



THE U.S. INTERNATIONAL TAX SYSTEM AND THE COMPETITIVENESS OF
AMERICAN COMPANIES

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April 20, 2005

THE NATIONAL FOREIGN TRADE COUNCIL COMMENTS
TO THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM
THE U.S. INTERNATIONAL TAX SYSTEM AND THE COMPETITIVENESS OF
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The National Foreign Trade Council (the "NFTC") is pleased to have the opportunity to offer input to the President's Advisory Panel on Federal Tax Reform (the "Panel"). We commend the Panel for including international tax issues and the competitiveness of American companies in their consideration of tax reform.

The NFTC, organized in 1914, is an association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. As such, the NFTC seeks to foster an environment in which U.S. companies can be dynamic and effective competitors in the international business arena. To achieve this goal, American businesses must be able to participate fully in business activities throughout the world through the export of goods, services, technology, and entertainment, and through direct investment in facilities abroad.

As global competition grows ever more intense, it is vital to the health of U.S. enterprises and to their continuing ability to contribute to the U.S. economy that they be free from the possibility of double taxation, excessive foreign taxation, and other impediments to the flow of capital that can serve as barriers to full participation in the international marketplace. Foreign trade is fundamental to the economic growth of U.S. companies. An efficient, fair tax regime that promotes competitiveness and compatibly with international norms and that is easily administered, is a crucial component of the framework that is necessary to allow that growth.

The foreign competition faced by American companies has intensified as the globalization of business has accelerated. American multi-nationals continue to voice their concerns that

the Internal Revenue Code places them at a competitive disadvantage in relation to multinationals based in other countries. *The NFTC Foreign Income Project: International Tax Policy for the 21st Century* (the “NFTC FIP”)¹, an international tax policy review project, was undertaken in response to this concern. The analysis with respect to the NFTC FIP led us to believe that the core principles and the basic structure of the U.S. international tax rules remain sound, although certain competing policies (as reflected in current law) have not kept pace with the rapid development of a global economy. The NFTC FIP focused on the anti-deferral, or income acceleration rules of subpart F, and the foreign tax credit. While many of the recommendations put forward in the NFTC FIP to overhaul the U.S. foreign tax credit regime were included in the *American Jobs Creation Act of 2004* (the AJCA”), the 40 year old plus subpart F regime was left virtually untouched and remains a significant challenge for U.S. companies competing in the international marketplace.

The ability of American companies to compete in the global marketplace is far more compelling today than 40 years ago when the subpart F rules became law; the U.S. dominance of international markets no longer exists. Back then, 18 U.S. companies were counted among the 20 largest international industrial companies; today, that number has declined to eight. While the U.S. has still not reevaluated its position to accelerate tax on the active business income of foreign affiliates of American companies, our major trading partners have generally declined to tax their companies in a similar fashion; American companies have been left to bear higher domestic taxation than their foreign competitors. The 21,000 foreign affiliates of U.S. multinationals now compete with the 260,000 non-U.S. affiliates of multinationals. While the U.S. economy represents a mature market for most companies and is relatively slow growing, the rapid expansion of the world economy over the last three decades represents an opportunity for U.S. companies that are able to participate in those growth markets.

Although it is difficult to compare the overall impact of a country’s income tax system on the cost of cross-border investments, the data and analyses reviewed in the NFTC FIP

¹ The NFTC FIP is available on the NFTC website at: www.nftc.org.

suggest that, from a tax perspective, the United States is a relatively undesirable location for a multinational company's legal domicile. Recent trends indicate that the vast majority of cross-border mergers and acquisitions have been structured as foreign acquisitions of U.S. companies, thus converting U.S. multinationals to non-U.S. multinationals and thereby reducing the number of U.S. multinationals. Recent examples include: Daimler-Chrysler, BP-Amoco, and Deutsche Bank-Bankers Trust mergers. Despite the intensified competition in world markets, the U.S. economy is more dependent on foreign direct investment than ever before. The United States is the world's largest importer of capital, with foreign investments in U.S. assets exceeding U.S. investments in foreign assets by over \$100 billion per year.

