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TAX REFORM TAXIPEDIA

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The tax reform debate is in full swing. This glossary of key tax terms is intended as a resource to help those currently less conversant in the language of tax reform to better understand and participate in the debate.

About Steptoe

Steptoe is an international law firm widely recognized for vigorous representation of clients before governmental agencies, successful advocacy in complex litigation and arbitration, and creative and practical advice in guiding business transactions. The firm has more than 500 lawyers and other professionals in offices in Beijing, Brussels, Century City, Chicago, London, Los Angeles, New York, Palo Alto, Phoenix, and Washington. The tax practice at Steptoe is known for the diversity and breadth of its experience in all aspects of state, federal, and international taxation. Our team consists of an extraordinary group of professionals, including former senior government officials from Congressional offices, the IRS, Treasury, and Justice Department, who have vast experience in sophisticated tax planning, audit, and controversy work.

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A

Ability to pay principle

A principle according to which taxpayers with higher incomes should be taxed at higher rates because they can afford to pay more than those with lower incomes.

Above-normal returns

Returns over and above what individuals or firms could normally expect to receive in a competitive marketplace. In the corporate environment, these returns might result from technological innovation, market power, or risk-taking and would generally accrue to the investors or owners of a firm. Above-normal returns may also be referred to as "economic rents." See also "normal return."

Accelerated depreciation

A method of depreciation that allows greater deductions in the earlier years of the period in which the asset is depreciated.

Accrual

A term referring to revenues that are taken into account for tax or financial statement purposes before they are received or expenses that are taken into account for tax or financial statement purposes before they are paid.

Active financing exception

When a foreign subsidiary of a U.S. company earns interest or similar investment income, the U.S. company is generally taxed (under subpart F of the Internal Revenue Code) on that income regardless of whether a dividend has been distributed from the foreign subsidiary to the U.S. company. The "active financing exception" generally exempts such investment income from being currently taxed if that income is earned by the foreign subsidiary in the active conduct of a banking, finance, or similar business. The active financing exception was first enacted in 1997 on a temporary basis and has been extended repeatedly.

Active income

Income earned from the conduct of a trade or business, in contrast to "passive" investment income.

Administrability

A principle that considers whether a law or rule may be efficiently administered by the tax authorities (e.g., the Internal Revenue Service).

Amortization

In tax law, a cost recovery system under which certain costs are deducted over a period of years. Start-up expenses and acquired intangible assets typically must be amortized.

Arm's length price

The price unrelated parties would charge in a comparable transaction.

Arm's length principle

A transfer pricing principle requiring that, when two related parties enter into a transaction with each other, the price be the same as the price that would be charged among unrelated parties.

B

Base broadening

A term applied to efforts to expand the tax base, usually by eliminating deductions, credits, exclusions, and other preferences.

Base erosion

Reduction in taxable income, often by means of deductible payments (such as interest or royalties).

Bonus depreciation

An additional amount of deductible depreciation (above the amount that would normally be available) allowed in the first year an asset is used in a business. Bonus depreciation rules generally are enacted on a temporary basis as a form of economic stimulus.

Branch

A division, office, or other unit of business located at a different location from the main office or headquarters of a business. A branch is not a separate legal entity.

Buy-in

Pursuant to a cost-sharing agreement, a payment made by one participant as consideration for another participant's contribution of pre-existing intangibles to the cost-sharing arrangement.

C

C corporation

An entity that is treated as a corporation for U.S. tax purposes and that is subject to the corporate income tax. These entities are referred to as "C" corporations because they are subject to tax under subchapter C of the Internal Revenue Code. U.S. business entities whose shares are publicly traded generally are C corporations.

Capital asset

Generally, an asset that is held as an investment rather than used in a business. When a capital asset is sold or exchanged, it generates capital gain or capital loss instead of ordinary gain or ordinary loss.

Capital export neutrality

Where a tax system is neutral regarding the choice between domestic or foreign investment because investors will face the same level of tax on similar investments regardless of whether they make those investments in their home country or in a foreign country.

Capital gain

Gain from the sale or exchange of a capital asset.

Capital import neutrality

Where a tax system is neutral regarding the import of capital because both domestic and foreign suppliers of capital to a market face the same level of tax on similar investments in that market.

Capital loss

Loss from the sale or exchange of a capital asset. Corporations cannot deduct net capital losses (i.e., capital losses can only be used to offset capital gains and not ordinary income), whereas individuals can deduct up to $3,000 of capital losses per year against ordinary income.

Capital ownership neutrality

Where a tax system is neutral toward the identities of capital owners.

Carried interest

A share of partnership profits allocated to a partner (often in the context of a private equity or hedge fund) as compensation for management services. This profits interest is in addition to the partnership interest this partner owns by reason of any capital investment that this partner may have made in the partnership. Partnership income allocated to a carried interest is generally long-term capital gain taxed at the lower U.S. federal long-term capital gains rate rather than the higher individual tax rates for ordinary income.

Carryback/carryforward

Deductions or credits from the current year that may be carried back to prior taxable years or carried forward to future taxable years to offset taxable income or tax in those years. Net operating losses, capital losses, and foreign tax credits are the most common deductions and credits that may be carried forward or back. The Internal Revenue Code provides rules for how many years forward or back such deductions or credits may be carried.

Charitable deduction

Deduction allowed for gifts to qualifying charities. Under the Internal Revenue Code, both individuals and corporations can deduct charitable contributions, although both are subject to various deduction limitations.

