

A Two-Pronged Approach to Reforming International Corporate Taxes in the U.S

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Reprinted from *Tax Notes Int'l*, September 26, 2011, p. 951

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The author would like to thank David Rosenbloom and Stephen Shay for their comments on earlier drafts.

The current system for taxing the income of controlled foreign subsidiaries of U.S. corporations — foreign-source income — makes no sense for U.S. multinational companies or the U.S. Treasury. In theory, foreign-source income is taxed at the standard U.S. corporate tax rate of 35 percent; in practice, Treasury generally receives no taxes on foreign-source income as long as it is held overseas.¹ In fact, U.S. corporations now hold abroad an estimated \$1.5 trillion in cash, which the current system encourages them to deploy by acquiring foreign companies and building overseas facilities.

In response, some U.S. multinationals are lobbying for a tax holiday on repatriation of their foreign-source income, similar to the one enacted in 2004.² Such a tax holiday would reduce the effective tax rate on those repatriations to 5.25 percent for a limited time period, for example one year. This proposal for another tax holiday is reportedly gathering steam in some circles of liberal Democrats.³

Another tax holiday for repatriated foreign profits would be a transition to nowhere. It does not address

the fundamental problems of the current tax system. Indeed, it reinforces the incentives for U.S. multinationals to keep their foreign profits in overseas accounts — waiting for the next tax holiday.

Nor can another tax holiday be justified on the same grounds as were asserted by holiday proponents in 2004 — that the holiday will substantially create U.S. jobs or increase investment in productive U.S. assets. Neither of these objectives was achieved by the tax holiday in 2004, according to a study by several economists, including one who worked in the White House in 2004.⁴ Most of the repatriated profits went to corporate shareholders in the form of higher dividends or stock repurchases.

At the same time, business lobbyists are advocating a territorial system in which foreign-source income would be subject to tax only in the country where the income is earned. These lobbyists correctly point out that almost all advanced industrial countries have now adopted some form of a territorial system.

However, most of these countries have limited their territorial systems in key respects. Almost all continue to tax “mobile” income earned by multinational corporations in foreign countries — such as interest received on corporate investments and royalties received from licensing. The U.S. already has similar rules, in subpart

¹U.S. corporations also commit to maintaining their foreign profits overseas in order to avoid lowering their reported earnings by deferred tax liabilities under Accounting Principles Board Opinion 23.

²David Kocieniewski, “Companies Push for a Tax Break on Foreign Cash,” *The New York Times*, June 20, 2011, at A1.

³Steven Sloan, “Senator Schumer Gives ‘Newfound Life’ to Tax Holiday Sought by Apple,” *bloomberg.com* (June 23, 2011); available at <http://www.bloomberg.com/news/2011-06-23/schumer-gives-newfound-life-to-tax-holiday-sought-by-apple.html>.

⁴Dharmika Dharmapala, C. Fritz Foley, and Kristin J. Forbes, “Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act” (Apr. 27, 2010), MIT Sloan Research Paper No. 4741-09, CELS 2009 4th Annual Conference on Empirical Legal Studies Paper, available at <http://ssrn.com/abstract=1337206>.

F of the Internal Revenue Code, for domestic taxation of mobile income that can easily be moved to a low- or no-tax jurisdiction. In other words, U.S. companies cannot defer U.S. taxation on subpart F income by keeping it overseas.

Also, several countries with territorial systems still impose domestic tax on foreign profits earned in tax havens specified on a blacklist. The territorial system is based on the premise that foreign-source income is being taxed once somewhere — at a reasonable rate by a credible tax-enforcing government. This premise does not hold for tax havens where either the tax rate is minimal or a reasonable official rate is not enforced.

In sum, no major industrial country has a pure territorial system for taxing foreign-source income⁵; the prevalent model is a modified territorial system. Along similar lines, this article proposes a modified territorial system with two main prongs.