While acknowledging the anti-competitive implications of subpart F, opponents of deferral frequently argue that U.S. direct investment abroad comes at the expense of the U.S. economy. Contrary to the current "outsourcing" argument that investing abroad drains jobs and production from the United States, economic evidence points to the opposite conclusion—U.S. investments abroad increases economic activity at home. This complementary relationship between the foreign and domestic operations of U.S. multinational corporations is discussed more fully in the NFTC FIP. In fact, academic studies support the hypothesis that U.S. investment abroad promotes U.S. exports. The NFTC FIP cites an OECD study that found that a dollar spent on foreign investment resulted in two dollars of additional exports. As demand for U.S. exports increases there is an associated increase in the demand for U.S. support services that creates additional U.S. jobs. There is also evidence that workers at U.S. companies with foreign operations earn higher wages than their counterparts in purely domestic companies in the same industries.

A territorial tax exemption system has frequently been touted as the solution to the ills of the U.S. international tax system. Most recently, a dividend exemption form of territorial tax system was suggested as a way to reform the U.S. international tax regime in "Options to Improve Tax Compliance and Reform Expenditures," a report issued by the Joint Committee on Taxation. There was also interest in a territorial tax system as a resolution to the unfavorable World Trade Organization decisions regarding the U.S. Foreign Sales

Corporation and the Extra-Territorial Income regimes. The NFTC undertook a study, the *Territorial Tax Study Report* (the “Territorial Study”)² to evaluate the efficacy of implementing some form of a territorial tax exemption system in the United States. The study evaluated the basic features of traditional territorial systems, as well as the features of one or more possible alternative exemption systems, in terms of: future U.S. competitiveness, effect on the WTO challenge, tax simplification and administration, and long term stability. Consideration was also given as to whether a switch to a territorial system would more likely address these considerations than simply reforming the current U.S. international tax system.

The Territorial Study concluded that a broad based, traditional territorial exemption system would improve the competitiveness of those U.S. companies with substantial foreign active business income taxed at source country rates that are significantly less than U.S. tax rates; U.S. companies with foreign business income in high tax countries might be worse off. However, the overriding conclusion was that to improve the competitiveness of any substantial group of U.S. companies would require resolving many of the same issues that make our current rules anti-competitive: the overly broad scope of subpart F with respect to active business income, the over allocation of expenses to foreign income, and the restrictive aspects of the foreign tax credits (note that most of the foreign tax credit issues were resolved by the AJCA).

Left unresolved, the traditional territorial exemption system would not only fail to improve competitiveness significantly, but would also leave in place the complexity and instability of the current U.S. tax system. Taking these factors into account, the Territorial Study concluded that efforts to improve the international tax system were best spent on adopting specific reforms to the current rules rather than adopting some form of a territorial exemption system.

The AJCA was a significant step toward that reform; however, expanding rather than contracting deferral, *e.g.*, eliminating subpart F, is essential to the long term health of

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American business. Without further reform, the U.S. international tax rules hinder the ability of U.S. companies to compete in the global marketplace.

We strongly urge you to preserve and to extend the deferral of U.S. tax on active business income earned by foreign subsidiaries of American companies. Broadening the U.S. tax deferral system (so that it does what it is intended to do, *i.e.*, defer tax on the earnings of a foreign subsidiary that engages in genuine business activities), is consistent with the basic tenets of U.S. taxation. Despite that, subpart F captures active income in the U.S. tax net without a policy justification. Some examples of active income that are subject to current U.S. taxation are: income that is earned outside a foreign corporation's country of incorporation (base company sales and services income), active financial services income, and certain oil-related income (*e.g.*, income from operating an oil or gas pipeline outside the country in which the oil or gas was extracted or sold). Active financial services income has had a temporary reprieve from characterization as subpart F income until the end of 2006, but unless it is extended, U.S. based financial services companies will again be at a competitive disadvantage vis-à-vis their foreign counterparts. Payments from one foreign affiliate (dividends, interest, rents, or royalties) to another foreign affiliate are also subject to current U.S. taxation. This ultimately limits the flexibility of U.S. companies to expand internationally. It is critical that these issues are resolved to safeguard the competitive position of U.S. firms abroad thereby safeguarding American jobs.

The growing economic integration among nations and the formation of common markets and free trade areas raises questions about the appropriateness of U.S. international tax rules that treat foreign transactions that cross national borders differently from those that occur within the same country. The use of tax policy by the United States to discourage investment in the world's growth areas is thoroughly antiquated. With the significant reform of the foreign tax credit area behind us, it is time to take today's competitive marketplace into account by modernizing subpart F so that U.S. based multinationals can compete more effectively with their non-U.S. counterparts.