Taxation of American Companies **in the Global Marketplace: A Primer**

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Business Roundtable℠

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Executive Summary

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As the United States begins to consider reform of our corporate income tax system, it is important to recognize that the manner in which we tax American corporations on both their domestic and their international activities has a significant impact on their ability to compete globally and, in turn, on the ability of American workers to succeed in the global economy. This report is intended to:

1. Provide an introduction to U.S. international tax policy issues and explain the ways in which the U.S. tax system has failed to remain competitive with the tax systems of the rest of the world.

2. Explain how globally successful American companies benefit the U.S. economy through increased U.S. investment, increased U.S. production and exports of goods and services, increased earnings and dividends for their U.S. shareholders and more and better-paying jobs for American workers.

The U.S. tax system has become an outlier relative to other advanced economies in terms of:

- **A significantly higher corporate rate than in other advanced economies,** and

- **An international system of taxation that imposes substantial additional tax on foreign earnings remitted to the United States by American companies,** in contrast to the territorial systems of other advanced economies.

In combination, these factors disadvantage American companies and their workers as they seek to compete with their foreign-headquartered competitors in markets around the world. Reform of the U.S. corporate tax system can enhance the competitiveness of American companies, their workers and the U.S. economy.

With 95 percent of the world's population living outside the United States, it is essential to the growth of the U.S. economy and the prosperity of American workers that American corporations be able to operate in these markets on a level playing field with their foreign-headquartered competitors.

American companies with operations both at home and abroad are responsible for 63 million U.S. jobs.[1] These companies directly employ 22 million American workers, and they create an additional 41 million American jobs through their supply chains and the spending by their employees and their suppliers.

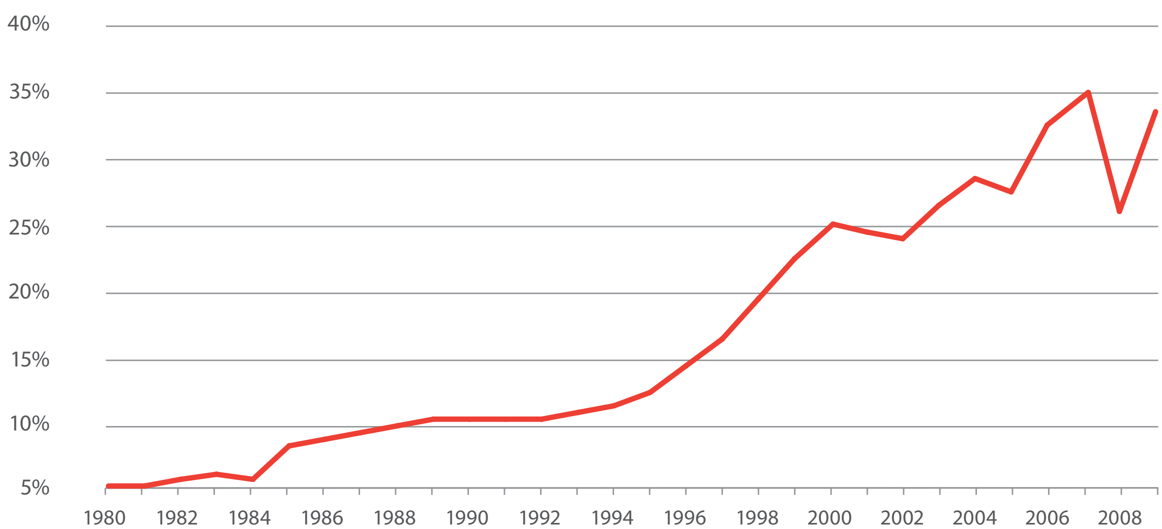
The typical American company with international operations buys $3 billion in goods and services from more than 6,000 American small businesses. Cumulatively, worldwide American companies purchased $1.52 trillion in supplies and services from U.S. small businesses in 2008.[2]

The ability of American companies to be competitive in both domestic and foreign markets is essential to job creation throughout the U.S. economy, and rising living standards for all Americans.

- The world is rapidly becoming more integrated. Reductions in the cost of communication and transportation, falling trade and investment barriers and increasing incomes of consumers around the world have opened the door to competition on a truly global scale. American workers are benefiting from the economic growth and higher living standards made possible by these new markets for growth—and stand to benefit further from increasing the ability of American businesses to serve these markets.

