John Ensign, Chairman
Pamela Thiessen, Staff Director

347 Russell Senate Office Building
Washington, DC 20510
202-224-2946
http://rpc.senate.gov

U.S. SENATE REPUBLICAN POLICY COMMITTEE

May 19, 2009

Repealing Deferral: How to Make U.S. Corporations Less Competitive and Destroy Jobs

Executive Summary

- President Obama's proposal to increase taxes on U.S. businesses operating abroad will do precisely the opposite of what the President asserts: it will destroy jobs in this country, generate relatively little tax revenue, and harm our nation's economic growth.
- The United States will soon be the only major country that taxes its corporations on their profits earned overseas after they pay taxes to the country in which they operate.
- The U.S. corporate tax rate is the second-highest in the Organization for Economic Co-operation and Development, making the cost of this double taxation significant to business.
- By forcing U.S. firms to pay U.S corporate income taxes on overseas profits, U.S. firms will be at a competitive disadvantage against their overseas rivals, none of which are required to pay taxes a second time to their home country.
- When U.S. companies expand operations abroad, it is generally to service overseas markets. This generally *creates* jobs in the United States in support operations such as marketing, information technology, and logistics. These are the skilled, highly-paid jobs that we *want* to create in this country—not discourage.
- The creation of a punitive level of taxation on overseas income will cause domestic companies to eschew such expansion. It will force many companies to either spin off their overseas operations or to relocate their headquarters elsewhere—costing U.S. jobs.
- A retrenchment of U.S. companies from serving overseas markets could actually result in fewer U.S. jobs, a perverse result of an ill-thought-out tax grab.
- The administration would be better served to take a long look at reforming our convoluted corporate tax code to help make U.S. businesses more competitive abroad.

Introduction

Corporations based in the United States with overseas subsidiaries generally do not have to pay U.S. corporate income taxes on their income from active business operations earned abroad until it is brought into the United States, a policy known as "deferral." This practice has been in the crosshairs since the Democratic takeover of Congress in 2007,[1] and the Obama administration has signaled its interest in eliminating or sharply curtailing this practice to generate revenue, which could be substantial—upwards of $20 billion a year, according to some estimates.[2]

In particular, the administration proposes two major changes to the tax treatment of multinationals. First, it seeks to gut the "check the box" rules that allow companies to choose how some of their foreign subsidiaries are treated for tax purposes. The Clinton administration originally put these rules in place as regulations to simplify the often complicated factual determination of whether a foreign entity should be regarded as a corporation, partnership, or other pass-through entity for U.S. tax purposes. The Obama administration claims that this amounts to a tax loophole and proposes to require all single-owner foreign entities organized in a different country than their owner be treated as corporations. This proposal would make it much more costly from a U.S. tax perspective for companies to redeploy foreign earnings from one subsidiary to another to meet operational needs. Rather than fix a discrete loophole exploited by a few businesses, this would burden nearly all U.S. multinationals with higher taxes and more complex rules.

Second, the administration wants to cut back on companies' ability to delay U.S. tax on their foreign earnings until that income is repatriated to the U.S. parent. Since the Kennedy administration, Congress has maintained this policy of "deferral" in recognition of that fact that U.S. companies, unlike their foreign competitors, must pay home-country tax (on top of foreign tax) on income earned by foreign subsidiaries competing abroad. The administration's proposal would require companies to delay deductions of certain U.S. parent expenses - such as interest expenses – which are deemed to support foreign earnings until those foreign earnings are taxed in the United States. The proposal would, in many cases, effectively repeal the benefits of deferral, and would amount to a tax increase of over $60 billion. The effect of this increased tax burden would be to make U.S. companies less competitive abroad and, when combined with the administration's other international tax proposals, could ultimately lead to more companies choosing to organize in countries other than the United States and to takeovers of U.S. companies by foreign companies in mergers.

Some Democrats' hostility towards deferral stems from a belief that allowing the deferral of tax on foreign-sourced income amounts to a tax break for companies that are moving U.S. jobs abroad. They assert that by making it less expensive to operate abroad, companies are more inclined to shift domestic operations there, especially in the manufacturing realm. Supporters of deferral, on the other hand, argue that when firms expand abroad it is usually done for solid non-tax business reasons, such as to serve international markets, rather than to replace domestic jobs. They contend that as companies expand into foreign markets they hire more people to do

---

[1] "Firms Move to Fight Overseas-Profits Tax," *Wall Street Journal*, April 6, 2009.
[2] *A New Era of Responsibility: Renewing America's Promise (2009 Federal Budget)* table S-6, p 122.

marketing, research and development, logistics and other administrative support tasks that tend to be done in a company's headquarters.