Check-the-box election

An election under U.S. federal tax regulations that allows certain domestic and foreign entities to choose how they will be treated for tax purposes, generally as (a) an association taxable as a corporation; (b) a partnership; or (c) disregarded for U.S. federal tax purposes. The check-the-box rules were issued to reduce uncertainty and complexity that existed under prior entity classification rules.

Classical tax system

A tax system under which a corporation is subject to corporate income tax and the corporation's shareholders are subject to tax on dividends from the corporation and dispositions of equity in the corporation. Under this system, corporate profits are taxed twice—once in the hands of the corporation and again when dividended to shareholders or when shareholders sell their equity in the corporation. The United States generally has a classical tax system, although dividends to shareholders are currently taxed at reduced rates.

Commensurate with income

A standard under the Internal Revenue Code providing that compensation must be made for the transfer or license of intangible property, and such compensation must be commensurate with the income attributable to the intangible, i.e., the compensation must reflect the income arising from the intangible property.

Competitiveness

A principle that considers whether a government policy or rule promotes the ability of businesses to compete successfully in the international marketplace. Some argue that U.S. tax policy, especially international tax policy, should promote the ability of U.S. companies to compete in foreign markets against foreign companies.

Comprehensive Business Income Tax (CBIT)

A method of corporate integration that would impose a broad-based flat tax on all business entities (corporate and non-corporate). Under a CBIT, dividends on stock and interest on debt would not be taxable to shareholders or creditors and would not be deductible by payors.

Consolidated return

A combined U.S. federal income tax return filed by a U.S. parent corporation on behalf of itself and its U.S. subsidiaries.

Consumption tax

A tax on spending for goods and services rather than on income. Sales taxes and value-added taxes (VATs) are the most common types of consumption taxes.

Controlled foreign corporation (CFC)

A foreign corporation in which more than 50% of the voting power or value of the stock is owned by U.S. shareholders. For purposes of this test, a U.S. shareholder is a U.S. person owning 10% or more of the voting power of the foreign corporation.

Conventional revenue estimates

A term used to refer to revenue estimates, such as those prepared by the Congressional Budget Office or Joint Committee on Taxation, that incorporate feedback from changes in the behavior of individuals and/or firms, but do not incorporate feedback from changes in the overall level of economic activity. See also "static revenue estimates" and "dynamic revenue estimates."

Corporate alternative minimum tax

Alternative calculation of U.S. federal corporation income tax with a 20% flat tax rate with fewer deductions and credits allowed. A corporation owes alternative minimum tax to the extent it exceeds the corporation's regular income tax liability. The corporate alternative minimum tax was designed to require corporations to pay a minimum amount of tax each year. A corporation receives a tax credit in future years for its payment of alternative minimum tax to the extent the regular tax in a future year exceeds the tentative minimum tax in that year.

Corporate expatriation

Where a company changes the location of its ultimate parent company. For example, a company that undertakes a transaction to change its ultimate parent from a U.S. corporation to a foreign corporation may be said to have undergone a corporate expatriation. See also "inversion." U.S. federal tax law contains rules to discourage corporate expatriations. Under these rules, expatriating companies may continue to be taxed as U.S. corporations or may be required to recognize certain gain.

Corporate income tax

A tax levied on a corporation's income each taxable year.

Corporate residence

A basis for the imposition of taxation on corporations. Under U.S. federal tax law, corporations are considered resident in the United States if they are incorporated in the United States. A corporation resident in the United States is subject to tax on its worldwide income, i.e., income that is earned in the United States or abroad. Some other countries consider a corporation resident in that country if the corporation is managed and/or controlled from that country.

Cost-sharing agreement

An agreement between related parties to share the costs of developing intangibles.

Council of Economic Advisors (CEA)

A group within the Executive Office of the President that advises the President on economic matters. The CEA and its staff study economic developments and analyze the economic effects of policies.

Credit

A dollar-for-dollar reduction of the amount of tax due. Credits may be non-refundable (in which case the credit can reduce tax liability no lower than zero) or refundable (in which case the credit can result in a payment from the government to the taxpayer). The earned income tax credit is an example of a refundable tax credit.

Credit invoice method

One of the methods by which a value-added tax (VAT) is collected. Under the credit-invoice method, all sales by businesses are taxable but businesses may claim credits for the VAT paid previously in the chain of production. The ultimate result is that transactions between businesses are untaxed but final sales from businesses to consumers are taxed. Most developed countries with a VAT use the credit-invoice method. See also "subtraction method."

Cross-crediting

A method of foreign tax credit planning in which foreign tax credits (in the same category of income or foreign tax credit "basket") associated with differing foreign tax rates are used together against U.S. federal tax on income of different types in the same basket. Because the U.S. federal foreign tax credit limitation restricts the amount of a foreign tax credit on a given item of income to the lesser of (a) the foreign taxes paid, or (b) the U.S. federal income tax that would be imposed on that income, companies may end up (i) having foreign tax credits that cannot be utilized (e.g., where the foreign tax rate is higher than the U.S. federal tax rate), or (ii) having residual U.S. federal income tax on foreign income (e.g., where the U.S. federal tax rate is higher than the foreign tax rate). For example, consider a foreign subsidiary of a U.S. company that earns $100 in a jurisdiction with a tax rate of 30%. The subsidiary pays $30 of foreign tax. If the subsidiary distributes $70 in earnings to its U.S. parent, the parent company will be treated as receiving a $100 dividend and will owe $35 of U.S. federal tax (assuming a 35% tax rate). The company can claim a foreign tax credit of $30, meaning that it has $5 of residual U.S. federal tax. If the U.S. company has a second foreign subsidiary that earns $100 in a jurisdiction with a 40% tax rate, the U.S. company might have that second foreign subsidiary distribute $60 (carrying $40 in foreign taxes) at the same time the first foreign subsidiary distributes its $70 (carrying $30 in foreign taxes). This simultaneous repatriation of income from the higher-tax and lower-tax countries will allow the U.S. parent to offset the $5 excess credits (e.g., the foreign taxes exceeding the U.S. federal taxes) from the distribution by the second subsidiary against the $5 of U.S. federal tax liability by the distribution from the first subsidiary. This offset is called cross-crediting.