Cross-border investment has become an increasingly important way in which modern business activities are conducted. Measured relative to the growth in worldwide production, cross-border investment has grown six times faster—from less than 6 percent of the world's output in 1980 to a peak of 35 percent of world GDP in 2007 *(see Exhibit 1)*.

Exhibit 1: World Foreign Direct Investment as a Percentage of World GDP, 1980-2009

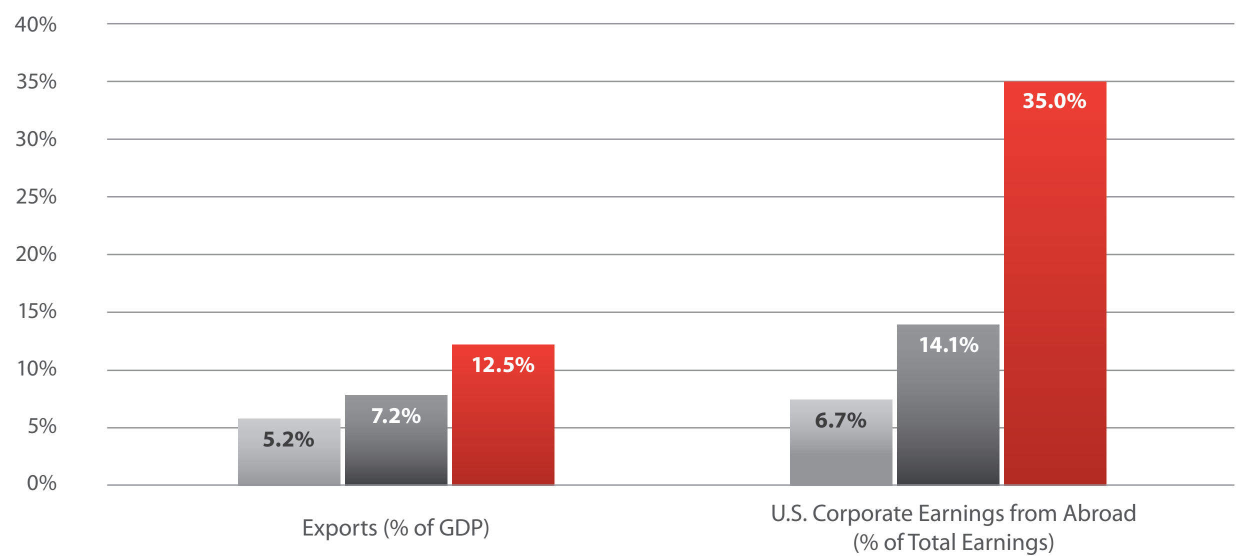


Source: United Nations Conference on Trade and Development (UNCTAD), stat database for accumulated foreign direct investment and world GDP.

Both American and foreign-based corporations have increasingly adopted global investment and marketing strategies. Over the past 45 years, exports by American corporations have more than doubled as a share of the size of the total economy, and the share of worldwide profits of American corporations attributable to foreign earnings has risen five-fold—from less than 7 percent of total profits in 1965, to 14 percent in 1985, to 35 percent by 2010 *(see Exhibit 2)*.

Among the largest American corporations, the share of worldwide profits attributable to foreign earnings is even greater. **In 2009, worldwide American companies in the Standard & Poor's 500 (S&P 500) had more than 55 percent of total income earned outside the United States.**

