits, increasing foreign source income for purposes of the limit increases their credits and reduces tax payments.

The allocation of interest provision relates to these excess credit firms. Basically, the more interest that is allocated to foreign source income, the smaller the income and therefore the smaller the credit limit.

Prior to the tax change, interest was allocated on a “water’s edge” basis: a share of domestic interest was allocated based on the foreign subsidiary’s share of total assets. That is, the firm took the value of its stock in the foreign subsidiary and divided it by total firm assets; that share was then multiplied by domestic interest expense which was then applied to reduce income for purposes of the foreign tax credit. This allocation ignored debt taken on by the foreign subsidiary.

The new worldwide interest allocation rule incorporates foreign debt, both for purposes of computing the asset share (which actually reduces the foreign tax credit limit) and allocating part of foreign interest expense to domestic income (which increases foreign source income and increases the foreign tax credit limit). The net effect is to increase the tax credit limit.

From the standpoint of providing a more accurate measure of income, this worldwide allocation seems more appropriate if one believes that debt is fungible and that one should not be able to alter the credit limit by shifting borrowing location (as demonstrated in the appendix).

Once foreign taxes are taken into account and assuming that the foreign jurisdiction does no allocation, the marginal incentives of any foreign tax credit system with a limit are to discourage substituting equity investment abroad for investment at home and encourage borrowing abroad rather than domestically. These effects occur because of the higher foreign tax rates of excess credit firms. Without an allocation rule, and with an equal pre-tax return, the additional tax from shifting investment abroad is the difference between the high foreign tax rate and the low U.S. tax rate allowed to be credited.

With water’s edge allocation, the foreign tax credit limit is lower (so more revenue is raised). In addition, when equity capital is shifted from domestic to foreign, three effects occur. The first two are the same as in the system with no allocation rules: foreign source income rises and has a higher foreign tax rate, and foreign income rises for purposes of the foreign tax credit limit. However, there is an offsetting and somewhat smaller effect on the foreign tax credit limit: the higher equity position abroad causes more interest to be allocated to foreign source income and therefore restricts the credit limit, causing taxes to go up more than would be the case with no allocation.

With a worldwide allocation rule, the foreign tax credit limit becomes larger as compared to the water’s edge, because some foreign interest is shifted to domestic sources, and this increases the foreign tax credit limit. At the same time, more is riding on the allocation of capital and when more capital is invested abroad the foreign tax credit limit contracts not only because more domestic interest is allocated to foreign sources but also because more foreign interest is allocated as well. Similar effects magnify the benefit of borrowing abroad and determine the overall investment in capital.

These marginal effects are undesirable from the standpoint of capital export neutrality, because they further magnify distortions. Thus both water’s edge, and
to a greater degree world wide, allocation of interest exacerbate distortions. At the same time, the worldwide allocation rule actually loses revenue for any given existing set of asset and debt positions by assigning part of the existing interest on foreign debt to U.S. sources and in general expands the available foreign tax credit, an outcome that also appears to be inconsistent with the alternative criterion of maximizing national welfare. Since it complicates administration as well by requiring monitoring of foreign debt as well as other assets, it would seem to fall clearly into the “bad” and “ugly” category.

There are two reservations to this assessment. First, the marginal effects would be reduced if the change in the foreign tax credit limit due to world wide allocation shifted a firm from an excess credit to an excess limit position, thereby achieving capital export neutrality for investment. (This discussion sets aside cross crediting issues discussed below.) In addition, one is reluctant to categorize this rule as bad when it seems to provide a superior income measure. The fly in the ointment, of course, is the treatment by foreign jurisdictions. If all countries employed worldwide allocation rules then the system’s incentives would be more consistent: a shift to foreign capital would attract a smaller tax because more interest would be allocated to it by the foreign jurisdiction as well, reversing the marginal incentive effects. In policy terms, one question overshadowing the evaluation of this provision is whether the U.S. should try to maintain a system with appropriate measures of income even when other countries do not, or should we pursue neutrality and revenue objectives?

