



Business Roundtable

Taxing U.S. Corporations in the Global Marketplace

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Business Roundtable

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I. Executive Summary

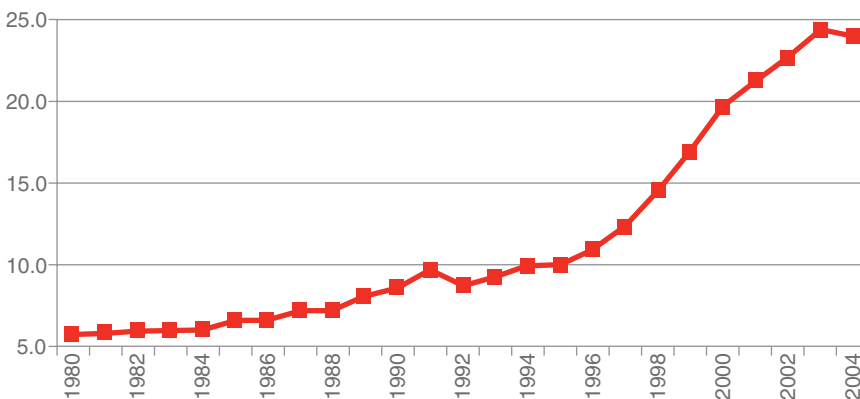
This report is an introduction to U.S. international tax policy issues. It is intended to document the impact of U.S. tax policy on the ability of American corporations to compete in a global marketplace. As the United States begins to consider reforming our tax system, it is important to recognize that increasingly the manner in which we tax the international activities of U.S. corporations not only determines their ability to succeed abroad, but also their ability to succeed at home.

- ▶ **The world is rapidly becoming more integrated. Reductions in the cost of communication and transportation and falling trade and investment barriers have opened the door to competition on a truly global scale. American corporations and American workers stand to benefit from the economic growth and higher living standards made possible by these new markets for growth.**

Cross-border investment has become an increasingly important way in which modern business activities are conducted. Measured relative to the growth in worldwide production, the stock of cross-border investment has grown four-times faster—from less than six percent of the world's output in the early 1980s to nearly 25 percent by 2004 (*see Exhibit 1*).

Exhibit 1

World Stock of Foreign Direct Investment as a Percentage of World Output, 1980 - 2004



Source: United Nations Conference on Trade and Development

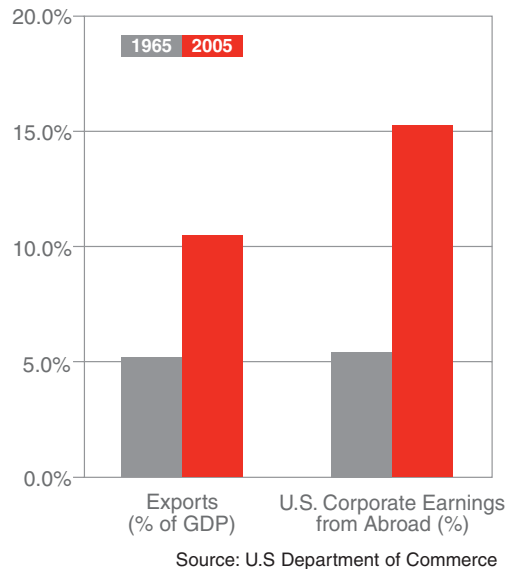
U.S. corporations have increasingly adopted global investment and marketing strategies. Over the past 40 years, exports by U.S. corporations have doubled as a share of the size of the total economy, and the share of worldwide profits of U.S. corporations attributable to foreign earnings has nearly tripled (see *Exhibit 2*).

Among the largest corporations, the share of worldwide profits attributable to foreign earnings is even greater. In 2005, of U.S. companies in the Standard & Poor's 500 reporting foreign earnings, more than 40 percent of worldwide income was earned outside the United States.

- ▶ **At the same time that U.S. companies seek to expand internationally, companies often find that the U.S. tax system poses an impediment to their plans. Despite important reforms to the tax system over the years, particularly the 2004 American Jobs Creation Act, the U.S. tax system today still reflects an economy of a different era—a time when international activity was far less important and the United States faced far less competition.**

In 1970, U.S. multinational firms were dominant globally, accounting for over 50 percent of the world's cross-border investment flows. In contrast, in the three most recent years for which data are available (2002-2004), the share of the world's cross-border investment made by U.S. firms averaged less than 25 percent.

Exhibit 2
Globalization of the U.S. Economy, 1965 - 2005



Today, dominance of U.S. corporations in foreign markets is no longer assured. Of the world's largest global corporations (measured by foreign assets), just four of the twenty largest *non-financial* firms and only three of the twenty largest *financial* firms are headquartered in the United States.

