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REVIEW & OUTLOOK

Foreign Tax Fight

No doubt the talks in Cancun have been, um, diverting. But meanwhile, back at the ranch Congress has three months to resolve a thorny -- and potentially dangerous -- trade problem.

Last spring, the World Trade Organization ordered the U.S. to repeal the Extraterritorial Income Exclusion. This is a fancy name for a tax break worth $4 billion to $5 billion a year to companies that make products in the United States but sell them overseas. The WTO ruled that these tax shelters constitute an illegal export subsidy. If the U.S. fails to act by January 1, the European Union is entitled to seek retaliation by levying $4 billion of sanctions annually. Duties up to 100% could be imposed on 1,600 items, including dairy and meat products, sugar, cereal, toys, clothes and machinery.

The ETI is one of many attempts in the past several decades to remedy a problem that lies deep within the international tax code. The U.S. taxes all income, including that earned in foreign countries. Most other industrial countries have territorial systems; the European Value Added Tax, for example, rebates taxes on exports and imposes taxes on imports. The U.S. also places greater restrictions on tax credits, leading to double taxation of international income. The net result is that U.S. companies pay relatively higher taxes than foreign competitors.

At the moment, Congress has two choices to replace the ETI. The bill introduced by Representatives Phil Crane (R., Ill.) and Charlie Rangel (D., N.Y.) has been scored as revenue-neutral and reduces the current corporate tax of 35% to 31.5% for U.S. manufacturers that export. There are, however, some twists that make Crane-Rangel less than meets the eye.

The full 10% rate reduction goes to companies that manufacture only in the U.S. Others, depending on the share of their products made domestically, receive less. A company that produces half its goods in the U.S. and half in a foreign country would get only a 5% reduction in its tax rate. This bias toward domestic manufacturing puts Crane-Rangel in the category of misguided industrial policy. But the real hooker is that Crane-Rangel is probably still in violation of the WTO's rule. Benefits under the current ETI would be phased out between 2003 and 2009 and the European Commission has warned that this transition period is not acceptable.

The other contender, offered by House Ways and Means Chairman Bill Thomas (R., Calif.), tries to balance the interests of domestic and multinational firms. His bill would reduce the tax rate on corporate income to 32% for all small and mid-size businesses and is not conditioned on export status or the share of their products manufactured domestically. As important, it offers about $17 billion in relief from the dread alternative minimum tax. In fact, the Thomas bill would free most small business from paying the AMT while reducing the penalty for bigger business.

Mr. Thomas also offers tax simplification by undoing some provisions from the 1986 Tax Reform Act and replacing the current nine foreign-tax credit categories with just two -- one for active and another for passive income. And, finally, this bill would encourage investment. The research-and-development tax credit would be extended and expanded; domestic manufacturers would get shorter depreciation schedules for equipment; and the bonus write-off for new investment, for both domestic companies and multinationals, would be extended.

The Thomas bill would finance these changes in part by allowing companies to repatriate earnings stored overseas at a lower tax rate (slightly less than 7%) for a six-month period. This provision could encourage anywhere from $175 billion to $300 billion to be repatriated, money that might otherwise never make it back to U.S. shores. The main sniping at the Thomas proposal is that it costs, on a static revenue basis, about $128 billion over 10 years. Deficit hawks are already squawking over this.

The bigger point here is that the U.S. international tax code has become an impediment to growth. It tangles exporters in a maze of tax liabilities, double-taxes multinationals and reduces the competitiveness of U.S. exports. It's pretty much impossible to remedy these faults in a piecemeal fashion. But the Thomas bill, at least, represents a good effort to tackle some of these problems. Congress has to act before the end of the year, so it might as well choose the better option.