OTHER FOREIGN TAX CREDIT PROVISIONS: SOME BAD, SOME GOOD

Some of the additional foreign provisions appear to be undesirable changes, while others may be desirable. Consider the following permanent foreign provisions outside of interest allocation and their share of the $6.1 billion total: the combining of foreign tax credit baskets ($1.1 billion or 18 percent), the extended carryforward of foreign tax credits offset by a one year carryback limit ($1.0 billion or 16 percent), the domestic loss provisions ($0.9 or 15 percent) and the elimination of the 90 percent limit of the foreign tax credit against the alternative minimum tax ($0.3 or 5 percent). These provisions account for over half of the cost of the international provisions and, along with interest allocation change, account for virtually all of it (although there are interactions that offset the independent totals). Each of these changes (as with the interest allocation provision) expands the degree to which foreign tax credits can be taken.

As with the interest allocation provision, it is important to set the standard by which these provisions should be evaluated. And, as noted in that discussion, while an unlimited foreign tax credit would achieve capital export neutrality, the U.S. imposes limits on the credit to protect U.S. revenues. The basic objective of the credit then becomes not so much to equalize returns across investments, but to protect against double taxation so that income is not subject to two taxes. If the objective is maximizing social welfare, then even a limited credit is probably too generous.

The limit on the foreign tax credit may discourage investment in high tax countries, but in the current tax code environment, that effect is lessened and a new distortion introduced, because the tax code permits the combining of income and credits across countries—called cross-crediting.

Cross-crediting to the degree permitted under current tax rules is not necessary. Income and associated credits could be separated in a variety of ways, such as
by country, by type of income, or both. Prior to AJCA, there were nine different baskets separated by type of income but not by country; the change collapses the number of baskets to two. A per–country limit existed during U.S. history and some have suggested that we should return to that regime as well as separating credits by type (Fleming and Peroni, 2004).

The argument commonly stated for allowing cross crediting is that it simplifies the law. However, the degree of this simplification and how important it is for the typically sophisticated firms that take foreign tax credits is rarely addressed. The principal argument against cross crediting is that it encourages companies operating in high tax jurisdictions (and who are therefore in excess credit positions) to invest in income that is lightly taxed to soak up the excess credits. It also defeats much of the purpose of the limit, and loses revenue.

Cross crediting also reduces the burden of high tax rates for firms that already have low tax income, but if that were our objective it would be better to have no limits at all, rather than adding the additional misallocation of capital to low tax rate countries and types. In addition, cross crediting weakens the penalties for other countries to impose high tax rates, by giving them a pass, at least for some U.S. investors.

From this discussion, one can conclude that cross crediting is probably not desirable, but some cross crediting may be worthwhile to achieve simplicity.

**Combining Foreign Tax Credit Baskets**

How then, would one view the recent combining of baskets? The pre–existing nine baskets largely involved a single active income basket and a series of passive or specialized baskets that were designed to present companies from using easily manipulated investments to reduce tax liability. These baskets included passive income in general, high interest withholding, financial services income, shipping income, income of 10/50 companies (minority ownerships), and separate baskets for income from the export subsidiaries (FSC, DISC and foreign trade companies). Most of the splitting of the passive basket into a number of baskets was done in the Tax Reform Act of 1986 and it targeted income that either had an unusually low tax rate, an unusually high tax rate (general interest on which a gross withholding tax was applied), or was easily manipulated as to domestic or foreign sources (see Joint Committee on Taxation, 1987, pp. 861–867). Combining these baskets seems to be less about effects on active investments (except for financial services) and more about relaxing the rules that limit tax avoidance.

Some proposals had suggested combining into three baskets, maintaining a separate basket for financial services income. Financial services income presents a problem because it is often taxed at low rates. The two basket approach would allocate this income to a general (active) basket for firms in the financial services business, allowing this income to be combined with other highly taxed income that is kicked out into the general basket.