- ▶ **Many countries have responded to the increasing importance of cross-border investment by removing tax obstacles to international commerce. The U.S. tax system has not kept pace with this need to adjust to new international realities.**

In 1986, after the United States reduced its top corporate income tax rate from 46 percent to 34 percent, most other major industrial countries followed suit. Today, at 35 percent the U.S. federal corporate income tax rate is no longer low; indeed it is now tied for highest among the thirty countries of the Organization for Economic Cooperation and Development (OECD), and is 8.6 percentage points above the OECD average tax rate of 26.4 percent. Including state and local corporate income tax rates, the U.S. rate is second highest in the OECD after Japan and is 10.4 percentage points above the OECD average of 28.9 percent. The U.S. rate is also 11 to 14 percentage points higher than the average national and combined corporate tax rates of the twenty-five countries of the European Union (*see Exhibit 3*).

The international trend overwhelmingly is for lower taxes on corporations. If U.S. companies are to remain competitive with foreign-headquartered firms, they cannot be subjected to corporate tax rates that are ten percentage points or more higher than those of their competitors.

Exhibit 3 Central Government and Central and Local Government Corporate Tax Rates, OECD, 2005

Country	Central Top Top Rate	Central and Local Top Rate
Japan	30.0	39.5
United States	35.0	39.3
Germany	26.4	38.9
Canada	22.1	36.1
Spain	35.0	35.0
Belgium	34.0	34.0
France	33.8	33.8
Italy	33.0	33.0
New Zealand	33.0	33.0
Greece	32.0	32.0
Netherlands	31.5	31.5
Luxembourg	22.9	30.4
Australia	30.0	30.0
Denmark	30.0	30.0
Mexico	30.0	30.0
Turkey	30.0	30.0
United Kingdom	30.0	30.0
Norway	23.8	28.0
Sweden	28.0	28.0
Korea	25.0	27.5
Poland	19.0	27.5
Czech Republic	26.0	26.0
Finland	26.0	26.0
Austria	25.0	25.0
Portugal	25.0	25.0
Switzerland	8.5	21.3
Slovak Republic	19.0	19.0
Iceland	18.0	18.0
Hungary	16.0	16.0
Ireland	12.5	12.5
OECD average	26.4	28.9
European Union average	24.2	25.3

Source: OECD and PricewaterhouseCoopers

- ▶ **Competition today between American and foreign-based firms is over commerce—and the things that flow as a result, such as income, jobs and security. Companies now look beyond their borders to survive as much as to pursue new opportunities.**

In many situations, a company must invest abroad in order to sell abroad. Market forces, such as the need to improve access to customers and control operating costs, require companies to locate parts of their operations around the world. According to a study by the OECD, a nation's exports increase by \$2 for every \$1 of foreign direct investment. It is clear that companies that operate solely within domestic borders will fail to match the competition and, in time, will lose viability both abroad and at home.

- ▶ **The U.S. tax system is out of date and in some cases actually hinders U.S. firms competing with foreign-based companies.**

U.S. tax rules are sorely dated for competing in a global economy, and are extremely complex and expensive to administer. Surprisingly, America's tax rules deviate significantly from those of many of our trading partners to the detriment of U.S. firms. In fact, a recent study found that, controlling for industry and other factors, U.S. multinationals paid a 7.4 percentage point higher tax rate than U.S. companies without foreign operations over the 1992-1997 period.¹

Addressing these issues is critical. The success or failure of U.S. companies in their quest to compete at home and abroad will have a significant impact on domestic jobs and the growth of our economy.

¹ Julie H. Collins and Douglas A. Shackelford, "Did the Tax Cost of Corporate Domicile Change in the 1990s?" *mimeo*, April 2000.

II. Competing in the Global Marketplace

U.S. enterprises are sometimes criticized for making foreign investments on the grounds that such investments come at the expense of the American economy and jobs, i.e., the so-called “runaway plant” theory. A number of market factors, however, clearly refute that criticism, underscoring the importance of a global strategy that combines exports with foreign investments.

Today, almost 80 percent of the world's purchasing power is located in markets outside the United States.

Vast Growth Opportunities

Foreign demand for consumer products and capital equipment is creating extraordinary opportunities for U.S. companies. Ninety-five percent of the world's population lies outside the United States. The prosperity of emerging market economies represents significant potential for the sale of U.S. products and services. Today, almost 80 percent of the world's purchasing power is located in markets outside the United States. U.S. companies rely on foreign markets for continued growth. For the largest American companies included in the S&P 500, sales by foreign subsidiaries have increased from 25 percent of total corporate sales in 1985 to a remarkable 39 percent in 2005.

Protecting Market Share

Foreign multinationals currently operate over 690,000 out-of-country affiliates, about 25,000 of which compete directly against U.S. businesses in the United States. American companies must expand into foreign markets to grow and maintain market share.

