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The National Foreign Trade Council Comments on the *Taxation of Foreign Source Business Income*

Economic Policy Working Group
The Office of President–elect Barack H. Obama
on
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The National Foreign Trade Council (NFTC) is pleased to offer input to the President-elect's Transition Team, regarding tax policy considerations relevant to a review of the U.S. tax rules applicable to the foreign source business income of U.S. multinational corporations (U.S. MNCs). The NFTC is an association of businesses that was founded in 1914; its membership consists primarily of U.S. firms engaged in international trade and investment, covering the full spectrum of industrial, commercial, financial, and service activities.

President-elect Obama is facing a "perfect storm" of tax and fiscal challenges, including the rising costs of entitlement spending and an unprecedented number of federal tax law provisions that are scheduled to expire before 2010. This fiscal and tax environment will require significant policy changes. As the incoming Administration considers legislative proposals during this transition period, the NFTC would urge the adoption of a moratorium on tax policy changes that could hamper the competitive efforts of American companies in the global marketplace. Rather, and particularly in view of the continuing turmoil in the U.S. economy, we urge the Transition Team to recommend that the in-coming Administration take the time needed to develop only such measured initiatives as are found to be necessary after a systematic analysis of the operation of current law.

The NFTC looks forward to working with the incoming Administration, and would be pleased to provide additional background about any of the tax policy issues in this submission.

I. Introduction and Background

During the presidential campaign, President-elect Obama pledged to reform deferral to end "the incentive for companies to ship jobs overseas" and to "repeal tax breaks and loopholes that reward corporations that retain their earnings overseas, and…use those savings to lower corporate tax rates

for companies that expand or start operations in the United States."[1] The NFTC prepared these comments in view of those statements, to highlight the importance of bolstering the international competitiveness of *all* American businesses and their workers, without discriminating against U.S. MNCs that have active businesses abroad.

This section first summarizes the conflicting economic policies underlying the patchwork of rules regarding U.S. worldwide taxation of business income. The second part of this section highlights developments that call into question whether the analytical framework used in structuring current law has continuing vitality in today's global economy.

Section II outlines one approach to reform of the U.S. taxation of foreign source income that was proposed in a 2007 bill introduced by the Chairman of the House Ways and Means Committee, Rep. Charles B. Rangel (D-NY), and also identifies concerns about how this approach could affect the international competitiveness of U.S. MNCs.

A. The basic structure of the U.S. international tax regime was enacted when the U.S. economy dominated the world.

The general principle of "*deferral*" has been a permanent feature of U .S. law since the inception of the corporate income tax in 1913. "Deferral" is not a "special rule" or "tax break;" rather, it results from the general rule that the owners of a corporation are not taxed on corporate earnings until they receive those earnings in the form of a dividend or other distribution. In the international context, this means that U.S. tax on business profits earned by a CFC is deferred until that income is paid as a dividend to its owner in the United States. (CFCs generally are subject to current tax under the laws of foreign countries in which they operate.)

Since the early 1960s the United States has pursued an international tax policy based on a compromise between two starkly different economic principles.[2] The first, capital export neutrality ("CEN"), is grounded in the concept that global economic welfare requires the taxation of earnings from an investment at roughly the same rate whether the investment is made "here" in the United States or "there" in a foreign jurisdiction. In a system governed solely by CEN, foreign income would be taxed at domestic rates, with a credit for foreign taxes paid. The second principle that is also commonly cited is capital import neutrality ("CIN"), under which foreign income would be taxed only at foreign rates, thus allowing U.S. MNCs to operate under the same tax burden as foreign competitors in the same markets.

CEN provided the rationale for the Kennedy Administration's 1961 proposal to impose current taxation on all foreign earnings of U.S. MNCs operating in developed countries (while simultaneously providing investment tax credits and accelerated depreciation allowances intended to encourage investment and production in the United States). At that time, U.S. MNCs faced only limited competition from foreign MNCs in post-WWII markets around the world. Nevertheless, even in this emerging global economy, American businesses argued the importance of CIN to the international competitiveness of the United States. In 1962, Congress opted to avoid undue harm

1 http://www.barackobama.com/pdf/taxes/Factsheet_Tax_Plan_FINAL.pdf

2 *See generally*, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations," A Policy Study published by the Office of Tax Policy, Department of the Treasury, December 2000. This study was initiated on December 11, 1998, during the Clinton Administration, by (then) Assistant Secretary of the Treasury for Tax Policy, Donald C. Lubick.

to the competitiveness of U.S. MNCs by adopting a compromise between CEN and CIN. Rather than repealing deferral, Congress preserved the ability of American firms to defer U.S. tax on active business income but imposed current U.S. tax on the "passive" income earned by CFCs.

B. Global developments call into question the decades-old policy choices underlying current law.

Any proposal to change the tax rules governing the international operations of U.S. MNCs should be evaluated in terms of whether the underpinnings of current law continue to be appropriate, particularly in light of the evolution of the global economy. When subpart F was enacted in 1962, the U.S. economy dominated the world, accounting for over half of all multinational investment in the world. As late as 1988, developed market economies were limited to North America, Western Europe, and parts of Latin America – even in these developed countries, laws and business operations tended to be locally and regionally oriented. Beginning in 1989, however, a period of rapid change began to occur around the world.