The justifications given for the combined baskets are in part to simplify the system, and there are also some justifications having to do with competitiveness and job creation that are not part of the efficiency objective. Thus, the issue is a trade off between efficiency and simplicity. Yet it is very difficult to determine how beneficial are the simplicity gains of the reduction in baskets. While many groups with a vested interest make simplification arguments, it is more difficult to find more objective analysts who view the reduction in baskets as a main gain in simplicity. Indeed, Peroni, Fleming and Shay (2003, p. 113) suggest that even with only two or three baskets there will still be a need to sort through income and deduction
items. They do suggest there are some administrative gains for IRS. A general review of the bill by Tuerff et al. (2004, p. 859) cited as an impact on international organizations a greater cross crediting, but had no mention of simplicity. A response to Peroni, Fleming, and Shay by Steines (2003) argued for a reduction of baskets without saying what baskets should remain, but premised this argument on the presumption that capital import neutrality is as valid an objective as capital export neutrality. One final bit of information: when the Tax Executives Institute (1997) proposed reforms in 1997, the reduction in baskets, although mentioned as a complication, was not among the proposals.

Thus, while it may be possible that the change is justified by simplification, there appears little hard evidence to support this view.

**Extended Foreign Tax Credit Carryovers**

Under prior law, excess foreign tax credits could be carried back two years (to reduce taxes on prior foreign earnings) and forward for five years. This provision reduces the carryback period to one year and the carryforward to ten. Generally carrybacks are more beneficial (if companies can use them) because they can be received immediately. Overall, however, the number of years over which excess credits can be spread is increased from seven years to 11 years. The carryforward provisions apply to credits accrued before the passage of the act, a more generous treatment than would be the case if they were limited to newly acquired credits, particularly in the context of other foreign tax credit changes.

The carryforward provisions inevitably interact with other provisions. For example, if the expanded interest allocation rule were to move a firm from an excess credit position (foreign tax credits in excess of the amount allowed) to an excess limit position (foreign tax credits less than the amount allowed), the extended carryover of excess credits will permit additional carryovers of credits. These firms will still get their credits that were denied by the more restrictive water’s edge rule (with a delay) while benefiting from the new worldwide allocation rule.

The carryovers and carrybacks of the foreign tax credit are often likened to the carryovers and carrybacks of net operating losses, especially when companies are making appeals for extending these benefits. Most economists would likely view these carryback and carryforward loss rules as beneficial because they produce a more symmetric treatment of losses and gains, which is beneficial to risk-taking—although some limits may be needed to avoid excessively complicating the tax system. But can the same type of argument be made about carryovers and carrybacks of excess foreign tax credits?

In general, no. Some carrybacks and carryforwards can aid with a potential mismatching problem of items of expense in different tax laws. For example, suppose the U.S. allows a deduction sooner than the foreign country’s tax laws. This provision will lower the U.S. tax due and thus the tax credit. In the next years, the U.S. tax will be higher and the foreign tax lower, and a carryforward would allow the previous year’s taxes to be credited. This carryover function allows the foreign tax credit to come closer to its role of preventing double taxation.

But probably the more important outcome of an extended carryover is that firms will have more scope for cross-crediting. Because foreign tax credit baskets are not separated by country, firms have a great deal of ability to cross credit active business income, and they will have an increased scope to do so for passive income. Such a role of the extended carryover is echoed in the following comment (Tuerff et al, 2004, p. 859): “The changes likely will reduce occurrences where foreign tax credits expire unused. The amendments limit the severity of the separate limitation categories by
allowing corporations additional time to generate foreign-source income in the specific limitation category to which the excess credits relate.” To the extent that this change facilitates more cross crediting, it is likely to further violate the efficiency objective of capital export neutrality by encouraging more investments in low tax jurisdictions (as well as the social welfare objective of maximizing national welfare).

Extended carryovers also complicate tax compliance and administration because there are more potential years of credits (as well as more scope for playing games), so this provision would also receive low marks on administrative costs. Thus, based on both economic incentive considerations and administrative concerns, this provision appears questionable.

Re-characterization of Domestic Losses

It is easier to explain this provision by explaining a related provision that allows for the recapture of foreign losses. If a firm has a foreign loss (and operates in a form so that the loss is recognized, such as a branch) that loss directly reduces U.S. tax liability. If the loss then becomes a gain in the next year, the U.S. tax rises but there is also a tax credit. This is a different outcome than would have been the case if the loss and gain in the two years (which may simply be due to the timing of expense items) had been averaged over the two years with a small gain in each year. Essentially this treatment allows a double benefit and for that reason the foreign losses would be recaptured and treated as U.S. source income.

