

January 28, 2005

PAGE ONE

As Europe Cuts Corporate Tax, Pressure Rises on U.S. to Follow

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BRUSSELS – European countries have been steadily slashing corporate-tax rates as they vie for foreign investment, potentially adding to pressure on the U.S. for similar cuts as it weighs a tax overhaul.

Following the lead of Ireland, which dropped its rates to 12.5% from 24% between 2000 and 2003, one nation after another has moved toward lower corporate rates with fewer loopholes. The Netherlands, the second most popular European target for U.S. investment, recently joined the movement, lowering its corporate rates by three percentage points to 31.5% and simplifying its tax structure.

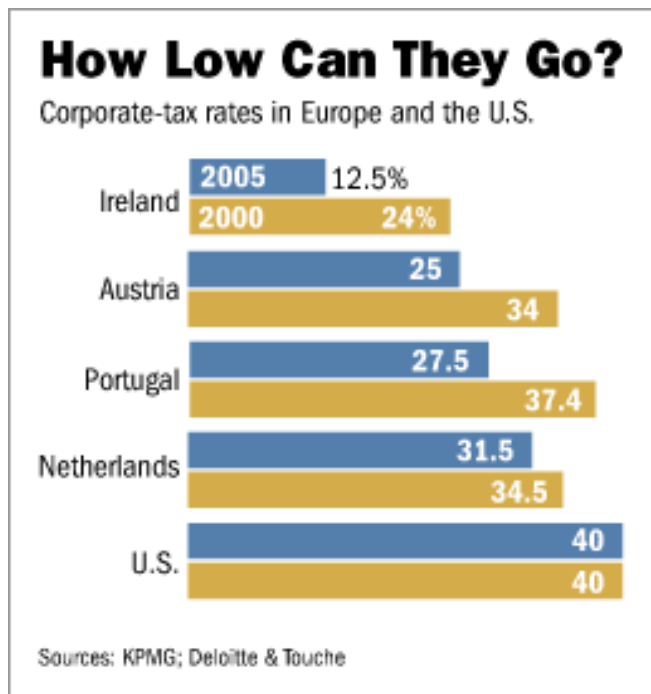
The corporate-tax cutters of recent years stretch from Portugal, where the rate has dropped 10 points to about 27%, to Austria, down nine points to about 25%. Even Germany, which has Europe's highest rate and has bitterly opposed the plummeting tax rates elsewhere in the region, has done some dramatic trimming -- from as high as 56% six years ago, according to data from KPMG LLP, to 38.3% last year.

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Germany's trims leave the standard U.S. rate -- about 40% including average state taxes -- above that of every country in Europe, according to separate studies by the Organization of Economic Cooperation and Development and KPMG.

Many large businesses, especially with the U.S.'s complex tax structure, use loopholes and shelters to pay far less than the national rates suggest. And the U.S. has recently done its own targeted cutting, such as lowering the tax on manufacturers last year in compensation for a lost export subsidy. But even the effective U.S. corporate-tax rate -- what is paid after all the deductions -- is above Europe's average, by as much as 10 percentage points, according to one analyst.

The upshot is that Europe, long known for steep and complex taxes on corporations, is more and more likely to prompt U.S. companies to expand there rather than at home, tax experts say. Shifting revenue -- and some of their operations -- to lower-tax countries is the single biggest way American companies avoid paying U.S. rates, bringing down their effective taxes.

"We are living in a global economy and we compete in a global economy, and if our corporations are competing against societies that don't tax their corporations as much, we have to consider that," says John Breaux, a former Democratic senator from Louisiana and the co-chairman of a new White House-sponsored tax-reform panel, in an interview.

The European tax rivalry has accelerated with the European Union's expansion this year to include Eastern European members like Poland, which cut its corporate rates to 19% from 27% last year. Poland now hosts a half-dozen facilities of **Delphi Corp.**, an auto-parts supplier based in Troy, Mich., whose chief executive is involved in lobbying for lower U.S. taxes and a simplified code.

Earlier this month, **Amazon.com Inc.** announced it would establish a European operations center in Ireland. **EBay Inc.** established its European base in low-tax Switzerland. **Hewlett-Packard Co.** last year set up a major research-and-development center in Ireland, allowing it to take advantage of low taxes on royalties from intellectual property. **Kellogg Co.** and **Lucent Technologies Inc.**'s Bell Labs division also set up major facilities in Ireland last year.

The latest addition to the tax-cutting club, the Netherlands, is a top U.S. trading partner and recipient of more than \$180 billion in annual investment by American companies. After its recent cuts in corporate rates, it expects to shave another point in 2007. Then, says Dutch Finance Secretary Joop Wijn, who is visiting the U.S. this week to tout the changes, "I am going even lower."

Bush administration officials have saluted the corporate-tax cutting in Europe. Last November in London, Treasury Secretary John Snow said of the Irish government, "I applaud them and believe they ought to be emulated."