Be There to Sell There

Relying solely on exports to penetrate foreign markets often does not suffice. Localized operations may be necessary to market products effectively, to cut transportation costs, to avoid tariff barriers, and to meet local content requirements. Services, the industry in which 61 percent of U.S. foreign affiliates are classified, often cannot be exported and must be supplied locally.

Economic studies published by the National Bureau of Economic Research and the OECD show that localizing operations may actually improve rather than hurt U.S. exports.² This research indicates that U.S. industries that invest heavily abroad tend to export more goods than firms that invest

lightly and that foreign employment by U.S. multinationals complements, rather than substitutes for, domestic employment. According to U.S. Commerce Department data, *57 percent of all U.S. exports are accounted for by companies with overseas operations*—that is, a U.S. company exporting to a subsidiary of a U.S. company. Moreover, Commerce Department data show that 90 percent of sales by foreign subsidiaries of U.S. multinationals are into foreign markets rather than back into the U.S. market. These data also show that the majority of the sales of foreign subsidiaries are in the local market in which they are based rather than exported back to the United States.

57 percent of all U.S. exports are accounted for by companies with overseas operations.

Attractive Returns

Foreign markets offer exceptional investment opportunities for U.S. investors. The return on assets of foreign subsidiaries is over 30 percent higher than that of their U.S. parents. According to the U.S. Bureau of Economic Analysis, U.S. corporate earnings from abroad amounted to \$206 billion in 2005, about 15 percent of total U.S. corporate profits. Foreign operations also result in higher wages for American workers. Domestic operations of U.S. multinational companies pay production workers 10 to 15 percent more and non-production workers five to seven percent more than comparable plants of U.S. companies without foreign operations.³

² See, R.E. Lipsey, "Home and Host Country Effects of FDI," *National Bureau of Economic Research, Working Paper no. 9293*, October 2002; L. Brainard and D. Riker, "Are U.S. Multinationals Exporting U.S. Jobs?," *National Bureau of Economic Research, Working Paper no. 5958*, March 1997; OECD, *Open Markets Matter: The Benefits of Trade and Investment Liberalisation*, 1998; and M. Desai, C.F. Foley, and J.R. Hines, "Foreign Direct Investment and Domestic Economic Activity," *National Bureau of Economic Research, Working Paper no. 11717*, October 2005.

³ M.E. Doms and J.B. Jensen, "Comparing Wages, Skills, and Productivity between Domestically and Foreign-Owned Manufacturing Establishments in the United States," in R.E. Baldwin, R.E. Lipsey, and J.D. Richardson (eds.), *Geography and Ownership as Bases for Economic Accounting*, University of Chicago Press, 1998, pp. 235-258.

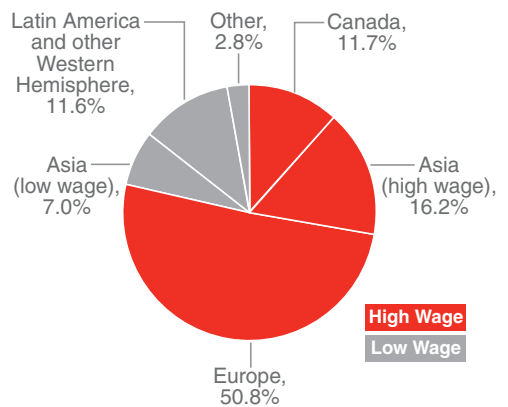
Competitive Costs

Global operations are critical to making products and services more attractive by reducing operational costs. U.S. enterprises with international perspective are able to realize efficiencies unavailable to companies that limit operations to their home market. The proliferation of regional free trade areas and the declining cost of communications make worldwide operational strategies inevitable. Because foreign competitors are adopting similar strategies, achieving global efficiencies is necessary for growth and survival.

Deploying resources efficiently worldwide, however, does not typically require locating operations in low-wage countries. On the contrary, 79 percent of sales by foreign affiliates of U.S. companies come from countries with relatively high-wage costs, namely Europe, Canada, Japan, Australia, Hong Kong, New Zealand, and Singapore (*see Exhibit 4*). Labor productivity, customer services, local laws and other factors are as important as wage levels in determining where to locate activities.

Foreign markets also support domestic research and development. Having access to foreign markets creates a larger base of sales over which to spread the costs of developing new products and processes. The R&D budgets of U.S. companies with international operations create high-paying jobs in the United States—86 percent of R&D spending of U.S. companies occurs at home, and the principal cost is employee compensation.