Similar problems apply with a U.S. loss. The foreign tax credit is limited in two ways: to the amount allowed on foreign income under the foreign tax credit limit and to the total U.S. tax paid. Suppose a firm has a U.S. loss and a foreign gain, leading to an overall loss. No foreign tax credit on the foreign income would be allowed because there is no tax. This provision allows a portion of U.S. income following a U.S. loss to be characterized as foreign source income for purposes of the foreign tax credit limit. Although the provision complicates administration, it creates a more symmetric treatment.

Foreign Tax Credits for the AMT

A final, somewhat less significant, provision is one repealing a rule that limits foreign tax credits to offsetting only 90 percent of tax for purposes of the alternative minimum tax (AMT). Since I don’t think an alternative minimum tax is good policy in general, I would be inclined to put this one in the good category. In addition, it can only simplify matters.

THREE TEMPORARY PROVISIONS: EXPENDING FOR SMALL BUSINESS, STATE AND LOCAL SALES TAX DEDUCTIONS AND FILM AND MOVIE PRODUCTION

This analysis concludes with a brief mention of three temporary (or apparently temporary) provisions: extension of higher limits on small business expensing, the optional state and local sales tax deduction, and expense of certain costs of producing films and television programs.

The small business expensing provision, initially adopted in 1958, allowed a small amount of investment in equipment ($4,000) to be deducted as incurred. The provision was considerably less important during the years when investment credits were available, because expensed investment was not eligible. The provision was therefore more valuable after the repeal of the investment credit in 1986. By 2003 the amount eligible had grown to $25,000. The 2003 tax bill contained a dramatic increase to $100,000, but on a temporary basis. Moreover, while the expensing provision produces a zero effective tax rate for the first $100,000 of investment, the benefit is phased out dollar for dollar over the
income range of $400,000 to $500,000. For a typical equipment investment with a seven year life, a 2 percent inflation rate and a 5 percent real discount rate, the present value of depreciation is $0.825 per dollar of investment; given a depreciation rate of 15 percent and a statutory tax rate of 35 percent, the effective tax rate is about 27 percent (see Gravelle, 1994 for methods of calculating effective tax rates). While eligible equipment benefits from a zero tax rate as the present value of depreciation rises to a dollar, each dollar of investment in the phase out range loses $0.175 in additional deductions, leading to an effective rate of 43 percent.

Other than to simplify accounting for firms with investments less than $100,000, there is no obvious rationale for this provision. As noted while firms with investments of less than $100,000 have a subsidy at the margin, there is a penalty for investments between $400,000 and $500,000 (these subsidies and penalties had a smaller scope of $25,000 for the permanent provisions). The provision favors small businesses, which are already preferred over corporations, and within businesses favors equipment assets. The complications saved by businesses with investments under $100,000 are offset by the complications of those with higher levels of investment.

The provision allowing an optional state and local sales tax deduction is unrelated to most of the thrust of the other legislation, although there has been some agitation about this provision since it was disallowed as a deduction in 1986. It is among a number of provisions that were considered to gain enough votes to pass EITI repeal. The main arguments made for restoring this deduction are that it was inequitable to taxpayers in the eight states without a general income tax and that allowing more favorable treatment for income taxes interfered with state choices of tax base.

Viewed in a less kindly light, the optional sales tax deduction is one more step (along with restoration of capital gains preferences and IRAs) away from the base broadening in 1986, and adds to the challenges of fundamental income tax reform. It adds to the fraction of people who itemize, and involves some complicated compliance provisions (adjusting the tables for local taxes and big items and deciding whether to use tables or itemize receipts), for a provision that applies only to a small fraction of people and involves a small amount. And its temporary nature probably means little, as it is likely to either be made permanent, or become yet another “extender” that is effectively a permanent part of the tax code.