First, Congress should exempt from U.S. taxes all corporate income (other than mobile income)⁶ earned in foreign countries with an effective corporate tax rate of 20 percent or higher. Such income could be repatriated at any time to the U.S., subject to payment of an administrative charge of 5 percent as is done in countries like France.⁷ This charge is a rough way to take into account some of the expense deductions previously taken by multinational corporations in their home countries in order to generate foreign-source income — for example, a portion of the salaries of U.S. executives who helped start European operations.⁸

Second, Congress should end the current deferral system for foreign-source income earned by U.S. corporations in countries with effective tax rates under 20 percent. That portion of foreign-source income would be taxed every year in the U.S. at a rate equal to the difference between 20 percent and the actual rate paid by the U.S. corporation in the tax haven. For example, if a U.S. corporation generated \$100 million of income in Barbados, which collected \$2 million in taxes on such income, it would pay \$18 million in corporate

taxes to the U.S. And if the company repatriated that income from Barbados to the U.S., it would pay the administrative charge of 5 percent or less.⁹

Let me address the major objections that would be raised to this two-pronged proposal.

Low-Tax Jurisdictions

Why does the U.S. not allow its multinational corporations to take advantage of no- or low-tax jurisdictions by locating facilities there if allowed by other major industrial countries?

This two-pronged approach is based on the underlying judgment that corporate income should be taxed at a reasonable rate, like 20 percent, wherever it is earned. If we allow any country with substantial production facilities located there to offer a very low tax rate to attract multinational corporations, then any one country can undermine the ability of all other countries in the same region to charge a reasonable tax rate. This produces a race to the bottom, to the detriment of all other countries trying to collect reasonable revenues from companies doing business within their borders.

20 Percent Effective Tax Rate

Why should the proposal be pegged to an effective tax rate of 20 percent?

The National Bureau of Economic Research recently published an international comparison of effective corporate tax rates — what companies actually paid on average, rather than the official tax rate.¹⁰ According to that study, the effective corporate tax rate was on average 22.5 percent in the U.S., and 19.8 to 21.5 percent in our major European trading partners.

Some might object to the 20 percent rate because it is much lower than the current 35 percent corporate tax rate. But this 35 percent rate is never paid by U.S. corporations on foreign-source income if it is kept overseas. Others might argue that the difference between the 35 percent tax rate on domestic income and the proposed 20 percent rate on foreign income would incentivize U.S. companies to build facilities abroad. But this incentive is much stronger under current law, under which the effective U.S. tax on foreign-source income for U.S. corporations is zero if such income is not repatriated.

Moving Income

Does the proposal encourage U.S. corporations to move income to countries like the U.K. or Germany where it would be exempt from U.S. corporate tax?

⁵Hong Kong and a few small countries have a pure territorial system.

⁶The U.S. would continue to tax passive corporate income under subpart F, which should be strengthened; and the U.S. Treasury should tighten the current rules on transfer pricing for intellectual property within U.S. multinational corporations.

⁷France has a 95 percent exemption for dividends received from controlled foreign corporations. The 5 percent remaining is then taxed at the statutory rate, resulting in an actual tax of approximately 2 percent of the repatriated income.

⁸Such a 5 percent charge would usually understate the value of these prior deductions, which include items such as research and development costs as well as interest expense. Therefore, I would support some form of the Obama administration's proposal to delay corporate deductions for interest expense allocated under current rules to deferred foreign earnings until these earnings are repatriated to the U.S.

⁹Congress should also end the practice of cross-crediting, which is used to repatriate corporate profits from tax havens without payment of any U.S. corporate taxes.

¹⁰Kevin S. Markle and Douglas A. Shackelford, "Cross Country Comparisons of Corporate Income Taxes," NBER Working Paper No. 16839 (Feb. 2011).

Yes, but that is much better than the current system, which incentivizes U.S. corporations to move income to countries that collect minimal corporate taxes based on their technical legal presence there. A corporation that moves income to the U.K., by contrast, will probably find that the income will be taxed there at an effective rate of 20 percent or higher.

Also, Congress should limit the availability of the check-the-box procedure, which (among other things) allows U.S. corporations to automatically create single-owner subsidiaries that are treated as passthrough entities for tax purposes. While this elective procedure generally makes sense for U.S. entities operating in the U.S., it should not be used outside the U.S. to shift corporate income to and from foreign countries by disregarding single-owner transparent entities.