Exhibit 4
Most U.S. Investment Abroad is in High-Wage Locations
(Sales by Location, 2003)



Note: Asia (high wage) includes Australia, Hong Kong, Japan, New Zealand, and Singapore.
Source: Bureau of Economic Analysis

III. U.S. Taxation of International Transactions

Assessing the impact of the U.S. tax system on the competitiveness of U.S. companies requires an understanding of the key elements by which the United States taxes the foreign income of U.S. companies. These key elements include the “worldwide” reach of the U.S. tax system, the foreign tax credit and related limitations, the source rules, the principle of deferral, and the export regime. Each element is discussed below.

Worldwide System of Taxation

The United States taxes American companies on the income they earn in foreign countries as well as the income they earn at home.

The major alternative to this “worldwide” tax system is a “territorial” tax system, whereby a country typically imposes no tax on active trade or business profits earned in some or all foreign countries. The President's Advisory Panel on Federal Tax Reform identified twenty-one of the thirty OECD countries as following a territorial approach, with the remaining nine countries exclusively using the worldwide approach (*see Exhibit 5*).

Exhibit 5

Taxation of Foreign Subsidiary Dividends, OECD Countries

Territorial Tax System

- | | |
|--------------|---------------------|
| 1. Australia | 12. Italy |
| 2. Austria | 13. Luxembourg |
| 3. Belgium | 14. Netherlands |
| 4. Canada | 15. Norway |
| 5. Denmark | 16. Portugal |
| 6. Finland | 17. Slovak Republic |
| 7. France | 18. Spain |
| 8. Germany | 19. Sweden |
| 9. Greece | 20. Switzerland |
| 10. Hungary | 21. Turkey |
| 11. Iceland | |

Worldwide Tax System

- | | |
|-------------------|-------------------|
| 1. Czech Republic | 6. New Zealand |
| 2. Ireland | 7. Poland |
| 3. Japan | 8. United Kingdom |
| 4. Korea | 9. United States |
| 5. Mexico | |

Note: In general, tax treatment depends on qualifying criteria (e.g. minimum ownership level, minimum holding period, the source country, the host country tax rate). The table reports the most generous treatment of foreign direct dividends.

Source: President's Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro Growth: Proposals to Fix America's Tax System, 2005, p. 243.

Foreign Tax Credit and Related Limitations

The Credit—One of the difficulties posed by the U.S. policy of taxing income earned abroad is that the host country normally imposes income and withholding taxes on the same income. If there were no relief from double taxation, the total tax burden would be prohibitive and might exceed the income itself. American companies could not afford to participate in foreign markets if taxes took most or all of the profit.

To avoid this over-taxation, the United States allows U.S. firms to offset U.S. tax on income earned abroad with a credit for the income tax that the company paid to the host country. This is the “foreign tax credit.”

For example, assume that a U.S. company earned \$1,000 in Japan and paid \$300 of Japanese income tax. U.S. tax on \$1,000 would be \$350, using the 35 percent corporate tax rate (step 1) (*see Exhibit 6*).

Absent a foreign tax credit, \$650 of income tax (\$300 in Japan and \$350 in the United States) would be collected worldwide on this \$1,000—a 65 percent tax rate. However, the United States allows the company to take a \$300 foreign tax credit for Japanese tax paid (step 2), reducing its U.S. tax to \$50 (step 3).

Thus, worldwide tax on \$1,000 of income earned in Japan would total \$350 (\$300 to Japan and \$50 to the United States), the same amount as if all the income had been earned in the United States.

The Limitations—There are limits, however, to the amount of foreign tax credit that companies may use. A U.S. company may take a credit for as much U.S. tax as would have been imposed had the income been earned in the United States, but not any greater amount. This ceiling is the “foreign tax credit limitation,” which ensures that a U.S. company pays at least as much income tax worldwide (and often more) on income earned abroad as it would pay on the same income earned at home.

Exhibit 6 How the Foreign Tax Credit Works

U.S. Company Earns \$1,000 in Japan

1. U.S. tax before credit	\$350
2. Less credit for Japanese income tax	\$300
3. U.S. tax after credit	\$50

Note: Total tax is \$350: \$300 to Japan, \$50 to the United States.

To illustrate the limitation using the previous example, suppose the Japanese tax on \$1,000 earned by a U.S. subsidiary is \$400. In this case, the foreign tax credit is limited to \$350—the amount of U.S. tax that would have been imposed if the income had been earned in the United States. Thus, the U.S. company would pay \$400 of tax worldwide (\$400 to Japan alone), a greater amount than if the income had been earned in the United States.

This example is greatly oversimplified. Since 1986—and continuing through 2006—foreign tax credit limitations must be calculated separately for each of nine different categories of income (called “baskets” in tax jargon), and separate limitations apply to oil-and-gas related income. Beginning in 2007, the foreign tax credit limitation system will be greatly simplified by reducing the number of foreign tax credit baskets from nine to two: passive income and general limitation income. Separate limitations will continue to apply to oil and gas related income.