Contrary to the assertions of the administration, the proposed changes to business taxes will put U.S. businesses at a competitive disadvantage, destroy jobs in this country and harm our nation's economic growth.

Taxing Income Earned Abroad: A Primer

When a company expands its operations into other countries it creates a question as to how its foreign profits should be taxed. There are two broad ways to approach this question. Most countries tax each company operating within their borders on all profits earned in the country, regardless of the actual "home" of the company, and ignore profits earned abroad by companies based in the country. Such a system is called *territorial* taxation; ideally, it results in each dollar of corporate income being taxed only once, in the jurisdiction where it was earned, and each dollar earned in a particular country being taxed at the same rate, regardless of where the company is based. After 2009, every single member of the Organization for Economic Co-operation and Development (OECD) except for the United States will have some version of territorial taxation.[3]

The United States, unlike the many countries that have a territorial tax regime, levies taxes upon the *worldwide* profits of domestic companies, regardless of where the company earns the profits. The ostensible goal in this system is to tax each dollar earned by a company based in the United States the same regardless of whether the dollar is earned here or in a foreign country. In a world where most countries employ territorial taxation, a company subject to worldwide taxation pays taxes on profits in the country where they were earned and then pays taxes to their home country, with a credit for the taxes already paid abroad.

Since the United States currently has the second-highest corporate tax rate in the OECD U.S. companies operating abroad will face a higher tax rate than most of the companies they are competing against in foreign markets.[4]

While the United States deploys a version of worldwide taxation, the fact that we allow companies to defer taxes on overseas profits until they repatriate that money back into the U.S. means that profits earned abroad are subject only to the typically lower corporate tax rate of the country in which the company is operating, at least for a while. Many Democrats believe that this incentivizes companies to take advantage of the lower tax rates by moving production abroad, along with the attendant jobs, and that equalizing the tax rates on foreign and domestic production removes that incentive.

Another objection many have to deferral is the fact that since profits can be fungible between units scattered across the globe, multinational companies operating under a territorial regime

[3] "Get Ready: The Coming Corporate Tax Battle," Douglas Holtz-Eakin, Newmajority.org, April 29, 2009.

[4] Approaches to Improve the Competitiveness of The U.S. Business Tax System For the 21st Century, Office of Tax Policy, U.S. Department of the Treasury, December 20, 2007 p 7.

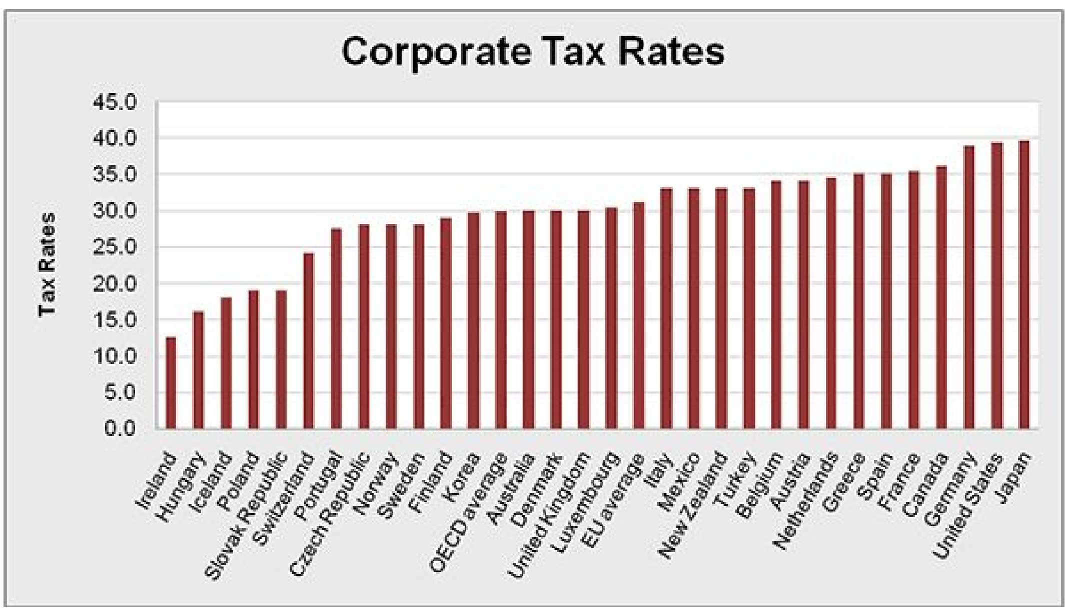
strive to maximize the reported profits in a low-tax country and minimize the profits earned in a high-tax country. A company based in a country with a worldwide tax regime can also play this game as long as it can defer its domestic corporate tax bill until it repatriates the money back to its domicile country.

