History and Background on Deferral

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 controlled foreign corporation (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.[1] 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. multinational corporations to operate under the same tax burden as foreign competitors in the same markets.

Capital export neutrality provided the rationale for the Kennedy Administration's 1961 proposal to impose current taxation on all foreign earnings of U.S. multinational corporations 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. multinational corporations faced only limited competition from foreign multinational corporations 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 to the competitiveness of U.S. multinational corporations 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.

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[1] *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.

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. multinational corporations 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% in 1986, 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. multinational corporations 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. multinational corporations on their own domestic operations.[2] 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.

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."

Another recent economic study prepared by the Business Roundtable and U.S. Council for International Business by Matthew J. Slaughter, Dean of the MBA program and professor of International Economics at the Tuck School of Business at Dartmouth, considers "How U.S. Multinationals Strengthen the U.S. Economy". Slaughter finds that "worldwide operations of U.S. multinational companies are highly concentrated in America in their U.S. parents, not abroad in their foreign affiliates*" and that "[p]*arent companies account for 69.6% of worldwide employment of U.S .multinationals—21.7 million parent workers versus 9.5 million at affiliates. This translates into a ratio of almost 2.3 U.S. employees for every one affiliate employee." Slaughter concludes:

> "Being globally competitive requires U.S. multinationals to establish operations abroad and also to expand and integrate these foreign activities with their U.S. parents. Expansion abroad by U.S. multinationals tends to support their operations in America. Foreign-affiliate activity tends to complement, not substitute for, key parent activities

[2] *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).

> in the United States such as worker compensation and capital investment. The idea that global expansion tends to “hollow out” U.S. operations is incorrect. Rather, the scale and scope of U.S. parent activities increasingly depends on successful presence abroad. Enhanced U.S. activities of U.S. multinationals, in turn, contribute to the productivity and average standard of living of all Americans.”

U.S. policy maker are once again considering the structure of the U.S. international tax rules in an era where the U.S. has the second highest tax rate among OECD countries and the U.S. world-wide tax system is becoming increasingly more isolated. In our increasingly global economy, it is critically important to ensure that U.S. multinational employers have a level playing field to compete at home and abroad.