United States Senate

Republican Policy Committee

Jon Kyl, Chairman

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<u>Democrats Would Increase Taxes on Companies' Income Earned Abroad</u>

Repealing the Deferral Rule: The Wrong Answer to U.S. Job Losses

Executive Summary

- Proposals to repeal the so-called "deferral rule" would undermine the competitiveness of U.S. multinational businesses, jeopardize their employment of millions of Americans, and stifle their ability to create new jobs in the future.

- The deferral rule allows U.S. multinationals to defer – not avoid – taxes on the earnings of their foreign subsidiaries until such earnings are no longer needed for the active business of the subsidiary and the earnings are returned to the United States.

- U.S. multinational enterprises are a critical component to the U.S. economy, providing 23.45 million jobs for Americans in 2001 – nearly 18 percent of payroll jobs in the United States – with a payroll in excess of $1.1 trillion.

- The United States has one of the world's highest corporate tax rates – 35 percent – on top of being one of the nations that taxes its corporations on their worldwide income. In contrast, other countries impose a significantly lower corporate-tax rate – for instance, Ireland taxes corporate profits at only 12.5 percent.

- Repeal of the deferral rule would substantially increase tax costs for U.S. companies trying to compete in the global marketplace. Repeal would likely result in lower profits or higher product prices, the burden of which ultimately would be borne by the company's U.S. customers, employees, and shareholders.

- Repeal of the deferral rule could also lead to the loss of U.S. multinational businesses through companies moving their headquarters offshore or foreign takeovers, both of which pose grave threats to U.S. jobs provided by such businesses.

Introduction

The recent debate over outsourcing of U.S. jobs to foreign countries has led some in Congress to respond with statutory proposals that would have far-reaching and potentially devastating consequences for U.S. multinational corporations.[1] One such proposal is to repeal the current tax rule that allows such companies to defer the tax on income that their foreign subsidiaries earn until it is repatriated, or brought back, to the United States.[2]

Democrats who view the deferral rule as a prime culprit for the outsourcing of U.S. jobs overlook a number of issues. Multinational businesses incorporated in the United States (U.S. multinationals) are a significant contributor to the U.S. economy and provide critical employment opportunities for American workers. The deferral rule is based on sound tax policy and was designed specifically to facilitate the efforts of U.S. multinationals to compete effectively in the global marketplace. Finally, repeal of the deferral rule would have unintended and adverse consequences not only for the U.S. multinationals at which it is targeted, but also for American workers.

In the final analysis, repeal of the deferral rule is simply not the answer to the nation's employment needs and may in fact lead to the acceleration of job losses if enacted.

A Profile of U.S. Multinational Corporations

While it is easy to vilify a large faceless corporation with multiple foreign subsidiaries, U.S. multinationals are a critical component of our economy. These companies operate in virtually every industry and have investments of more than $13 trillion in facilities located across the nation.[3] As employers, they provided 23.45 million jobs for Americans in 2001 – nearly 18 percent of payroll jobs in the United States – with a payroll in excess of $1.1 trillion.[4]

A recent study also indicates that U.S. multinationals are significant job creators – and not through "exporting" of jobs to foreign nations with low-labor and low-tax costs, as some Democrats contend. In fact, during the 10 years from 1991 through 2001, "for every one job that U.S. multinationals created abroad in their affiliates, they created nearly two U.S. jobs in their

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[1]See RPC Policy Paper, "Outsourcing: Meeting the Challenges Without Destroying the Benefits," March 3, 2004 – http://rpc.senate.gov/_files/Mar0304SourcingMWKH.pdf.

[2]Senator Ernest Hollings introduced S. 2235, Domestic Workforce Protection Act, in March of this year. Section 4 of the bill – Termination of Deferral to Eliminate Tax Benefits for Offshore Production – purports to accomplish the goal of repealing the deferral rule.

[3]Bureau of Economic Analysis (BEA), "U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and Their Foreign Affiliates, Preliminary 2001 Estimates," Table II.M 1 – http://www.bea.gov/bea/ai/iidguide.htm#link12b.

[4]BEA; U.S. Census Bureau, "National Employment, Hours and Earnings," 2001 Annual Employment – http://www.bls.gov/webapps/legacy/cesbtab1.htm.

[parent corporations].”[5] In addition, during that same decade, U.S. multinationals increased domestic employment at a faster rate than the overall economy.[6]

With these facts in mind, it seems ill-advised to propose changes to the U.S. international-tax rules that could undermine the competitiveness of U.S. multinationals, jeopardize their employment of millions of Americans, and stifle their ability to create new jobs in the future. Nevertheless, that is the risk presented by proposals to repeal the deferral rule.