The last major drop in the U.S. corporate-tax rate was in 1986 in a radical round of streamlining and rate reductions. Since then, U.S. tax law has become riddled with deductions and shelters. Influential corporate groups such as the Business Roundtable, citing recent tax-rate cuts by U.S. trading partners, now are lobbying the White House panel for rate cuts even if it requires eliminating some business tax breaks.

"We're looking for a tax system that permits U.S. companies to operate on a level playing field with foreign competitors, both at home and abroad," said J.T. Battenberg III, who heads the Roundtable's fiscal-policy task force and is CEO of Delphi.

Others also question whether this fight among European nations for foreign investment involves genuine economic competition. "It is very obvious that the profits taxed in Ireland are not all made in Ireland," says policy analyst Guillaume Durand of the European Policy Center, a Brussels think tank. In a study last year, analyst Martin A. Sullivan of the nonprofit journal Tax Notes estimated that U.S. companies in 2002 made \$26.8 billion in profits in Ireland, a huge sum for a country of just four million people. The companies paid an 8% effective tax, according to Commerce Department data.

Three years earlier, before most of Ireland's tax cuts, U.S. companies reported \$13.3 billion in profits there. In Mr. Sullivan's analysis, in 2002 U.S. companies had an effective tax rate of 9% in Portugal, 9% in the Netherlands, 12% in Belgium, and 13% in Spain.

Europe's longstanding reputation as antibusiness is no longer "justified," says Mr. Durand. "It is a very difficult business to compare aggregate levels of taxation, but by all measures, as a general trend it is very clear that capital is much more taxed in the U.S. than in Europe, and labor and consumption are much less taxed."

Talking about standard, statutory corporate-tax rates can be misleading because loopholes mean many companies pay less. "The rate matters, but even more important is what you tax. So if we only tax half of corporate profits, the rate is not nearly as significant as you might think," notes Robert S. McIntyre of the Washington group Citizens for Tax Justice, which is funded by organized labor. U.S. corporate taxes were equal to less than 2% of U.S. gross domestic product in 2001, he notes, and only two countries -- Germany and Iceland -- had a lower ratio of corporate taxes to national output. "If low corporate taxes make us competitive, then we've got them," Mr. McIntyre says.

General Electric Co., for example, reported paying an effective tax rate of 19% last year on world-wide income, compared with 26.7% in 2003. GE attributed the lower rate largely to foreign sales; about half of its \$152.36 billion in 2004 revenue came from overseas. For the fourth quarter, GE's tax rate was 16%, compared with 26% in the year-earlier quarter.

Jane Gravelle, a tax expert at the U.S. Congressional Research Service, estimates the "effective" rate in the U.S., after deductions are taken into account, at 32% in 2001, the most recent figures she has studied.

This year, the effective tax rates of many U.S. companies are expected to decline because of a one-time tax holiday on overseas profits. Margie Rollinson, an international tax expert at Ernst & Young, who

estimates the U.S. effective tax rate at about 10 points higher than the European average, said the law behind the tax holiday is viewed by many tax professionals as possibly readying the political ground for more cuts in the U.S. corporate rate. "There are many people speculating whether that is a precursor to a lower tax rate in general," she said.

The European reduced rates have in many cases been paid for by eliminating deductions. According to tax studies, European governments are getting about the same revenue as before the changes. But the lower flat rates are still attractive to companies.

Ms. Rollinson said companies often note in their annual 10-K reports effective tax rates dramatically lower than the official rate because Generally Accepted Accounting Principles allow companies to report their tax rate based on their world-wide profits, and profits from abroad are taxed only when they are repatriated. "For book purposes their 10-K will show a rate much lower," Ms. Rollinson says. If they were ever to return the money to the U.S., they'd pay U.S. rates, but that anomaly doesn't have to be shown in the reports -- making their picture look healthier.

In Europe, the new competitive environment, combined with the 2001-03 recession, clearly rattled the Netherlands. Holland was once known as something of a tax haven for its network of advantageous tax treaties and cooperative revenue officials, but tax-law changes reduced those benefits. The Dutch government's concerns may have peaked last year, when the European operation of U.S. software maker McAfee Inc. decamped to Ireland.

In a barnstorming tour of the U.S. that began Monday in New York, Mr. Wijn, a 35-year-old former venture-capital executive at ABN Amro Holding NV, has been pitching the new Netherlands tax policy to dozens of American tax lawyers, accountants and corporate tax directors. Altogether, he planned to meet with 28 U.S. companies.

American companies have favored Holland for selling to Europe's more than 400 million consumers because of its efficient ports, location close to population centers, and highly educated, English-fluent work force. But now "there is a sense of urgency that [the tax climate] has to improve, that we are in competition with countries like Ireland and do lose direct investment from the U.S. to countries like Ireland," said Amsterdam tax lawyer Fred de Hoos of the U.S. firm Baker & McKenzie.

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