Exhibit 2: Globalization of the U.S. Economy, 1965-2010



Source: U.S. Department of Commerce, Bureau of Economic Analysis

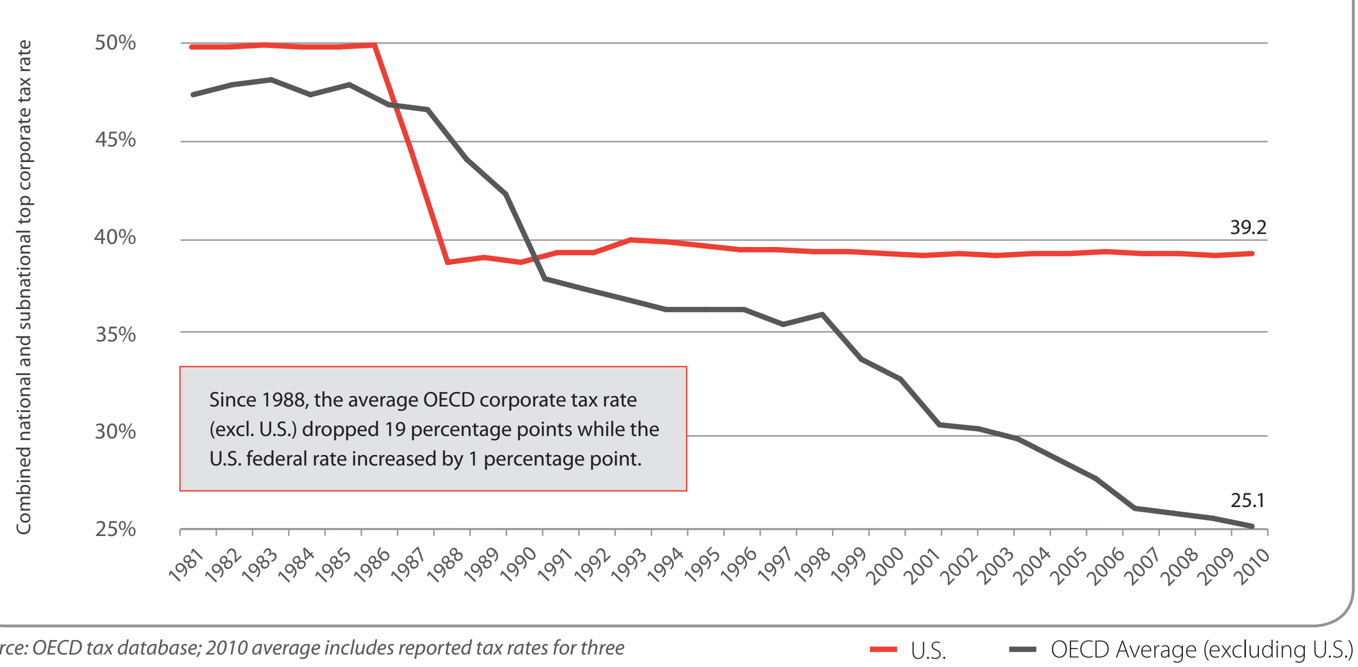
While the opportunities presented to American companies from expanding internationally are great, the competition they face today is far greater than in previous decades. American companies today account for less than one-fourth of all cross-border investment in the world, down from about 40 percent in the early 1980s. In other words, cross-border investment of foreign companies is now three times greater than that of American companies. Of the world's largest corporations, American companies represent a smaller and smaller share. Measured by total sales, **just six of the largest 20 companies in the world were American companies in 2010, down from 13 in 1985 and 17 in 1960.**

- 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.

The U.S. tax system is now an impediment to the competitiveness of American companies. The U.S. tax system has become an outlier relative to the tax systems of our trading partners, imposing a high rate of tax on corporate income and maintaining antiquated international rules based on taxing worldwide income that reflect an economy of a different era. As noted in a study by the Congressional Budget Office (CBO), a significant portion of the corporate income tax burden is borne by labor in the form of lower wages. This is caused by reduced investment in the United States and reduced worker productivity. As a result, an uncompetitive U.S. corporate tax system has immediate consequences for all Americans.

Corporate rate. In 1986, the United States reduced its top corporate income tax rate from 46 percent to 34 percent. In the following 25 years, all other major industrial countries also significantly reduced their corporate rates *(see Exhibit 3)*. Today, at 35 percent, the U.S. federal corporate income tax rate is no longer low.[3] Including state and local income taxes, the combined corporate tax rate in the United States of 39.2 percent was the highest after Japan among the 34 countries of the Organization for Economic Cooperation and Development (OECD) in 2010, 14.1 percentage points above the average tax rate of 25.1 percent in the rest of the OECD *(see Exhibit 4)*. With Japan planning a five-percentage point reduction in its corporate rate, the U.S. corporate tax rate will soon be the highest in the OECD.

Exhibit 3: Average OECD Member Country and U.S. Corporate Tax Rates, 1981-2010



Source: OECD tax database; 2010 average includes reported tax rates for three members that acceded to the OECD in 2010 that are not yet included in the tax database. The U.S. rate is based on the 35 percent federal tax rate and average state taxes of 6.47 percent, which are deductible from federal taxes.