A Primer: U.S. Taxation of Foreign Earnings of U.S. Corporations

The ramifications of repealing the deferral rule are best reviewed in the context of the United States’ international-tax system. The United States taxes all of the worldwide income of its citizens, including all domestic and foreign earnings of U.S. companies.[7] The United States also fully taxes income earned overseas by foreign subsidiaries of U.S. multinationals. In contrast, many foreign countries (notably France and Germany) tax their companies on a territorial basis. As a result, these countries only tax income earned within their borders and do not impose tax on the earnings of their multinational companies’ foreign subsidiaries that are located outside of their national borders.

A foreign company taxed under a territorial-based tax system has a significant advantage over a U.S. multinational. For example, a U.S. company with a Malaysian subsidiary would pay U.S. tax and Malaysian tax on the subsidiary’s income. A French company with a Malaysian subsidiary will pay only the Malaysian tax – France collects no tax because the income was earned abroad. Hence, the U.S. company in Malaysia would face a much higher tax burden than its French competitor.

Current U.S. tax law addresses this problem in two ways. First, since 1917, the United States has allowed a U.S. company that repatriates the income of its foreign subsidiary to reduce its U.S. taxes by the amount of any foreign taxes paid on that income.[8] That reduction is accomplished through a “foreign tax credit,” which helps prevent the U.S. multinational from paying both U.S. and foreign taxes on the same income.[9] As a result, this provision reduces the tax disadvantage that U.S. multinationals face in the international marketplace.

Second, the U.S. tax code does not subject American companies to tax on income from the active business operations of a foreign subsidiary *until* that income is brought back to the United States, usually in the form of a dividend paid to the U.S. parent company. This is referred to as the “deferral rule,” meaning that the U.S. tax is deferred until the earnings are

[5]Matthew J. Slaughter, “Globalization and Employment by U.S. Multinationals: A Framework and Facts,” *Daily Report for Executives*, Bureau of National Affairs, March 26, 2004, p. 1.

[6]Slaughter.

[7]See *Cook v. Tait*, 265 U.S. 47 (1924).

[8]Section 901 of the Internal Revenue Code of 1986, as amended (IRC).

[9]The foreign tax credit, however, may not exceed the maximum U.S. corporate-tax rate of 35 percent. IRC Section 904(a). If the foreign tax rate is higher, the foreign tax credit stops at 35 percent, and the taxpayer pays double taxes to the extent of the excess. If the foreign tax rate is lower (e.g., 12.5 percent), then the foreign tax credit will also be limited to that lower rate and additional U.S. taxes will be owed up to the full 35 percent U.S. rate.

repatriated.[10] It is essential to note that deferral is ***not*** the forgiveness of U.S. taxes. It simply means that the United States imposes the full tax at a future point, instead of today, on the company's foreign income.

The policy underlying the deferral rule is to allow American multinationals to remain competitive against their foreign competitors who are not subject to tax on their worldwide income. As President Clinton's international tax counsel put it: "Current U.S. tax policy generally strikes a reasonable balance between deferral and current taxation in order to ensure that our tax laws do not interfere with the ability of our companies to be competitive with their foreign-based counterparts."[11] By deferring tax on their foreign earnings, U.S. multinationals are able to employ their full earnings in the active conduct of their foreign operations on par with foreign competitors who are paying little or no taxes on their foreign income.

It is also important to note that the deferral rule applies only to those foreign earnings that relate to *active* business operations. Congress has modified the tax rules over the years to prevent companies from abusing the deferral rule to shelter income that is not necessary to maintain their competitive standing. Most notably, the Subpart F rules were enacted in 1962 to prevent U.S. multinationals from deferring tax on foreign income that is generally not related directly to the active operation of their foreign businesses, such as interest and dividends from investments of their foreign earnings.[12]

The Wrong Idea: Repealing the Deferral Rule

Recently, some Democrats have assailed the deferral rule as a major cause of outsourcing of U.S. jobs to foreign countries like India, China, and the Philippines. They have argued that the deferral rule is an enormous tax loophole that encourages U.S. multinationals to move their operations and jobs abroad. Unfortunately, they overlook several important consequences of repealing this rule.

Repeal Would Create a Competitive Disadvantage for U.S. Multinationals

First, the complete repeal of the deferral rule would substantially reduce the ability of U.S. multinationals to compete globally. The United States has one of the highest corporate-tax rates in the world – 35 percent – on top of being one of the nations that taxes its corporations on their worldwide income. In contrast, the following chart reflects the corporate-tax rates of the United States' major trade competitors that utilize a territorial-based tax system:

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[10] Senate Report Number 1881, 87th Congress, 2d Session, 1963, p. 78.