Carryovers—Foreign tax credits that are not used currently may be used in the first preceding year or ten succeeding years. Carryovers are meant to reduce the effects of timing differences between U.S. and foreign tax laws. But in some cases, U.S. companies are prevented by restrictive sourcing rules from using credits before they expire, which results in double taxation of foreign earnings.

Source Rules

For purposes of the foreign tax credit, rules are needed to split worldwide income, expenses, and taxes into U.S. amounts and foreign amounts.

In general, income is sourced to the place where the activity occurred that gave rise to the income, netted against directly related expenses. Other expenses are apportioned among all the baskets to which they relate. A portion of U.S. interest, R&D, and general and administrative expenses must also be treated as foreign costs and apportioned among all the baskets. For example, suppose that a U.S. multinational earns \$2000 of income worldwide, with half in the United States and half in Japan.

If this company were required to allocate \$200 of U.S. interest expense against foreign source income, the foreign tax credit limitation would be reduced from \$350 to \$280, i.e., \$700 of U.S. tax on worldwide income (35 percent of \$2000) times the ratio of foreign source income (\$800 after reduction for allocated U.S. interest expense) to worldwide income (\$2000) (see Exhibit 7). In this case the company's foreign tax credit would be \$280, \$20 less than the \$300 of income tax actually paid in Japan, resulting in double taxation.⁴ The reason double taxation occurs is that no country, including Japan, allows a deduction for U.S. interest expense allocated to foreign source income under U.S. rules. Beginning in 2009, the U.S. interest expense allocation rules will be significantly modified to reduce the amount of U.S. interest expense allocated against foreign source income.

Exhibit 7
How Source Rules Work

U.S. Multinational Earns \$2,000	
Income from United States	\$1,000
Income from Japan	\$1,000
Interest expense	-\$200
	\$800
Foreign tax credit	\$280
	(35% of \$800)
Income tax actually paid	\$300
	(30% of \$1,000)
Amount of double tax	\$20

“Sourcing” is a highly complicated step. It is made many times more complicated by the “basketing” of the foreign tax credit. Net losses incurred in any one foreign tax credit basket must be allocated pro rata among the other baskets, and then reversed in future years when the loss-generating basket becomes profitable. These sourcing issues will be simplified to a large extent once the reduction in foreign tax credit baskets occurs in 2007.

Similarly, to the extent that domestic income is reduced by overall foreign losses, future foreign source income must be recharacterized as domestic to restore domestic income (i.e., “foreign loss recapture”). A symmetrical rule will apply after 2006 to restore foreign source income that is reduced by domestic losses, increasing the taxpayer's foreign tax credit limitation.

⁴ Taking into account the \$35 of withholding tax that Japan would impose on a \$700 dividend to the U.S. parent, double taxation actually is \$55.

Deferral

Under U.S. tax law, U.S. multinational corporations generally are not subject to U.S. tax on the operating earnings of their foreign subsidiaries until those earnings are actually paid to the U.S. parent in the form of a dividend. Thus, U.S. tax generally is deferred until a foreign subsidiary's earnings are paid to the U.S. parent. Similarly, individuals who own shares in U.S. corporations pay tax on the corporation's earnings only when they receive a dividend, which provides cash from which tax might be paid. This principle for determining when tax is due has been given a label: "deferral."

The major conceptual alternative to deferral is taxation of corporate earnings whether or not they are distributed to shareholders. This alternative would require tax payments from shareholders who have received no cash themselves. To pay the tax, foreign income would likely need to be repatriated, reducing available funds for reinvestment abroad. This would raise the cost of capital for U.S. multinationals relative to their foreign-based competitors.

Originally adopted in 1962, subpart F of the Internal Revenue Code terminates deferral for foreign base company income (FBCI) derived by U.S.-controlled foreign corporations. The four categories of FBCI are: foreign personal holding company income, foreign base company sales income, foreign base company services income, and foreign base company oil-related income. Compared to major competitor countries, the U.S. anti-deferral regime is the most far-reaching, and extends to many types of active business income. One of the consequences of terminating deferral on a category of income is that it weakens the incentive for many U.S. companies to reduce foreign income taxes on such income because each dollar of foreign tax savings is immediately offset by an additional dollar of U.S. tax.

The U.S. worldwide tax system discourages U.S. companies from repatriating foreign income even when it is not needed for investment abroad. A temporary approach enacted in 2004 to address this repatriation barrier was to permit taxpayers to elect for one year to bring back foreign earnings to the United States at a 5.25 percent tax rate (for repatriations in excess of historic levels). This temporary incentive has resulted in hundreds of billions of dollars brought back to the United States to invigorate the U.S. economy. However, as discussed below, more permanent solutions to these issues need to be addressed.