D

Deduction

A reduction of the amount of income on which tax is calculated.

Deferral

The earnings of foreign subsidiaries of a U.S. corporation are generally not subject to U.S. federal income tax until those earnings are distributed to the U.S. corporation. This is often called deferral because U.S. tax is deferred until the earnings are distributed. Under the subpart F rules, certain passive or highly mobile earnings of foreign subsidiaries are taxed to their U.S. shareholders on a current basis (i.e., U.S. federal income tax on those earnings may not be deferred).

Deficit neutral

A term applied to legislation that neither adds to nor reduces the U.S. federal budget deficit over a defined period.

Depreciation

A cost recovery system under which the cost of an asset is deducted over a period of years, on an annual basis, rather than all at the time the cost is incurred. The number of years over which costs are deducted is generally determined by the type of the asset.

Destination principle

A principle of international taxation that the country in which a good or service is sold is the country in which the good or service is taxed.

Direct foreign tax credit

A credit against U.S. federal income tax provided to a U.S. person for foreign income taxes directly paid by that U.S. person. In contrast, an indirect foreign tax credit is a credit allowed to a U.S. corporation against U.S. tax on dividends received from a foreign subsidiary (in which the U.S. corporation owns 10% or more of the voting power) where the foreign subsidiary paid foreign tax on the underlying income.

Disregarded entity

An entity that is disregarded as separate from its owner for tax purposes. The assets and income of the disregarded entity are treated as the assets and income of the entity's owner.

Distribution table

A table that reports the allocation of tax burden or tax liability by income group. A distribution table can indicate the progressivity of the current tax system or the progressivity of proposed changes to the tax system.

Dividend deduction system

A method of integration under which a company pays corporate income tax on its earnings and shareholders pay tax on corporate dividends, but the corporation is allowed a deduction for dividends paid to shareholders.

Dividend exemption system

A method of integration under which a corporation pays corporate income tax on its earnings, but dividends to shareholders are exempt from tax. The term is also used to refer to a territorial tax system in which dividends paid by a foreign subsidiary to its parent corporation are not subject to tax in the country of the parent corporation.

Dividend imputation system

A method of integration under which part of the tax paid by a company on its earnings is attributed (or imputed) to the shareholders of the company by providing a credit to the company's shareholders that reduces the tax payable by the shareholders on the company's distributions. Imputation systems may be full (where a shareholder is entitled to a full credit for its share of tax paid by the corporation on its earnings) or partial (where a shareholder is entitled to a credit for only a portion of its share of the tax paid by the corporation on its earnings). Australia and New Zealand have dividend imputation systems.

Domestic production deduction (also referred to as domestic manufacturing deduction)

A U.S. federal income tax deduction allowed for the costs of certain domestic activities, including manufacturing, production, construction, engineering, and developing software.

Double taxation

A term used to refer to a situation in which amounts are taxed twice. Double taxation can arise in several contexts. For example, income that is taxed in a foreign country and also taxed in the United States is subject to double taxation. Another example occurs in the context of a classical tax system in which corporate earnings are taxed twice—once when earned by the corporation, and a second time when the shareholders receive dividends or when the shareholders recognize gain upon sale of their stock.

Dynamic revenue estimates (or dynamic scoring)

A type of revenue estimate that incorporates feedback from changes in the overall level of economic activity as well as changes in the behavior of individuals and/or firms. The latter, but not the former, are taken into account in conventional revenue estimates. See also "conventional revenue estimates" and "static revenue estimates."

E

Earnings stripping

The reduction of taxes through the payment of deductible amounts such as interest, rents, and royalties. In the United States, the term is most often used to refer to a foreign-owned U.S. corporation's reduction of its U.S. tax liability by making deductible payments to its foreign parent or another foreign affiliate. A provision of the Internal Revenue Code, Section 163(j), limits the deductibility of interest paid to certain related parties if no income tax is imposed on the interest and (1) the payor's debt-to-equity ratio exceeds 1.5 to 1 and (2) the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion).

Economic depreciation

The declining economic value of a depreciable asset over time due to factors such as obsolescence or physical wear.

Economic efficiency principle

A principle to evaluate the merits of a tax policy or rule by the extent to which the policy or rule optimizes economic activity while minimizing distortion of economic behavior.

Economic rents

See "above-normal returns."

Effective actual tax rate

A specific type of effective tax rate; it results from dividing income taxes paid by pre-tax book income. See also "effective tax rate."