Identifying High Tax Rates

Is it feasible to identify countries with effective corporate tax rates, on average, of 20 percent or higher?

Yes. In most cases, the conclusion is clear — Japan has an effective tax rate over 20 percent and Bermuda does not. To be workable, the new system would have to be based on average rates paid by corporations in a country, and not the rate paid by a specific company.

Of course, there will be countries with borderline tax systems that will have to be analyzed by the U.S. Treasury — which should establish a transparent determination process with a method for appeals.¹¹ These borderline countries would have an incentive to become exempt by bringing their effective tax rates clearly up to 20 percent.

What to Do About Ireland

How would the proposal address Ireland and a few other countries where U.S. corporations have located substantial operations because of their low tax rates?

Since Ireland has a corporate tax rate of 12.5 percent, income of a U.S. corporation from Ireland would be taxed by the U.S. at 7.5 percent (20 percent - 12.5 percent) every year even if it were kept in Ireland. If the U.S. corporation decided to repatriate that income to the U.S., it would also pay the administrative charge of 5 percent on the repatriated income.

As a result, U.S. corporations would choose where to locate operations in Europe based on nontax factors such as the productivity of the workforce, the cost of building facilities, and transport links to relevant mar-

kets.¹² This result would be strongly supported by our major trading partners in Europe, which have objected to Ireland's efforts to attract corporate business primarily by offering such a low tax rate.

Transitional Rule

What would be the transitional rule for taxing past profits of U.S. corporations earned in foreign countries, especially those with rates below 20 percent?

When U.S. companies built facilities in Ireland and similar countries, they reasonably relied on the current U.S. system that allows indefinite deferral of taxation on foreign-source income that is kept overseas. Therefore, Congress should enact a transitional rule that would allow prior foreign profits of U.S. corporations to be repatriated to the U.S. for the next few years at a favorable rate such as 10 percent.

U.S. Treasury officials have opposed a temporary tax holiday for the repatriation of foreign-source income — like the one a few years ago. However, they would support a favorable transitional rule if it were part of a sound overall plan to reform U.S. taxation of foreign-source income.¹³

Comprehensive Reform

Why not wait for comprehensive corporate tax reform before enacting new rules for international income of U.S. corporations?

Both the Obama administration and the business community would like to lower the corporate tax rate from 35 percent to approximately 25 percent on a revenue-neutral basis. However, it is unclear whether such a package can be enacted because tax neutrality can be achieved at a much lower rate only if many important industries and social causes lose their special tax benefits.

By contrast, the current tax system for foreign-source income is so poorly designed that reform is not a zero-sum game. Since the current system raises almost no tax revenue, it should be feasible to simplify the rules and give companies more flexibility on their business decisions without reducing the total revenues collected by the U.S. government.

In short, Congress should adopt a new, two-pronged system for taxing foreign-source income. It should exempt such income from U.S. corporate tax if it is actually being earned in a foreign country with an effective

¹¹However, if it is not feasible to compute the average effective corporate tax rates by country, or if the differences among industries within the same country are too great from a political perspective, the first prong of this proposal could be reformulated to apply the exemption from U.S. corporate taxes to earnings by a U.S. company in all countries where earnings are actually taxed at a rate of 20 percent or higher.

¹²See <http://www.treasury.gov/resource-center/tax-policy/pages/archive.aspx>.

¹³After that transitional period, those prior foreign profits could be repatriated by the relevant U.S. corporation only by paying the 5 percent administrative charge plus the difference between 20 percent and the actual tax paid by the corporation in the low-tax jurisdiction.

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corporate tax rate of 20 percent or higher. Such an exemption would modestly increase U.S. tax revenues — some U.S. corporations would pay an administrative charge of 5 percent if they decided for business reasons to repatriate their foreign profits. On the other hand, Congress should end the ability of U.S. corporations to

defer foreign income generated in tax havens — subject to a low transitional tax rate on *past* foreign profits. This second prong of the proposal would deter U.S. corporations from devising elaborate schemes to allocate their income to tax havens — to the detriment of the U.S. government and our major trading partners. ♦