That companies spend significant resources taking advantage of the vagaries of international tax law to reduce taxes understandably draws the ire of individual taxpayers, and the move to end deferral has certainly been fed by this anger. However, a solution to this problem that results in putting U.S. companies at a competitive disadvantage when operating abroad would be a pyrrhic victory. A solution lies elsewhere.

The High U.S. Corporate Tax Rate Creates Problems

The United States taxes corporate profits—and more generally the returns to capital investment—higher than nearly all other developed countries, making it costlier for U.S.-based corporations to compete against their foreign-based rivals. Figure 1 shows that we have the second-highest corporate income tax rate in the OECD, with Japan threatening to cut their rates to give us the crown in the near future.[5]

Figure 1 (Source: Treasury Dept)



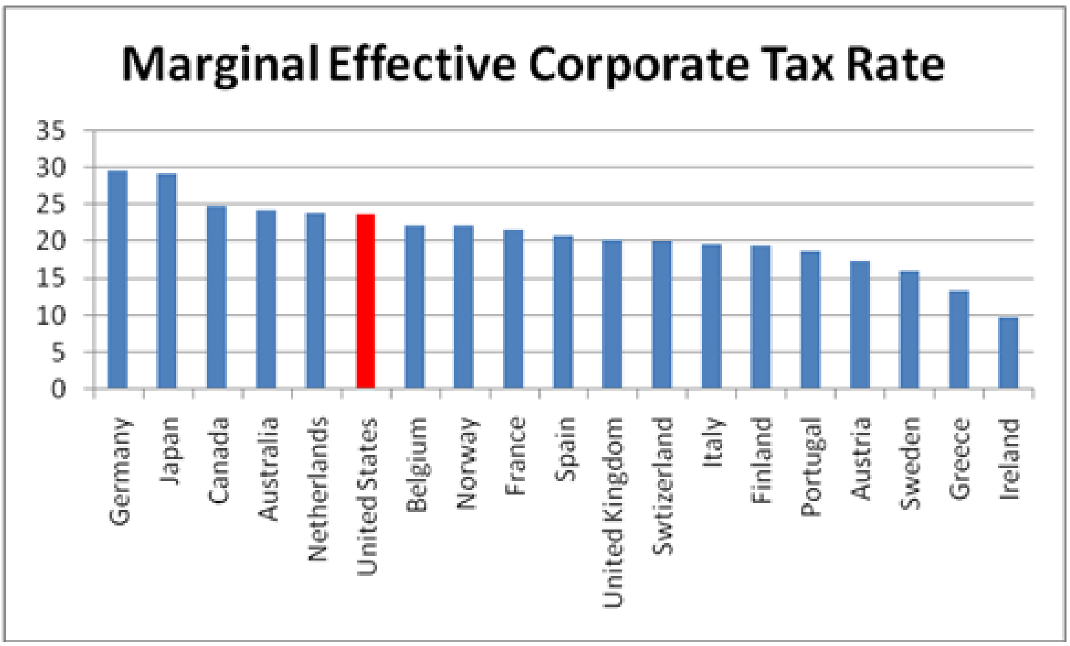
Democrats often counter this by arguing that the "effective" tax rate facing U.S. businesses, which measures the taxes actually paid by corporations after adjusting for the various deductions and exclusions built into the code, is the better metric to compare and in fact reveals us to be a low corporate-tax country. For instance, President Obama said in the first presidential debate

[5] "Tax Code Changes: Industry in the Crosshairs," *CQ Weekly,* April 11, 2009.

that ". . . our businesses pay effectively one of the lowest tax rates in the world." [6] While it is true that the effective corporate tax rate in the U.S. is lower—in absolute and relative terms—than the statutory rate, it remains above the average of OECD nations. According to a 2007 Treasury Department study, the U.S. effective tax rate for equity-financed investment is 24 percent, below the statutory rate of 39 percent[7] but still above the average tax rate for equity-financed investment in the OECD, as can be seen in Figure 2.[8]

Furthermore, the highest marginal tax rate, not the effective tax rate, is the most relevant and most significant indicator of the impact of a tax. That is, if a U.S. corporation earns an additional $100 of income, it will pay $39 of additional tax. By contrast, if an Irish company has an additional $100 of income, it will only pay an additional $12.50 of tax. Such a disparity in marginal tax rates would put a U.S.-based company at a disadvantage compared with a competitor subject only to Irish taxes.