Effective marginal tax rate

A term used to refer to the rate of tax paid by a taxpayer on that taxpayer's last dollar of income. In the context of analyzing investment incentives, the effective marginal tax rate refers to the additional income required over the life of an investment to cover taxes. It can take into account not only the major features of the corporate income tax, such as the corporate income tax rate, depreciation allowances, and source of finance, but also investor level taxes on capital gains, dividends, and interest payments.

Effective tax rate

A term used to refer to the actual rate of tax paid by a taxpayer. The measurement of an effective tax rate may differ depending on the method used to calculate the tax paid and the tax base. Some calculate effective tax rates by reference to financial statements, looking at a company's income tax as a percentage of income as those items are reported on the financial statement. Because income is calculated differently for financial statement purposes than for tax purposes, however, an effective tax rate calculated using financial statements may differ from an effective tax rate based on taxes and income reported for tax purposes. Further, where financial statement information is used, the effective tax rate calculated can differ depending on which specific information from the financial statement is used.

Excise tax

A tax on specific goods and services. The most common excise taxes are levied on gasoline, alcohol, and tobacco products.

Exemption

A rule providing for no tax on certain income, often income earned from a particular activity or asset or by certain entities.

Expatriation

With respect to individuals, a term generally used to refer to the process of giving up U.S. citizenship. The Internal Revenue Code generally requires persons giving up their U.S. citizenship to pay an exit tax on their appreciated property. See also "corporate expatriation/inversion."

Expensing

Deducting from gross income the full cost of an asset in the year it is purchased.

Expense disallowance

Denial of a deduction for an expense. An example of expense disallowance is a proposal to disallow interest expense, which would otherwise be deductible for U.S. federal tax purposes, to the extent it is allocable to foreign earnings exempt from U.S. tax. Expense disallowance has also been proposed in conjunction with proposals to implement a territorial tax system. In a territorial tax system, an alternative to expense disallowance limits the participation exemption (e.g., 95%) so that a portion of the income (5%) is taxable and serves as a proxy for the disallowed expenses. Many U.S. trading partners use this proxy in their territorial tax systems.

Extenders (or tax extenders)

A term used to refer to temporary tax provisions that expire unless renewed.

F

Fairness principle

A principle that asks whether a policy or rule is "fair." The term "fairness" may have different meanings for different people.

FIFO (First-In, First-Out)

A method of accounting for inventories in which the cost of a unit of inventory sold is recorded as the cost of the oldest unit of inventory.

Fiscally transparent entity

An entity that itself is not subject to income tax, and its income and losses are reported by its owners. Fiscally transparent entities include disregarded entities and pass-through entities.

Flat tax

A tax that imposes a single tax rate on all income.

Foreign base company income

A category of foreign income earned by a controlled foreign corporation. This income is currently taxable to the controlled foreign corporation's U.S. shareholders (for this purpose, defined as U.S. persons owning 10% or more of the voting power of the controlled foreign corporation) under subpart F of the Internal Revenue Code, even if the income is not distributed by the controlled foreign corporation. There are four general types of foreign base company income: foreign personal holding company income, foreign base company sales income, foreign base company services income, and foreign base company oil-related income.

Foreign base company oil-related income

A type of foreign base company income earned by a controlled foreign corporation. Foreign base company oil-related income generally includes income from the sale of oil and gas products, except where the income is earned in the country in which it is extracted.

Foreign base company sales income

A type of foreign base company income earned by a controlled foreign corporation. Foreign base company sales income generally includes income earned in connection with the purchase of property from, or sale of property to, a related party where the property originates outside the foreign country in which the subsidiary is created or organized and is sold for use outside that country.

Foreign base company services income

A type of foreign base company income earned by a foreign subsidiary. Foreign base company services income generally includes income from services for or on behalf of a related person where those services are performed outside the foreign country in which the subsidiary is created or organized.

Foreign personal holding company income

A type of foreign base company income earned by a controlled foreign corporation. Foreign personal holding company income generally includes dividends, interest, royalties, rents, and other types of investment income earned by the controlled foreign corporation. Where this income is earned by a controlled foreign corporation whose business is the active conduct of a banking, financing, or similar business, however, the income may qualify for the "active financing" exception from subpart F taxation. The subpart F "look-through rule" also provides an exception for payments of interest, dividends, rents, and royalties received by a controlled foreign corporation from a related controlled foreign corporation to the extent that such payments are attributable to active earnings of the payor controlled foreign corporation.

Foreign source income

Income considered to arise outside the United States. U.S. federal tax law contains various rules for determining the source of an item of income. For example, the source of an interest payment is determined by reference to the residence of the payor – interest paid by a foreign person is considered foreign source income.

Foreign tax credit

A tax credit that allows U.S. persons to subtract foreign income taxes from U.S. federal income tax due. The credit is subject to various rules and limitations and is generally limited to the amount of tax that the United States would have imposed on the foreign income. The foreign tax credit generally is intended to relieve potential double taxation, i.e., when income would otherwise be subject to tax by two countries. In lieu of claiming a foreign tax credit, taxpayers generally may choose to deduct foreign taxes paid.

Foreign tax credit basket

A category of income into which foreign income and associated taxes must be segregated and for which a separate foreign tax credit limitation must be calculated. There are currently two foreign tax credit baskets for U.S. federal income tax purposes – the general (e.g., business income and salaries/wages) and passive (e.g., interest, dividends, capital gains) baskets. Foreign taxes paid with respect to foreign income in a particular basket may only offset taxes on foreign source income in the same basket.