[11] Joseph Guttentag, then-Treasury Department International Tax Counsel, testimony before the Senate Committee on Finance, July 21, 1995.

[12] IRC Sections 951 through 964. Other anti-abuse rules include the foreign personal holding company provisions under IRC Sections 551 through 558, the foreign investment company rules under IRC Sections 1246 and 1247, and the passive foreign investment company provisions under IRC Sections 1297 and 1298.

Country	2004 Corporate-Tax Rate
Australia	30.00%
Belgium	33.99
Canada	22.10
France	33.33
Germany	25.00
Netherlands	34.50
Switzerland	24.10
Source: KPMG, "Corporate Tax Rate Survey – January 2004."	

As this chart demonstrates*, the United States' 35-percent corporate-tax rate applicable to worldwide income well exceeds the rate that competing nations impose only on the income their companies earn domestically.*

Repealing the deferral rule would effectively mean that the United States would be exporting the high U.S. tax rates to U.S. business operations around the globe. For example, without the deferral rule, a U.S. corporation operating in Chile would pay 17 percent in taxes to the Chilean government[13] and 18 percent to the U.S. government, net of the foreign tax credit[14] – taxes that are currently deferred until the income is repatriated to the United States. In contrast, the U.S. company's German competitor would pay 17 percent in Chilean taxes and nothing to the German government because the income was earned outside of Germany's borders. This disparity translates into an 18-percent competitive disadvantage for American companies seeking a share of the Chilean market.

To remain competitive, the U.S. multinational would have to absorb the cost of its additional U.S. tax burden by cutting its profit margin or raising prices. Reduced profits would depress the company's stock price, which in turn could adversely affect employee stock ownership plans and company pension plans.[15] Ultimately, the business' reduced profitability could force cost-cutting measures – which would threaten jobs both in the foreign subsidiary and in the U.S. parent company.

Alternatively, the U.S. multinational could raise prices to offset the increased U.S. tax burden. Even if it has the superior products or services, increased prices would likely lead to a loss of market share by the U.S. company to its foreign competitors, which greatly benefit from

[13]KPMG, "Corporate Tax Rate Survey – January 2004," p. 6.

[14]Without the deferral rule, the United States would tax all of the U.S. companies' Chilean income at 35 percent. However, the company would receive a 17-percent foreign tax credit for the Chilean taxes paid, reducing the actual taxes paid to the United States to 18 percent.

[15]Gary Clyde Hufbauer and Paul Crieco, "Senator Kerry on Corporate Tax Reform: Right Diagnosis, Wrong Prescription," Institute for International Economics, April 2004, p. 9.

territorial-based tax systems, and so can maintain lower prices on their products and services.[16] As a result, foreign markets available for U.S. exports would shrink. In the end, U.S. companies would gradually be consigned to operating in just the U.S. marketplace – again, threatening, rather than improving, the ability of U.S. multinationals to retain and create new U.S. jobs.

Repeal Would Create an Incentive for U.S. Companies to Move Offshore

Second, advocates of eliminating the deferral rule overlook the fact that repeal would provide a significant incentive for U.S. corporations to move their headquarters offshore. By forming a new corporate headquarters in a lower-tax jurisdiction, a U.S. multinational corporation could reorganize its business structure so that the U.S. company and all of its foreign subsidiaries become subsidiaries of the newly formed foreign parent. As a result, the multinational corporation could avoid U.S. taxation on all of its worldwide income that is not earned in the United States. *This is exactly the type of "corporate inversion" that both Democrats and Republicans have tried to prevent over the last couple of years.*

The only other alternatives would be for a U.S. multinational to sell its operations to foreign companies or be acquired in a hostile takeover by a foreign company. Such companies would be attractive to foreign multinationals looking to enter the U.S. marketplace – what better way than to simply purchase a U.S. company with an established share of the U.S. market? The sale or takeover alternative would accomplish the same result as a corporate inversion – eliminating U.S. tax on company income earned outside of the United States – but U.S. shareholders would no longer own the company. Ultimately, an increase in corporate inversions or foreign takeovers of U.S. multinationals would lead to a significant reduction in U.S. tax revenues because the foreign earnings of such companies would no longer be subject to U.S. taxation. This, of course, is contrary to advocates' intention for the repeal of the deferral rule – to raise revenues.

More importantly, rather than keeping American jobs at home, repealing the deferral rule ultimately would lead to the loss of even more jobs in this country. According to data from the U.S. Bureau of Economic Analysis (BEA), more than 70 percent of the jobs provided by U.S. multinationals are located in their U.S. headquarters – that amounts to more than 23 million jobs.[17] In addition, these U.S. jobs tend to require higher skills and pay more than comparable jobs in U.S. businesses that do not operate internationally.[18] As a result, if repeal of the deferral rule forces U.S. multinationals to move their headquarter operations offshore or to be taken over by foreign competitors, this country stands to lose an enormous number of well-paying, white-collar positions that will not be easily replaced.