Figure 2 (Source: CBO)



When the U.S. last cut its corporate tax rate following the 1986 tax reform, its rate was one of the lower tax rates in the world, but in the ensuing years countries all over the globe have cut their

---

[6] *Debate Transcript:Presidential Debate McCain Obama, September 26, 2008,* http://news.spreadit.org/debate-transcriptpresidential-debate-transcript-mccain-obama.

[7] The federal corporate income rate is 35 percent, but the combined state and federal corporate tax rate of 39 percent is the one most applicable for international comparisons.

[8] Effective corporate tax rates are not as straightforward as statutory tax rates: they crucially depend on how investment is financed, since in the U.S. interest is deductible but dividends are not. A detailed discussion on this can be found in the 2007 Treasury Report *Approaches to Improve the Competitiveness of The U.S. Business Tax System For the 21st Century*, pp 11-14.

tax on capital. The U.S. is the only country in the OECD to not reduce its corporate income tax in the last fifteen years.[9]

The broad reduction in capital taxes has been largely a response to the increase in capital mobility. As the barriers to moving capital have fallen, capital flows have become more sensitive to the relative rates of return, meaning that a high corporate tax rate has a greater impact on domestic investment now than it did ten or 20 years ago.

Corporations Consist of People

Another change has come in our understanding as to who actually pays the corporate income tax. Economists recognize that the entity that actually writes the check to the government is not necessarily who bears the burden of a tax—for instance, few dispute that while employers and employees "split" the Social Security tax, in reality the workers bear the tax charged to employers via lower wages.[10]

The corporate income tax affects three different groups: the shareholders, via lower profits; consumers, via higher costs as the corporations attempt to pass on the taxes; and the workers, via lower wages. The distribution of those costs depends crucially on the mobility of capital. In less-than-competitive retail markets with relatively immobile capital, which described a fair number of markets in the 1960s and 1970s, the shareholders and consumers bore the brunt of the tax. In today's competitive retail markets with substantial capital mobility, the workers bear the brunt of the tax.[11] It cannot be passed on to consumers without losing sales, and if it is passed on to shareholders, investment will move elsewhere.

The Cost of a High Corporate Tax Rate

Businesses that operate on small profit margins simply cannot remain competitive in foreign markets if they are required to pay a higher tax rate on their profits than are their rivals. A couple of examples illustrate the problems that ending deferral would create for U.S.-based companies operating abroad.

Pepsi in Eastern Europe

A few years ago, Pepsico embarked on an aggressive expansion program in Eastern Europe, largely by buying up existing bottlers and snack chip producers, upgrading plants and equipment and improving distribution while increasing their marketing efforts in these countries, achieving large gains in sales as a result.

---

[9] "Comparing International Corporate Tax Rates," *Fiscal Fact No. 143*, Tax Foundation, August 28, 2008.
[10] For a discussion and an empirical test, please see "The Distribution of Payroll Tax and Income Tax Burdens, 1979-1999," Andrew Mitrusi and James Poterba, *National Tax Journal* LIII, 2000, pp 765-794.
[11] *Taxes and Wages*, Kevin Hassett and Aparna Mathur, American Enterprise Institute, 2008.

As a result of this expansion, Pepsico's employment abroad increased, but no one would conclude that these jobs cost any Americans their jobs. For starters, these "new" jobs already existed—Pepsi merely took over existing plants and their workers. What's more, these are jobs that could never be done in America—the bulkiness and weight of soda and chips make them too costly for these to be shipped across the ocean in a cost-effective way.

But Pepsico's foreign expansion did create jobs in the United States. In order to support their overseas operations, the company needed to expand their logistics, marketing and other support operations, jobs that would typically be done in their U.S. headquarters. As a result, expanding operations abroad led to an increase in employment here in the United States, and in occupations that typically pay wages well above average to boot.