Foreign tax credit limitation

A restriction on the amount of foreign income taxes paid that a U.S. person may credit against its U.S. federal income taxes. The foreign tax credit limitation is the lesser of (a) foreign taxes paid, or (b) foreign source income divided by worldwide taxable income, multiplied by the U.S. tax imposed on worldwide taxable income (before the credit). The foreign tax credit limitation must be calculated for each foreign tax credit basket. If for a particular taxable year the foreign tax exceeds the foreign tax credit limitation, the excess foreign tax may generally be carried back one year or carried forward ten years to offset taxes imposed in the same basket.

Formulary apportionment

A system that allocates a company's income across countries or subnational units by reference to a formula. The formula takes into account one or more factors, usually property, payroll and/or sales.

Fungibility

The principle that a good or asset is interchangeable with another good or asset.

H

Healthcare exclusion

Internal Revenue Code provisions exempting health insurance benefits provided by employers from U.S. federal income tax and employment tax.

Holding company

A company whose main purpose is to hold the stock of one or more other companies.

Home mortgage interest deduction

A deduction allowed under the U.S. federal income tax law for interest paid on a home mortgage. Under the Internal Revenue Code, the deduction is limited to interest paid with respect to the first $1 million of debt used to acquire, construct, or substantially improve a main or second home. A deduction is also permitted for interest paid with respect to the first $100,000 of a home equity loan regardless of how the loan proceeds are used.

Horizontal equity

The principle that persons with the same income level, or similar ability to pay, should pay similar amounts of tax.

House Ways and Means Committee

The tax-writing committee in the U.S. House of Representatives. The committee has jurisdiction over taxes, tariffs, and other revenue-raising measures as well as Social Security, Medicare, and other entitlement programs.

Hybrid entity

An entity that is treated differently for U.S. tax purposes than it is for foreign tax purposes. The term is often used to refer to an entity that is fiscally transparent for U.S. tax purposes but is treated as a corporation for foreign tax purposes.

Hybrid instrument

An instrument that is classified one way for U.S. tax purposes but a different way for foreign tax purposes. For example, an instrument may be treated as debt for U.S. tax purposes but equity for foreign tax purposes, or vice versa.

Hybrid system

A tax system that does not purely reflect one particular type of tax system. For example, the U.S. federal income tax system is actually a hybrid system because it has features of a consumption tax in that certain types of investment income (e.g., income from retirement savings) are not subject to tax. In addition, the U.S. international tax system is sometimes described as a hybrid system because it contains elements of both a worldwide system of taxation (i.e., both U.S. and foreign income are taxed) and a territorial system of taxation (i.e., active foreign income earned by foreign subsidiaries is not taxed unless and until distributed to a U.S. company).

I

Incidence of corporate tax

Because individuals ultimately bear the economic burden of taxes, the question of the incidence of the corporate tax considers which individuals ultimately bear the corporate tax. It is generally thought that the corporate income tax is borne by capital providers, labor, and consumers, although economists have different views as to the percentage borne by each of these groups of individuals.

Income

Generally, the amount that is earned by a person. Individuals and corporations are generally taxed on their net income, which is gross income minus deductions.

Income shifting

Generally, moving income from a higher-tax jurisdiction to a lower-tax jurisdiction. The movement of such income can be accomplished, for example, through the transfer of assets, activities, or risks by an entity in a higher-tax jurisdiction to an entity in a lower-tax jurisdiction.

Income tax

A tax imposed on income.

Indirect foreign tax credit

A foreign tax credit allowed to a U.S. corporation against U.S. tax on dividends (actual or deemed) received from a foreign subsidiary (in which the U.S. corporation owns 10% or more of the voting power) where the foreign subsidy paid foreign tax on the underlying income.

Intangible property

Generally, property that does not physically exist. Intellectual property (e.g., patents, copyrights, and trademarks) is intangible property. The tax code contains different definitions of intangible property for different purposes. Whether certain items fall within those definitions is sometimes an area of dispute between taxpayers and the Internal Revenue Service.

Integration

A method of taxing corporate profits that combines (or "integrates") corporate and individual taxation so that the profits are taxed only once, in contrast to the double taxation that occurs under a classical system, under which corporate profits are taxed once when earned by the corporation and a second time when the shareholders receive dividends or when the shareholders recognize gain upon sale of their stock. There are various ways that integration can be achieved, such as through a dividend imputation system, a shareholder allocation (full integration) system, a dividend exemption system, a dividend deduction system, or a Comprehensive Business Income Tax (CBIT) system.

Interest deductibility

For U.S. federal income tax purposes, a corporation may generally deduct the interest it pays from its gross income. Individuals are permitted to deduct only certain types of interest, such as certain home mortgage interest and student loan interest.

Internal Revenue Code (IRC or the "Code")

The U.S. federal tax law as enacted by Congress. It is contained in Title 26 of the United States Code.

Internal Revenue Service (IRS)

The U.S. federal government agency responsible for tax collection and tax law enforcement.

Inversion

Where a company changes the location of its ultimate parent company. For example, a company that undertakes a transaction to change its ultimate parent from a U.S. corporation to a foreign corporation may be said to have inverted. See also "corporate expatriation." U.S. federal tax law contains rules to discourage corporate inversions. Under these rules, inverted companies may continue to be taxed as U.S. corporations or may be required to recognize certain gain.

J

Joint Committee on Taxation

A tax committee of Congress including members of both the Senate and House of Representatives. The Joint Committee on Taxation has a staff of economists, attorneys, and accountants. The committee is officially chaired on a rotating basis by the Chairman of the Senate Finance Committee and the Chairman of the House Ways and Means Committee.