Proposals to reform the current U.S. deferral system include permitting movement of overseas active income between related controlled foreign corporations without triggering current U.S. tax (a look-through rule); repealing active income categories of subpart F income; treating the European Union as one country for subpart F purposes;⁵ and making permanent the ability to apply deferral to active financing income.

In May 2006, Congress enacted a temporary look-through rule for subpart F purposes with respect to payments of dividends, interest, rents, and royalties between related controlled foreign corporations (CFCs). Specifically, such overseas payments will not give rise to subpart F income to the extent the payments come from active, non-subpart F earnings of the payor CFC. The provision is effective for three years beginning in 2006.

The CFC look-through provision would provide U.S. multinational corporations the ability to redeploy active foreign earnings to the foreign locations in which they are most needed without incurring additional tax liability. The proposal also may provide U.S. multinational corporations opportunities to receive more complete crediting for U.S. tax purposes of foreign taxes paid to foreign governments.

⁵ In 2004, both the House and the Senate passed separate legislation to provide this treatment, but it was not included in enacted legislation.

FSC / ETI Regime

In 1984, the United States enacted the Foreign Sales Corporation (FSC) regime. The FSC regime replaced a prior Domestic International Sales Corporation (DISC) regime that was held to have violated international trading rules. The FSC regime exempted a portion of the income of a qualified foreign subsidiary attributable to certain export-related activities. In 1997, the European Union (EU) unexpectedly challenged the FSC, following a number of losses in World Trade Organization (WTO) disputes with the United States. Setting aside the 1981 GATT Council Directive, the WTO Appellate Body in 2000 upheld a panel decision against the FSC regime. In response, the United States in November 2000 adopted the Extraterritorial Income (ETI) regime as a replacement for the FSC. Like the FSC, the ETI regime exempts a portion of foreign export-related income but, unlike the FSC, extends the exemption to certain earnings from *foreign* manufacturing activities.

In 2002, following a new EU challenge, the WTO Appellate Body concluded that the ETI regime was a prohibited export subsidy. In August 2002, a WTO arbitration panel determined that the European Union was entitled to impose over \$4 billion of annual countermeasures against U.S. exports if the United States failed to come into compliance with the ETI ruling. The EU imposed a portion of those sanctions beginning in March 2004.

The U.S. responded in October 2004 with the passage of the American Jobs Creation Act, which repealed the ETI regime. The EU withdrew its sanctions upon implementation of the Jobs Act in January 2005.

However, the Jobs Act did not repeal the ETI regime immediately but rather over the course of the next two years and provided transitional relief to certain long-term lease transactions entered into in prior years. The EU took issue with this transition relief and brought further action to the WTO against the United States. The WTO ruled for the EU in 2005, and a WTO Appellate Panel confirmed that ruling in February 2006, allowing the EU to reimpose the earlier sanctions against the United States.

Because of this concern, Congress enacted legislation to repeal a portion of this transition relief. The Tax Increase Prevention and Reconciliation Act of 2005, signed into law on May 17, 2006, eliminated both the FSC binding contract relief and the ETI binding contract relief, which were provided in the Jobs Act (that is, the “grandfathered” FSC and ETI benefits that would have continued beyond 2006 will instead terminate this year). According to a Congressional summary, this repealed provision was intended to comply with the recent WTO rulings. In response to the enactment of this legislation, the EU repealed the sanctions that were scheduled to go into effect against U.S. products in May 2006.

IV. Analysis of U.S. International Tax Rules

U.S. rules taxing foreign source income have become increasingly complex and unwieldy. Recent legislation in 2004 has provided some important positive steps to address the competitiveness of U.S.-based multinationals and the U.S. economy, including numerous changes to address the complexity of the foreign tax credit rules. However, complexities and barriers remain that continue to handicap U.S. companies in the global marketplace. Major drawbacks inherent in the U.S. international tax system are:

- ▶ U.S. multinationals in many cases must pay U.S. tax in addition to foreign tax on income earned abroad. By contrast, competitors headquartered in countries with territorial tax systems generally do not pay home-country tax on active business income earned abroad.

U.S. rules taxing foreign-source income clearly handicap U.S. companies in the global marketplace.

- ▶ U.S. tax rules discriminate against foreign income. For example, foreign subsidiaries of U.S. companies are denied the benefits of accelerated depreciation, the R&D credit, and tax consolidation that are provided to domestic corporations.
- ▶ Hiring U.S. citizens for foreign posts is often more costly than hiring foreign nationals because the United States is the only developed country that taxes income earned by its citizens working abroad.