Ending deferral would dramatically increase Pepsico's costs abroad and would likely result in the company selling its foreign operations. If the cash flow from its operations in Eastern Europe were greater in the hands of a foreign-based company that operated under a lower tax rate, then it would be its fiduciary duty to spin off those operations. We saw this happen when the 1986 tax reform ended deferral for the U.S. shipping industry, with the result being that today there are virtually no U.S.-flagged ships.[12]

Caterpillar in Asia

Caterpillar Inc., a manufacturer of construction and mining equipment, diesel and natural gas engines and industrial gas turbines, is one of the leading exporters from the U.S. In 2008, Caterpillar's overall sales of $51 billion included $16 billion of U.S. exports, while 67 percent of its total sales were outside the U.S. To reach its customers in international markets, Caterpillar has nearly 500 locations in 50 countries.

Today, China is one of Caterpillar's top five U.S. export markets, and one of the fastest growing markets in the world. To serve this market the company has dramatically increased its manufacturing presence in China in the last few years, more than doubling its Chinese workforce.

But as Caterpillar increased its presence in China, the company's U.S. exports to that country grew significantly—200 percent since 2004. In fact, Caterpillar exports to China about four times as much as it imports from there, resulting in Caterpillar increasing its U.S. employment by 14,000 from 2004 to 2008, most of which came in such high wage areas as research and development[13]. Caterpillar's competition in China comes from both Chinese manufacturers as well as other foreign-based companies from Asia and around the world. Currently, Caterpillar and its competitors all pay the Chinese corporate tax of 25 percent. However, if the U.S. repeals or restricts deferral, Caterpillar would be forced to pay a 35percent tax rate, amounting to a 40 percent tax increase, putting Caterpillar at a distinct disadvantage in its most important growth market and jeopardizing the American jobs that depend on sales in China.

---

[12] "Get Ready: The Coming Corporate Tax Battle," Douglas Holtz-Eakin, Newmajority.org, April 29, 2009.
[13] According to the *Chillicothe Independent*, Caterpillar hired over 1,000 engineers at its Mossville Technical Center in 2007 alone ("Expansion in Mossville Continues," July 28, 2007).

Ending Deferral Will Cost U.S. Jobs

When asked about his administration's intent to end deferral, President Obama remarked that it is unfair if two domestic companies face different tax rates just because one has operations in another country.[14] However, to remedy this would necessarily mean that U.S. companies operating abroad face a higher tax rate than their competitors. This would be a seismic change in our corporate tax system and put our corporate tax code diametrically opposed to the rest of the world. It would not only make U.S. companies less competitive abroad but it would also result in fewer corporations being based in the United States since moving its headquarters outside of this country would dramatically lower a corporation's tax bill. While the economic importance of having companies headquartered in this country is a matter of debate, communities such as St. Louis and Milwaukee, which have recently seen major businesses taken over by foreign operations, would no doubt assert that they have experienced a loss of leadership in their cities.

Changing domiciles and spinning off foreign operations would likely result in the government collecting less money than the administration forecasts. Indeed, Jason Furman, Deputy Director of the President's National Economic Council, pointed out in 2007 that CBO, the Joint Committee on Taxation, Treasury, and others have estimated that ending the taxation of income earned abroad would actually *increase* the amount of tax revenue collected from multinationals.[15]

Lower the Corporate Tax Rate

The Solomonic solution to this would be for the President to realize that in today's world of capital mobility, high corporate tax rates increasingly fall on our nation's workers, and that it is past time to reform our convoluted corporate tax code while lowering the rate to a competitive level. A significant corporate tax rate reduction could make the entire question of deferral moot while making U.S. companies more competitive in the global marketplace. While reducing the rate would definitely result in lost revenue (the corporate rate raises about $350 billion annually) the increased domestic investment and economic activity in the United States would lessen the tax revenue impacts while creating jobs here in the United States.

Jean Baptiste Colbert famously said that the art of taxation consists in so plucking the goose as to get the most feathers with the least hissing.[16] Our current corporate tax code creates a lot of hissing for the feathers we get, and ending deferral will merely amplify the hissing without giving us any more feathers. It's a step in precisely the wrong direction.

[14] "US Firms Gird for Battle in Obama Foreign Profits Tax," Martin Vaughn, *Wall Street Journal,* March 13, 2009.
[15] "Achieving Progressive Tax Reform in an Increasingly Global Economy," The Brookings Institute, June 2007, p 19.
[16] *The International Thesaurus of Quotations*. Rhoda Thomas Tripp, Crowell Publishing, 1970, p 628.