The past twenty years saw several seminal changes to the relationship of the U.S. economy to external markets. The former Soviet Union, China, and other parts of Asia shed the yoke of non-market socialism, as a result of which the great majority of the world's population became engaged in what rapidly evolved as a global marketplace. As high technology advances in computers, software, and electronic communication dramatically reduced the cost of doing business, market participants were able to maximize global reach while minimizing the time and cost of the delivery of products and services to customers and consumers around the globe. Today 95% of the world's population lives outside the United States. To the extent that tax policy constrains the ability of American businesses to participate in growing overseas markets, their foreign competitors will have a permanent advantage.

The rapid growth in large new developing markets has had a profound impact on the general trend of global tax legislation, with many governments in the developed world recognizing the need for new approaches to take advantage of the dynamics of a fast-changing world economy. After the United States lowered the top corporate tax rate to 34% in1986, other countries followed suit, so that by 2000, only 5 of the 30 member countries in the Organization for Economic Cooperation and Development (OECD) had higher statutory corporate tax rates. Today, as authorities worldwide have overhauled their tax systems by reducing marginal rates, the United States finds itself with the second highest corporate tax rate in the OECD, just under Japan (whose current government recently proposed cutting the corporate tax burden).

Recent economic literature offers new insights regarding the effects that occur as U.S. MNCs globalize to be close to their ever increasing base of foreign customers. A recent paper by Harvard economists Mihir Desai and Fritz Foley, and University of California, Berkeley economist James Hines examined the effect of increased foreign activity by U.S. MNCs on their own domestic operations.3 Employing confidential affiliate-level information, these economists were able to match individual foreign operations to the domestic activities of the same firms, making it possible to analyze the extent to which expansions in foreign business activity coincided with changes in domestic activity.

3 *See* Desai, Mihir A., C. Fritz Foley, and James R. Hines Jr. "Domestic Effects of the Foreign Activities of U.S. Multinationals." *American Economic Journal: Economic Policy* (forthcoming).

Desai, Foley, and Hines concluded that "manufacturing firms that expanded their foreign operations between 1982 and 2004 simultaneously expanded their domestic operations….Foreign investment that is triggered by foreign economic growth is associated with growing domestic capital accumulation, employment compensation, R&D, and exports to related parties." They noted, for example, the following positive relationships between foreign and domestic changes in assets and numbers of employees:

- 10 percent greater foreign investment is associated with 2.6 percent greater domestic investment, and
- 10 percent greater foreign employee compensation is associated with 3.7 percent greater domestic employee compensation.

Significantly, in the latter regard, there is evidence that is "consistent with a model of complementarity in which foreign employment compensation affects domestic employment compensation through changes in employment levels and not through changes in compensation per employee." "While there may be considerable individual variation," they concluded, "the average experience of all U.S. manufacturing firms over the last two decades is *inconsistent* with the simple story that all foreign expansions come at the cost of reduced domestic activity."

II. Proposals to Reform the International Tax Regime Should be Carefully Analyzed to Determine the Impact on U.S. International Competitiveness.

On October 25, 2007, Ways and Means Committee Chairman Rangel introduced H.R. 3970, the "Tax Reduction and Reform Act of 2007," a bill to reduce corporate tax rates while making substantial changes to the international portions of the Code, *inter alia*. Chairman Rangel has indicated that he will re-introduce a modified version of this legislation in the next Congress, and it is fair to assume that he will view this bill as a starting point for any move to overhaul the income tax law. Reducing U.S. corporate income tax rates is a worthy goal; however, despite the proposed reduction in the corporate tax rate, there is a concern that H.R. 3970 would cause U.S. MNCs to pay substantial additional tax on foreign business income under provisions that would require them to:

(1) Defer deductions (and the recognition of foreign taxes) that are viewed as allocable to income eligible for deferral (based on the ratio of current year's deferred foreign source income to total foreign source income);

(2) Calculate foreign tax credits ("FTCs") and related earnings and profits on a consolidated basis, treating *all* their CFCs as a single CFC. As a result, FTCs could only be claimed for a *pro rata* share of foreign taxes as the income is repatriated, and taxpayers would lose the ability to minimize U.S. residual tax on repatriation by choosing to bring back high-taxed foreign earnings; and

(3) Continue the treatment of U.S. interest expense as supporting the worldwide activities of the U.S. MNC, including the operations of foreign subsidiaries that incur interest expense of their own. In this regard, the bill would repeal the rule that would address a defect in current law that fails to allow U.S. MNCs to allocate interest expense on a worldwide basis. The rule currently in effect inappropriately reduces the availability of FTCs by over-allocating U.S. interest to foreign-source income — the corrective

provision (in section 864(f)) was enacted with a deferred effective date and is now scheduled to go into effect after 2010.