[16]Hufbauer and Crieco.
[17]BEA, Table II.M 1.
[18]Slaughter, p. 5.

Still Wrong: The Partial Repeal Proposal

In an apparent effort to avoid the adverse consequences of completely repealing the deferral rule, some Democrats have proposed a partial repeal.[19] This proposal would still harm rather than help U.S. employment. Under this proposal, the deferral rule would be repealed only so far as it relates to the income that a U.S. multinational's foreign subsidiary earns on products produced abroad but imported back into the United States.[20]

Following the general business rule of thumb that "you have to be there to sell there," many U.S. multinationals have established manufacturing facilities in foreign countries to make products, not primarily for sale in the U.S. market, but to sell in the foreign country where the facility is located. For example, a foreign subsidiary of a U.S. company manufactures toasters in China, 90 percent of which are sold throughout Asia, and 10 percent of which are imported into the United States for sale in this country. The Democrats' limited-repeal proposal would repeal the deferral rule with respect to the 10 percent of the income from the toasters sold in the United States, but continue to allow deferral on the remaining 90 percent of the toaster-sale income.

This proposal, presumably, is intended to maintain the competitiveness of U.S. multinationals against their territorial-based competitors with respect to the products made and sold abroad, while discouraging U.S. companies from moving their production facilities offshore for products imported back into the United States. Nevertheless, it fails to accomplish this goal. According to the most recent BEA data, only about 7 percent of all sales of U.S. multinationals' foreign subsidiaries are from products and services sold in the United States in 2001.[21] Consequently, the deferral rule would continue largely as it does today, applying to the vast majority – 93 percent – of the income from products that U.S. multinationals produce abroad to sell in foreign markets.

Moreover, while this limited-repeal proposal would do little to discourage the conduct of U.S. multinationals that Democrats are decrying, it would create two negative results. First, the proposal would increase taxes on the companies producing those products for sale domestically. Second, it would create significant compliance burdens for U.S. multinational businesses. For example, complex tracing procedures would have be developed to ensure the accurate accounting of income, as well as the direct and indirect costs relating to products sold domestically and internationally. Additional tax reporting and financial audit costs would ensue.

As noted above, companies faced with rising tax costs – be it increased tax dollars or higher compliance costs – are likely to absorb them by reducing profits or raising prices. In either event, the company's U.S. shareholders, employees, and customers ultimately bear the

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[19]Senator Byron Dorgan has filed Senate Amendment 2922 to S. 1637, the Jumpstart our Business Strength (JOBS) Act. He offered a similar amendment in 1996 in response to the movement by U.S. companies of certain manufacturing operations to lower cost countries – often referred to as "runaway plants." See Senate Amendment 5223 to H.R. 3756, 104th Congress, Second Session (tabled 58-41, vote number 282, September 11, 1996). Senator John Kerry has also proposed a repeal of the deferral rule, although it has not been offered in legislative language – http://www.johnkerry.com/issues/economy/10million.html.

[20]See Senator Byron Dorgan, *Congressional Record*, April 6, 2004, p. S3740.

[21]BEA, *Survey of Current Business*, November 2003, Table 13.

cost of these additional taxes. More broadly, these additional costs would *not* apply to foreign businesses competing against U.S. multinationals in the U.S. marketplace. Accordingly, even the partial repeal of the deferral rule will have adverse effects on U.S. multinational companies' ability to compete domestically if they cannot match the prices or the profitability of foreign companies competing in the U.S. market. In the end, a company that cannot compete effectively will not prosper and may not survive. As a result, its ability to create new jobs is severely limited, and ultimately the current jobs it provides could be threatened.

Conclusion

While promoted as a defense against domestic U.S. job losses, proposals to repeal the deferral rule would simply exacerbate the current employment situation, threatening – not protecting – even more U.S. jobs. Ultimately, to ensure the survival of U.S. businesses in the global marketplace and encourage them to retain U.S. jobs, the Senate must substantially reduce the U.S. corporate-tax rate. Even if the deferral rule is left untouched, U.S. multinationals face an increasingly uneven playing field in the global marketplace. With other first-world nations taxing their multinationals at substantially lower corporate-tax rates – for instance, Ireland taxing corporate profits at only 12.5 percent – American businesses simply cannot be expected to succeed if they are handicapped by a 35-percent corporate-tax rate on their worldwide income.[22]

[22]KPMG.