Complexity of Foreign Tax Credit and Limitations

To mitigate international double taxation, the United States allows a corporation to reduce its U.S. tax for certain amounts of foreign income taxes it has paid. However, even with the significant changes in 2004 there remain complexities. For example, U.S. multinationals must measure foreign income using U.S. “earnings and profits” definitions, rather than the numbers already derived for financial statement or foreign tax purposes.

Source Rules Can Aid Foreign Competitors

To compute the foreign tax credit limitation, U.S. companies must source their income, expenses, and taxes into multiple categories. These rules have a number of anti-competitive impacts:

- ▶ U.S. multinationals must allocate domestic R&D expense against foreign-source income, which can reduce foreign tax credits. By contrast, foreign companies with U.S. operations are not subject to a similar requirement. The United States is unusual in requiring allocation of domestic R&D against foreign-source income.

- ▶ *Foreign companies can borrow and invest in America at a lower income tax cost than U.S. companies.* The United States requires U.S. multinationals to allocate domestic interest expense to foreign-source income, once again creating the possibility of double taxation. Foreign companies with U.S. operations are not subject to a similar requirement. Other countries generally do not require domestic interest allocation unless the debt directly supports foreign operations. The relatively harsh effect of the U.S. rules for interest expense allocation will be mitigated in 2009. This is a good step, but does not completely alleviate the current problems.

- ▶ *U.S. source rules impose high compliance costs* because they are more complex than those of other countries.

Foreign companies can conduct research in the United States at a lower after-tax cost than U.S. multinationals.

Restrictions on Deferral

The United States treats certain income of U.S.-controlled foreign corporations as having been distributed for tax purposes even though the U.S. parent company receives no distributions.

- ▶ No other country limits deferral as rigorously as the United States. Absent deferral, a U.S. company has only 65 percent of its foreign-source earnings to reinvest (with up to 35 percent going to U.S. tax) while a foreign competitor can reinvest up to 100 percent, depending on the foreign tax rate.
- ▶ Unlike many other countries, the U.S. anti-deferral regime applies to numerous categories of active income, including income from financial services (after a temporary exemption expires at the end of 2006), certain oil-related activities, and sales and services activities of foreign “base” companies.
- ▶ The numerous U.S. anti-deferral regimes (subpart F, Personal Holding Company, Passive Foreign Investment Company, and the Accumulated Earnings Tax) each have highly technical and overlapping rules that generate burdensome compliance costs and create traps for the unwary.

Tax Treaties: Too Few, Too Narrow

Tax treaties are meant to reduce international double taxation by limiting withholding taxes (on interest, dividends, and royalties) and other taxes that may be collected by the country in which the income is earned. However, the U.S. tax treaty network does not sufficiently protect U.S. companies engaged in global competition. To cite two examples:

- ▶ The U.S. treaty network is significantly smaller than that of many other major industrial countries.
- ▶ Unlike other developed countries with worldwide tax systems, the United States refuses to enter into treaties that preserve tax incentives offered by developing countries to foreign investors (so-called “tax sparing”). Other countries sign treaties that limit their tax on income benefiting from developing country tax incentives, putting U.S. multinationals at a serious disadvantage in these markets.

Moreover, the mutual agreement procedures included in these treaties—which provide a mechanism for resolving instances of double taxation—frequently fail to operate in a timely fashion, with the burden borne by the taxpayer.

Higher Tax Compliance Costs for Foreign-Source Income

U.S. companies pay much more per dollar of economic activity to figure their U.S. tax on foreign-source income than on domestic income. Foreign activities account for 39 percent of costs incurred by U.S. companies to comply with federal income tax, even though only 21 percent of their assets and 18 percent of their employment are located abroad (*see Exhibit 8*).

In contrast, researchers have found no such compliance cost differential for European firms. The extra compliance costs are like a special tax on foreign-source income paid by U.S. companies, but not by their European-based competitors.

Double Taxation of Domestic Income

All of the major trading partners of the United States relieve or eliminate the double taxation of corporate income, which occurs when corporate profits (but not the profits of any other type of business) are taxed at both the corporate and shareholder levels.

Partial relief from double taxation was enacted in 2003 in the form of a reduced individual tax rate on corporate dividends received by shareholders. This partial relief, extended by legislation enacted in May 2006, is now set to expire after 2010 unless further extended or made permanent by Congress.

Exhibit 8 Higher U.S. Tax Compliance Costs for Income Earned Abroad

Survey of Large U.S. Corporations

Foreign	Domestic
<i>U.S. Tax Compliance Costs</i>	
39%	61%
<i>Assets</i>	
21%	79%
<i>Employment</i>	
18%	82%

Source: M. Blumenthal and J. Slemrod, *International Tax and Public Finance*, vol. 2, no. 1 (1995) pp. 37-54.