L

LIFO (Last-In, First-Out)

A method of accounting for inventories in which the cost of a unit of inventory sold is recorded as the cost of the unit of inventory most recently produced or purchased.

Limited liability company (LLC)

An entity formed by one or more persons under the limited liability company laws of a state. The owners of an LLC, often called members, have limited personal liability for the debts and obligations of the entity. A U.S. limited liability company generally may choose whether to be treated for U.S. federal income tax purposes as a corporation or partnership if it has multiple owners or a corporation or disregarded entity if it has a single owner.

Limited liability partnership (LLP)

An entity formed by two or more persons under the limited liability partnership laws of a state. Although the specific laws of individual states may differ, partners of an LLP generally have limited personal liability for the debts and obligations of the partnership. A U.S. limited liability partnership is treated as a pass-through entity for U.S. federal income tax purposes unless it elects to be taxed as a corporation.

Limited partnership

An entity formed by two or more persons under the limited partnership laws of a state. Although the specific laws of individual states may differ, a limited partnership generally must have at least one general partner (who is liable for the debts and obligations of the partnership). The other partners may be limited partners (i.e., partners who are not liable for the debts and obligations of the partnership). A U.S. limited partnership is treated as a pass-through entity for U.S. federal income tax purposes unless it elects to be taxed as a corporation.

Lock-in effect

The disincentive for investors to sell appreciated capital assets because they will have to pay tax upon the sale of those appreciated assets. The assertion that investors can be locked in to their investments because of potential taxes is cited as a justification for lower tax rates on capital gains.

Lock-out effect

The disincentive for U.S. companies to have their foreign subsidiaries repatriate earnings to the United States. The earnings of foreign subsidiaries of U.S. corporations are generally not subject to U.S. federal income tax until those earnings are distributed to the U.S. parent. The potential U.S. tax on distributions from foreign subsidiaries is said to create a lock-out effect causing U.S. companies to leave foreign earnings overseas rather than repatriate the earnings to the United States.

Look-through rule

An exception under subpart F of the Internal Revenue Code providing that payments of interest, dividends, rents, and royalties received by a controlled foreign corporation from a related controlled foreign corporation will not be considered foreign personal holding company income to the extent that such payments are attributable to active earnings of the payor controlled foreign corporation (i.e., the character of the income will be determined by looking through to the nature of the income earned by the payor controlled foreign corporation). The "look-through rule," contained in Internal Revenue Code section 954(c)(6), was enacted on a temporary basis and has been extended repeatedly.

M

Management and control test

A test used by some countries to determine whether a corporation is resident in that country (and thus subject to tax) by considering whether the corporation is managed and/or controlled from that country. Other countries, such as the United States, consider a corporation resident where it is incorporated.

Marginal tax rate

The rate of tax that would apply to the last dollar of the tax base. Thus, in a system with progressive taxation, the marginal tax rate would be higher than the average tax rate since a portion of income is taxed at lower rates.

Multinational corporation or enterprise (an MNC or MNE)

A corporate group that operates in many countries. For example, the term U.S. MNC may be used to refer to a U.S.-headquartered corporate group with global operations.

N

National Economic Council (NEC)

A group within the Executive Office of the President that coordinates the President's economic policy, monitors the implementation of the President's economic policy agenda, and helps ensure that economic policy decisions and programs are consistent with the President's economic goals.

Net operating loss

Where tax deductions exceed taxable income for a taxable year. The Internal Revenue Code allows these losses to be carried back or carried forward and applied against income in prior and future tax years.

Normal return

Return that individuals or firms could normally expect to receive in a competitive marketplace. The term also refers to the return for a good or service at which the amount of earnings from the sale of that good or service is equal to the amount of earnings required to prevent the factors of production (e.g., land, labor, and capital) that produce that good or service from being switched to a more profitable use.

O

Office of Management and Budget (OMB)

An office within the Executive Office of the President that assists in developing and submitting the President's annual budget to Congress and oversees executive agency performance and financial activities.

Office of Tax Policy

An office within the Department of the Treasury that develops and implements tax policies and programs, reviews tax regulations and rulings, negotiates tax treaties, provides analysis for tax policy decisions, and provides estimates for the president's budget.

Ordinary income

Income other than capital gain, including income from the conduct of a trade or business and wages, salaries, and other compensation from employment.

Organisation for Economic Co-operation and Development (OECD)

An international economic organization, currently with 34 members, including the United States.

Origin principle

A principle of international taxation that the country in which a good or service is produced is the country in which the good or service is taxed.

P

Parent company

Generally, a company that owns all or most of the stock of another company (its subsidiary).

Participation exemption

A feature of several foreign countries' tax laws, providing an exemption (or near exemption) from taxation with respect to the dividends received by a parent company from subsidiaries (often both foreign and domestic subsidiaries) and, in some circumstances, capital gains from the sale of the parent's shares in the subsidiaries. A certain percentage of ownership in the subsidiary and a minimum holding period may be required for a parent company to qualify for the participation exemption.

Partnership

An unincorporated state-law entity formed by two or more participants to engage in a joint enterprise. A partnership is recognized for U.S. federal tax purposes if the participants carry on a trade, business, financial operation or venture and divide the profits therefrom. A partnership is treated as a pass-through entity for U.S. federal tax purposes, unless it elects to be taxed as a corporation.