It is perhaps appropriate to end a paper themed on the movies with the tax benefit adopted for the film industry (in addition, of course, to classifying film–making as part of production for the production activities deduction).

The cost of producing films and television programs must be depreciated using an income forecast method (based on the pattern of expected earnings). This provision allows production costs for certain film and television shows to be deducted when incurred. The provision targets small domestic productions (generally with a cost of less than $15 million, with at least 75 percent of compensation for services performed in the U.S.). The provision expires after 2008, only the first 44 episodes of a television series qualify, and sexually explicit productions are not eligible.

Expensing speeds up deductions and is most beneficial per dollar of cost for productions whose expected income is spread out over a long period of time and whose production period is lengthy. The provision encourages film and television producers to locate in the United States and counters the growth in so-called “runaway” production.

Since the average cost of producing a movie for theatrical release in 2003 (by members of the Motion Picture Associa-
tion of America, 2004) was $63.8 million, many of these movie productions would not qualify. Studies found that made–for–television movies and mini–series, in particular, have experienced relocation abroad, and that most of this business has gone to Canada (Monitor Corporation, 1999; U.S. Department of Commerce, 2001). Many countries, including Canada, provide subsidies for production.

The purpose was to discourage the “runaway” of film and television production to other countries, where tax and other incentives are often offered. Essentially the return to investment in eligible films is subject to a zero tax rate. The magnitude of the benefit depends on the average lag time from production to earning income. If that lag is five years and the discount rate is 7 percent, for example, the value of the deduction is increased by 40 percent, and with a 35 percent tax rate, the reduction in cost would be about 14 percent. If the average lag is only a year, the reduction is slightly over 2 percent.

In general, special subsidies to industries and activities tend to lead to inefficient allocation of resources, at least in the long run and are costly to society as a whole. The provision might be more acceptable as a short run adjustment tool since the shift of film making has caused problems for U.S. providers of services, but, as indicated above, experience suggests that temporary tax provisions have a way of becoming permanent.

CONCLUSION

Was the tax bill as a whole an improvement or a worsening of the tax code? There seemed to be more revenue associated with provisions that seem unambiguously bad (the production activities deduction and the repatriation holiday) than those that were unambiguously good (repeal of ETI), from a social efficiency standpoint. Yet there was much in the bill that seemed to have some merit (such as tax shelter provisions and some of the international provisions) or where it was difficult to make a determination (again with some of the foreign tax credit rules, and even some of the temporary extensions). My own suspicion is that the administrative complications associated with the production activities deduction are going to prove so detrimental to tax administration that they will color all views of this bill. But it may be that Congress will soon transform this provision into a uniform deduction or rate cut, and the bill overall can move more in the direction of, at least, not so bad.

Acknowledgment

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REFERENCES


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APPENDIX

This appendix discusses formally the effects of the interest allocation rule.

The shape that a neutral allocation rule takes assuming debt is fungible means that shifting the location of borrowing should not shift the location of investment. To see how worldwide allocation achieves this effect, consider first the basic foreign tax credit limit without any allocation of interest. (Note: this discussion is based on Brumbaugh and Gravelle, 1999).

U.S. tax liability is:

\[ U.S. \text{ Tax} = t(Y + D/(1 - tf) - iB_d) - tD/(1 - tf); \]

where \( t \) is the U.S. tax rate, \( Y \) is U.S.-source income before interest deductions, \( D \) is dividends from a foreign subsidiary, \( t_f \) is the foreign tax rate, \( I \) is the interest rate, and \( B_d \) is domestic borrowing. The first term is the tax on total firm income and the second is the foreign tax credit, which is limited to the U.S. tax on grossed up dividends. Foreign tax credits are also limited to actual foreign taxes paid (or deemed paid, in the case of dividends), so this limit and formula apply only to firms in “excess credit” positions, where the foreign tax rate is higher than the U.S. rate.