Double taxation increases the cost of capital for U.S. companies compared to foreign competitors whose countries have eliminated or reduced this handicap. Absent relief from double taxation, the U.S. company has to earn a return that is big enough to compensate its shareholders and cover two layers of U.S. tax, whereas the foreign competitor with a lesser overall tax burden has a cost advantage in competing for capital. With this reduced tax burden, the foreign competitor can profitably undertake some projects that a U.S. company would be unable to afford. The net effect of the double tax is to reduce the growth of the U.S. economy and reduce the living standards of U.S. citizens.

V. Fundamental Reform— A Territorial Tax System?

The President's Advisory Panel on Federal Tax Reform (the "Panel") recommended certain fundamental reforms to the U.S. tax system. One option included a move in the direction of the territorial tax systems employed by some of our major trading partners. Although somewhat oversimplified by this summary description, the Panel's proposal would generally exempt from U.S. tax the dividends paid from the active earnings of a foreign subsidiary to its U.S. parent corporation. The Panel gave several reasons for such an approach. First, the Panel stated that its proposal would remove tax barriers for U.S.-based multinationals that hinder the return of foreign earnings to the United States for productive domestic uses. Second, the Panel felt the proposal would improve the competitiveness of U.S. corporations in their foreign operations. Third, the Panel believed the proposal would result in simplification of the complex U.S. tax rules applying to international commerce and reduce compliance costs for U.S. corporations.

While not identical to a foreign dividend exemption proposal contained in a January 2005 report of the Joint Committee on Taxation, which was estimated to significantly increase corporate income tax payments, the Panel's proposal includes certain potentially detrimental features that could increase the tax burden of U.S. multinational corporations. These features include disallowing deductions for expenses allocable to the exempt dividends and a potential tax increase on certain foreign royalty and export income.

The Panel's recommendation of a territorial proposal serves to highlight the inefficiencies and non-competitive features of our current international tax system. Before considering adoption of any particular territorial proposal, however, the different variations of territorial tax systems employed by our major trading partners, as well as other possible variations, should be examined to determine the particular features of a territorial tax system that would serve to enhance the competitiveness of U.S. multinational corporations in the global marketplace.

VI. Conclusion

The U.S. tax system was not designed for the current international marketplace and is now critically in need of an overhaul.

U.S. tax rules depart from international norms and increase tax burdens for U.S. companies compared to their foreign counterparts. With growing world economic integration, the shortcomings of U.S. international tax policy will be magnified.

U.S. tax rules can make the United States an unattractive location to locate the headquarters of a multinational corporation. This has led to a variety of cross-border transactions that convert U.S.- into foreign-headquartered companies and have raised concerns among some members of Congress.

First, many cross-border mergers and acquisitions involving U.S. companies are being structured so that the merged entity is headquartered outside the United States. The result is that the merged company (but not its U.S.-headquartered competitors) can expand abroad without being subject to the burdens imposed by anti-competitive U.S. tax rules.

The U.S. tax system was not designed for the current international marketplace and is now critically in need of an overhaul.

Second, many start-up U.S. companies are choosing to incorporate in foreign jurisdictions rather than in the United States. As a result, these companies can operate globally with only their U.S. operations subject to U.S. corporate tax rules.

Third, recent legislative action has focused on some transactions in which companies "inverted" in a desire to avoid the anti-competitive features of the U.S. tax on their foreign activities. In an inversion, a U.S.-headquartered company arranges to be acquired by its own foreign subsidiary. Anti-inversion legislation was enacted in 2004 to chill these transactions.

Each of these trends points to the impact of the U.S. tax system on the ability of U.S.-based multinational corporations to remain competitive in their international activities. If U.S. companies cannot successfully compete against their foreign-based competitors in the global marketplace, the growth of the U.S. economy will ultimately be restrained.

The time has come to consider fundamental changes to the U.S. tax system. The need for U.S. corporations to compete on a global scale means that we can no longer ignore the competitive disadvantages imposed by our tax rules. We must undertake reforms to our tax code to make it more competitive with the tax systems of our major trading partners.

How the U.S. Tax System Departs from International Norms

- ▶ Taxes the foreign-earned income of its citizens working abroad.
- ▶ Requires allocating and apportioning domestic R&D and interest expense against foreign income.
- ▶ Requires special measures of foreign income for implementing the foreign tax credit and Subpart F, rather than using calculations already made for other purposes (e.g., financial reporting).
- ▶ Taxes numerous categories of active foreign-source income before received by U.S. shareholders.
- ▶ Requires corporations to compute income tax under both regular and alternative minimum tax rules.
- ▶ Does not enter into bilateral income tax treaties that protect tax incentives offered to foreign investors by developing countries.
- ▶ Does not provide permanent relief from the domestic double taxation of dividend income at the corporate and shareholder levels.



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