Passive income

Generally, investment income such as interest, dividends, or similar income, not earned through the conduct of a trade or business.

Pass-through entity (also called "flow-through" entity)

An entity that is not subject to income tax. Its income, deductions, and credits flow through to its owners. Partnerships, limited liability companies, and S corporations are the most common entities treated as pass-through entities.

Patent box

A preferential tax regime for profits arising from patents and other intangible assets developed domestically. A patent box regime is intended to encourage domestic research and development. Several countries have enacted patent box regimes.

PAYGO

A requirement that legislation increasing mandatory spending either not increase the federal deficit or else be offset by additional revenues. In the last two decades, this requirement has been implemented through Congressional budget rules and/or legislation. The Statutory Pay-As-You-Go Act of 2010 is the most recent legislation creating this requirement, and generally requires that spending enacted in legislation passed after February 12, 2010 be offset by spending cuts or additional revenue.

Payroll tax

Taxes which are deducted directly from an employee's paycheck such as Social Security and Medicare taxes.

Per se corporation

A type of entity that is automatically treated as a corporation for U.S. federal tax purposes and may not elect to be treated otherwise through a check-the-box election. For example, an entity incorporated under state law is a per se corporation.

Progressive taxation

Where the rate of tax increases as income increases. The U.S. federal income tax is a progressive tax.

Publicly traded partnership

A partnership whose interests are traded on a public market. A partnership that is considered publicly traded for U.S. federal tax purposes is taxed as a corporation unless substantially all of its income is passive (e.g., interest, dividends, and certain income from real property).

R

Real Estate Investment Trust (REIT)

A real estate entity that receives favorable tax treatment under the Internal Revenue Code if certain requirements are met. An entity generally qualifies as a REIT if it would (but for the REIT rules) be taxable as a corporation for U.S. federal tax purposes, has transferable shares, has 100 or more owners, and meets certain other requirements. At least 75% of its income and assets must relate to real estate investments and at least 95% of its income must be passive (e.g., interest, dividends, and certain income from real property). A REIT generally must distribute at least 90% of its income annually to its owners. Unlike other corporations, a REIT can deduct distributions for U.S. federal income tax purposes, thus generally resulting in no tax at the entity level.

Realization

A concept in tax law referring to when gain or loss is created. For example, gain or loss is generally realized when an asset is sold or exchanged. See also "recognition."

Recognition

A concept in tax law referring to when gain or loss that has been realized is taken into account on a tax return. See also "realization."

Regressive taxation

Where the rate of tax decreases as income increases.

Regulated Investment Company (RIC)

An investment entity that receives favorable tax treatment under the Internal Revenue Code if certain requirements are met. An entity generally qualifies as a RIC if it is a U.S. corporation registered under the Investment Company Act of 1940. At least 90% of its income must be certain passive income and it must satisfy certain asset diversification requirements. A RIC must generally distribute at least 90% of its income annually to its shareholders. Unlike other corporations, a RIC can deduct distributions for U.S. federal income tax purposes, thus generally resulting in no tax at the entity level.

Repatriation

When earnings of a foreign subsidiary of a U.S. corporation are distributed to the U.S. corporation.

Research and experimentation (R&E) credit

A nonrefundable tax credit for U.S. federal income tax purposes for certain research and development expenses in the United States. The amount of the credit is determined under complex rules. The R&E credit is a temporary provision that frequently expires and is extended.

Residence

A basis for the imposition of taxation that considers where a person resides. A corporation is considered resident in the United States if it is incorporated in the United States. An individual is generally considered a U.S. resident if he or she is a lawful permanent resident of the United States or (subject to certain exceptions) satisfies a substantial presence test. The United States taxes the worldwide income of U.S. citizens and U.S. residents.

Revenue estimate (or revenue scoring)

A forecast of the budgetary effects of a change in policy from current law. See also "dynamic estimates" and "static estimates."

Revenue neutral

A term applied to legislation that has no net cost. In other words, revenue neutral legislation will neither raise revenue nor lose revenue on a net basis.

Reverse hybrid

An entity that is fiscally transparent for foreign tax purposes but not fiscally transparent for U.S. tax purposes.

Round tripping

A term used to refer to the sale of products in the United States by a foreign subsidiary of a U.S. company.

S

Senate Finance Committee

The tax-writing committee in the U.S. Senate. The committee has jurisdiction over taxes, tariffs, and other revenue-raising measures as well as Social Security, Medicare, and other entitlement programs.

S corporation

An incorporated entity that is treated as a corporation for state law purposes but that elects to be taxed as a pass-through entity for U.S. federal tax purposes. The shareholders of an S corporation report their pro rata share of the S corporation's income, deductions, and credits. Only domestic corporations with no more than 100 shareholders who are individuals (or shareholders who are qualifying trusts or exempt organizations) can qualify as S corporations.

Shareholder allocation method

A method of integration under which a corporation itself does not pay corporate tax. Rather, the net income of the company, whether distributed to shareholders or not, is included in the income of shareholders in proportion to their stock ownership. This method is also sometimes referred to as a full integration system.

Simplicity

A principle that considers the extent to which a policy or rule is easily understandable, can be easily complied with, and can be easily administered.

Sole proprietorship

A business conducted in one owner's individual capacity. No separate legal entity exists for holding and conducting the business. The owner of the sole proprietorship reports the income from the business directly on the owner's tax return.

Source

Where income is considered to arise. U.S. federal tax law contains various rules for determining whether the source of an item of income is domestic or foreign.