Define foreign subsidiary dividends in terms of foreign earnings and other income elements.

\[ Y_f = D + R + iB_f + tf(Y_f - iB_f) \]

where \( Y_f \) is foreign earnings before deducting interest, \( R \) is retained earnings, and \( B_f \) is borrowing by the foreign subsidiary. Therefore:

\[ D/(1 - t_f) = Y_f - R/(1 - t_f) - iB_f \]
Thus, one could also rewrite equation [1] by substitution as:

\[ U.S. \ Tax = t(Y + Y_f - R/(1 - t) - iB_f - iB_d) \]

\[ - t(Y_i - R/(1 - t) - iB_f) \]

For a firm in an excess credit position, the limitation, \( L \), is the last term on the right:

\[ L = t(Y_f - R/(1 - t) - iB_f) \]

In this case, the taxpayer could increase the limitation and reduce U.S. taxes by shifting borrowing from the subsidiary—that is, by reducing \( iB_f \) and increasing \( iB_d \) by an equal amount (we assume the same interest rate in this example).

There are many types of arbitrary allocations that would eliminate any effect of the borrowing cost (e.g., allocating all of it to foreign or all to domestic), but if debt is fungible, you might wish debt to be allocated in proportion to total investment, that is:

\[ L = t(Y_f - R/(1 - t) - iB_f) \]

Pre-existing law provided a “water’s edge” allocation for domestic borrowing, based on relative capital investment. Because the subsidiary’s own interest payments reduce repatriated earnings and not domestic-source income, all the subsidiary’s borrowing costs are automatically allocated to foreign sources. In addition, not all the subsidiary’s assets are included in the allocation rule—only the parent’s equity stake in the subsidiary is included. Thus, the subsidiary’s capital is \( K_f - B_f \) and the total assets are \( K_f - B_f \). Thus the rule for the foreign tax credit limit is:

\[ L = t(Y_f - R/(1 - t) - iB_f - iB_d (K_f/K_p)) \]

But this simplifies to:

\[ L = t(Y_f - R/(1 - t) - iB_f) \]

Clearly, this rule violates the principle of fungibility in that the limitation is dependent on the location of borrowing (i.e., the respective values of \( B_f \) and \( B_d \)). A taxpayer can increase or decrease the limitation by shifting the location of borrowing. Since \( dL/dB_f > 0 \), a taxpayer can increase his limitation by shifting borrowing from domestic locations to foreign ones.

For worldwide allocation, all assets of the subsidiary are included in the allocation formula and the interest expense of the subsidiaries subject to allocation as well. This can actually be carried out by allocating part of domestic interest to foreign sources and part of foreign interest to domestic sources (since foreign borrowing is already netted out of the dividend). This can be integrated into the limitation formula as follows:

\[ L = t(Y_f - R/(1 - t) - iB_f - iB_d (K_f/K_p)) \]

\[ + iB_f (K_p/K_f) \]

which is exactly equation [8], the ideal limitation formula.

The rules do have behavioral effects. (Note that the allocation rule only applies with the foreign debt ratio is less than the domestic debt to asset ratio). One can assess these by adding to the companies’ total tax the foreign tax paid. If the foreign country imposes no allocation rules, the additional term is \( t_f (Y_f - iB_f) \), where \( t_f \) is the foreign tax rate, higher than the U.S. rate. By differentiating these formulas (see Brumbaugh and Gravelle, 1999 for more details) you can establish that the worldwide limit has the largest effect in encouraging foreign borrowing and discouraging foreign equity investment. These effects are constrained, however, because the allocation rule would not apply if the foreign debt to equity ratio is higher than the U.S. debt to equity ratio.

First, because of the limit on the foreign tax credit and the higher foreign tax, there is an incentive to borrow abroad because of the higher
foreign tax rules. With no allocation rule, this incentive is partly offset because such interest reduces dividends and therefore the foreign tax credit limit and the benefit is the differential between the two taxes. This incentive is greatest for the worldwide allocation system when the location of interest has no effect on the credit limit.

In all three cases, the tax systems of the two countries discourage equity investment abroad (because of the high tax country). With no allocation rule and with the same pre-tax return, the additional tax is the difference in the tax rates times the return times the shift in investment. Allocation rules for interest increase the cost of investment abroad because the adjustment to the limit on the foreign tax credit is larger the larger the capital stock located abroad and the worldwide allocation rule has the largest effect.