A. H.R. 3970 would substantially tilt the playing field against U.S. MNCs competing abroad.

The increased tax burden under H.R. 3970 proposals would clearly reduce the ability of many U.S. MNCs to compete in serving customers and consumers in foreign locations. American companies currently subject to a relatively low foreign effective tax rate would be faced with the decision whether to forgo deductions for current expenses incurred in the U.S. or repatriate a greater amount of foreign earnings on which there could be substantial amounts of residual U.S. tax. Some U.S. MNCs could find that this provision would "effectively" repeal deferral, to the extent it becomes more cost effective to repatriate foreign income than to suffer the disallowance of expenses on the U.S. return. This provision could also inadvertently encourage U.S. MNCs to move functions outside the United States since a portion of such expenses would not be currently deductible.

By requiring U.S. firms to pay more income tax than their foreign counterparts on non-U.S. earnings, the bill would create a permanent cash drain that over time would so weaken U.S. firms that they could not catch up. This structural handicap can not be offset by simply hoping U.S. firms can "out think" the foreign competition.

B. U.S. MNCs would also be less competitive at home.

What may be less obvious is the impact the approach of H.R. 3970 could have on competition here at home. Consider, for example, a U.S. MNC and a foreign MNC, each with the opportunity to build a new manufacturing and distribution facility in the United States. The foreign MNC would make its U.S. investment through a U.S. subsidiary with no foreign operations. As a result, the proposals outlined above would have no effect on the foreign MNC's ability to deduct interest and other expenses on the return filed by its U.S subsidiary, and would be unlikely to suffer any similar disallowance under the tax law of its home country. In the case of a U.S. MNC, however, the use of borrowed funds to make a similar domestic investment would result in the loss of deductions for interest, administrative and management expenses, and possibly other costs related to the project, to the extent the U.S. MNC has deferred foreign income. This means that the American company would require a greater risk adjusted rate of return on its U.S. investment than the foreign company.

Even in advance of any comprehensive review of the international tax regime, the NFTC urges the incoming Administration to support the continued application of two temporary provisions that provide appropriate exceptions to the anti-deferral rules of subpart F: rules relating to active financial services income and look-through treatment for inter-affiliate payments of active foreign earnings between related CFCs, both of which have broad, bi-partisan support in Congress.

The active financing exception to Subpart F is a temporary provision that applies the general U.S. rule of "deferral" to our financial services companies; thus, like their foreign-based competitors, our companies will only pay a *current* tax in the country where their foreign operations are located. In the history of the U.S. income tax, the non-U.S. active financial services income of U.S. companies has been subject to current U.S. tax for only one ten-year period. At

present, this provision is due to expire on December 31, 2009. Extension of the active financial services exception in 2009 would preserve the ability of U.S financial firms to compete in the difficult and competitive global marketplace.

The CFC look-through provision, which also expires at the end of 2009, is consistent with similar laws in other countries that permit MNCs to redeploy active business income without triggering a current tax. As explained by the staff of the Joint Committee on Taxation, "[m]ost countries allow their companies to redeploy active foreign earnings with no additional tax burden. The Congress believes that this provision will make U.S. companies and U.S. workers more competitive with respect to such countries. By allowing U.S. companies to reinvest their active foreign earnings where they are most needed without incurring the immediate additional tax that companies based in many other countries never incur, the Congress believes that the provision will enable U.S. companies to make more sales overseas, and thus produce more goods in the United States."4

Conclusion

It is vital to the health of the U.S. economy that American businesses engaged in foreign trade remain free of international double taxation and similar barriers to the flow of capital. As tax policy makers begin to analyze the difficult choices ahead, they will face many decisions that are critically important to the long-term competitive position of American businesses in world markets. A forward-looking approach that assures a level playing field is essential.

The threshold policy concern in today's competitive international business arena is to pose the right question. In the past, that often was to ask whether the proposed change in law would encourage the American business to "make it here or to make it there." While this foundation for international tax policy may have made some sense at a time when U.S. business dominated the world's markets, it makes little sense today.

American businesses seeking to compete in the global economy are not choosing to invest either in America or in a foreign land. The decision to invest is no longer a decision to invest "here or there". Rather today's global markets offer opportunities to serve customers and consumers both "here and there". Ninety-five percent of the world's people live outside the United States. To the extent that tax policy constrains the ability of American businesses to participate in growing overseas markets by making them carry a greater tax burden than their foreign competitors, the latter will have a permanent advantage.

The NFTC supports international tax policies that reflect both the position of the United States in the global economy and the position of the individual American firm seeking to grow and prosper in global markets. U.S. policy should pursue a goal that would permit American companies to pay roughly the same amount of tax as their foreign competitors in markets both at home and abroad. Given a level playing field American businesses will have a fair chance to succeed.

The NFTC also strongly supports the bilateral tax treaty program that promotes greater

4 General Explanation of Tax Legislation Enacted in the 109th Congress, January 17, 2007, [Joint Committee Print] page 267; 109th Cong. 2d Sess. (JCS-1-07).

certainty, the avoidance of double taxation, and the prevention of discriminatory treatment against U.S. companies.