Static revenue estimates (or static scoring)

An alternative term for conventional revenue estimates. Such estimates may be called "static" because they do not incorporate changes in the overall level of economic activity. They do, however, incorporate feedback from changes in the behavior of individuals and/or firms. See also "conventional revenue estimates" and "dynamic revenue estimates"

Statutory tax rate

The tax rate imposed by law.

Subpart F

Shorthand name for the portion of the Internal Revenue Code that relates to the calculation and taxation of income from U.S.-owned foreign subsidiaries (controlled foreign corporations). The subpart F rules require certain types of income of a controlled foreign corporation to be currently included in the gross income of the foreign corporation's U.S. shareholders even if such income is not distributed to the U.S. shareholders.

Subsidiary

An entity that is substantially or wholly owned by another entity (its parent).

Subtraction method

One of the methods by which a value-added tax (VAT) is collected. Under the subtraction method, businesses subtract the full costs of their inputs from their sales. The VAT is imposed on the difference between the two amounts. See also "credit invoice method."

T

Tax arbitrage

Obtaining multiple tax benefits as a result of the differing treatment of assets, business entities, or other items in the tax regimes of different countries.

Tax avoidance

A term generally used to refer to the reduction of tax through legal methods.

Tax base

The measure upon which the determination of tax liability is based. For example, the base of the U.S. federal income tax is generally taxable income.

Tax credit

See "credit."

Tax evasion

A term generally used to refer to the reduction of tax through illegal methods. For example, knowingly failing to report income from an overseas bank account generally would be considered tax evasion.

Tax expenditure

A special deduction, credit, exclusion, or exemption from gross income or a preferential tax rate.

Tax gap

The difference between the amount of tax owed by all taxpayers and the amount that is paid.

Tax haven

A term commonly used to refer to a jurisdiction with low or zero tax rates.

Tax holiday

A period of exemption or reduction of tax for certain activities or investments.

Tax planning

Proactively taking steps to minimize taxes. The term is usually used to refer to steps taken that are in accordance with the law.

Tax Reform Act of 1986

The most recent fundamental reform of the U.S. Internal Revenue Code. It was signed into law by President Reagan in October 1986. In general, it broadened the tax base while lowering tax rates.

Tax shelter

A term used to refer to a plan or scheme to reduce taxes. The term is often used to refer to illegal or legally questionable means for reducing taxes.

S — Z

Tax sparing

Typically where a developed country grants a foreign tax credit for specific foreign taxes that would have been payable in a developing foreign country but for a tax exemption in that developing foreign country. The purpose of tax sparing relief is to prevent the loss of a foreign tax credit from negating the incentive offered by the developing country's tax exemption. The United States historically has not engaged in tax sparing.

Tax treaty

An agreement between two countries to address issues involving the taxation of income that a resident of one of the countries earns in the other country. Important purposes for tax treaties include prevention of double taxation (i.e., a situation in which both countries tax an item of income) and information exchange. The United States has tax treaties with over 60 countries.

Taxable year

The period used as the basis for computing tax. A taxable year is typically 12 months long, but in some situations it can be shorter. The taxable year of most individuals and many corporations corresponds to the calendar year (i.e., January 1 to December 31).

Territorial tax system

A system of taxation under which the active foreign earnings of a foreign subsidiary are generally not subject to tax by the country of the foreign subsidiary's parent corporation, either when earned or when distributed to the parent corporation. Territorial tax systems are used by most U.S. major trading partners (although the specific provisions vary from country to country).

Thin capitalization

Where an entity has a high level of debt compared to its equity investment.

Transfer pricing

The pricing of transactions between related parties. Because of the possibility of shifting income from one jurisdiction to another, transfer pricing is often a source of controversy between taxpayers and tax authorities.

Treaty shopping

A term used to refer to the structuring of international transactions to take advantage of a particular tax treaty providing for a lower rate of tax.

U

U.S. source income

Income considered to arise in the United States. U.S. federal tax law contains various rules for determining the source of an item of income. For example, the source of an interest payment is determined by reference to the residence of the payor. Thus, interest paid by a U.S. person is considered U.S. source income.

V

Value-added tax (VAT)

A consumption tax on the sales of goods and services to consumers. The tax is levied at each stage of the production process on the value added, which is calculated as the difference between a firm's sales and a firm's purchase of inputs from other firms. All U.S. trading partners and approximately 130 countries impose a VAT, but the United States does not.

Vertical equity

The principle that those with higher incomes or a greater ability to pay should pay more in taxes than those with lower incomes or a lesser ability to pay.

W

Withholding tax

Where a tax on income is withheld by the payor of the income. For example, employers generally withhold tax on wages paid to employees. In the international tax context, the United States (and many other countries) may require persons making certain types of payments (e.g., interest, dividends, and royalties) to nonresidents to withhold a portion of the payment.

Worldwide tax system

A system of taxation under which all earnings, whether domestic or foreign, of a domestic corporation and its foreign subsidiaries are taxed in that corporation's home country. The United States currently has a worldwide tax system but allows tax on active foreign earnings of a foreign subsidiary of a U.S. corporation to be deferred until such income is distributed to the U.S. corporation.

X

X tax

A consumption tax with graduated rates originally developed by the late Princeton University economist David Bradford. Under the X tax, individuals would be taxed at progressive rates only on their wages. Businesses would be taxed at the top individual tax rate on their gross business receipts less purchases and wages.