International tax system. The United States is also one of the few remaining advanced economies that taxes its companies on foreign earnings from active business operations when remitted home. All other G-7 countries and most other OECD countries have adopted "territorial" tax systems that largely exempt these active earnings from home country taxation.[4] The United Kingdom and Japan both adopted territorial tax systems in 2009 as a way to help their companies compete—and grow their economies.

The international trend is overwhelmingly for lower taxes on corporations and the territorial treatment of foreign earnings.

If American companies and their workers are to remain competitive with foreign-headquartered firms, they cannot face corporate tax rates on domestic and foreign earnings that are 10 to 20 percentage points higher than those of their closest competitors.

Competition today between American and foreign-based companies is over commerce—and the things that flow as a result, such as income, jobs and security. The ability of American companies to succeed in foreign and domestic markets enhances American living standards.

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, often require companies to have their "feet on the ground" in local markets around the world.

These foreign operations stimulate exports for U.S.-produced goods and services into the local market, increase investment and production in the United States, and increase employment for American workers at home.

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

"We know what it will take for America to win the future. We need to out-innovate, we need to out-educate, we need to out-build our competitors. We need an economy that's based not on what we consume and borrow from other nations, but what we make and what we sell around the world. We need to make America the best place on Earth to do business."

President Barack Obama, February 7, 2011

Exhibit 4: OECD Combined National and Sub-National Corporate Tax Rates

Rank in 2010		Rate in 2010	Enacted or Proposed Reductions, 2011-2014
1.	Japan	39.5	34.5
2.	United States	39.2	
3.	France	34.4	
4.	Belgium	34.0	
5.	Germany	30.2	
6.	Australia	30.0	29.0
7.	Mexico	30.0	
8.	New Zealand	30.0	28.0
9.	Spain	30.0	
10.	Canada	29.5	25.0
11.	Luxembourg	28.6	
12.	Norway	28.0	
13.	United Kingdom	28.0	23.0
14.	Italy	27.5	
15.	Portugal	26.5	
16.	Sweden	26.3	
17.	Finland	26.0	
18.	Netherlands	25.5	
19.	Austria	25.0	
20.	Denmark	25.0	
21.	Israel	25.0	21.0
22.	Korea	24.2	
23.	Greece	24.0	
24.	Switzerland	21.2	
25.	Estonia	21.0	
26.	Turkey	20.0	
27.	Slovenia	20.0	
28.	Czech Republic	19.0	
29.	Hungary	19.0	10.0
30.	Poland	19.0	
31.	Slovak Republic	19.0	
32.	Chile	17.0	
33.	Iceland	15.0	
34.	Ireland	12.5	
OECD average, excluding U.S.		**25.1**	

Source: 2010 rates from OECD tax database; 2011-2014 enacted and proposed rates from various sources. The U.S. rate is based on the 35 percent federal tax rate and average state taxes of 6.47 percent, which are deductible from federal taxes.

Competing in the Global Marketplace

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 closer examination of the foreign investments undertaken by American corporations, however, shows that, on balance, they complement the domestic activities of these corporations and result in more investment in the United States and more jobs for American workers. Foreign direct investment is an important component of a global strategy for American corporations that combines domestic activities and exports of U.S.-produced goods and services to promote U.S. economic growth.

Vast Growth Opportunities

Foreign demand for consumer products and capital equipment is creating extraordinary opportunities for American companies. Ninety-five percent of the world's population lies outside the U.S. The prosperity of emerging market economies represents significant potential for the sale of U.S. products and services. Today, 75 percent of the world's purchasing power is located in markets outside the United States. American companies rely on foreign markets for continued growth. Among worldwide 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 47 percent in 2009.

Today, 95 percent of the world's population and 75 percent of the world's purchasing power are located in markets outside the United States.

And while many of the growth opportunities for American companies are increasingly outside the United States, these American companies remain decidedly U.S.-based in their production, investment and employment. American companies with foreign operations produce two-thirds of the value of their goods and services in the United States, undertake more than 70 percent of their capital spending in the United States, and employ two-thirds of their workforce in the United States.[5] In 2008, these American companies produced $2.5 trillion of value added in the United States, purchased $500 billion of plants and equipment in the United States and paid their 22 million American workers $1.5 trillion in compensation.[6]

Protecting Market Share

Foreign multinationals operate globally, including more than 750,000 cross-border affiliates, about 5,500 of which compete directly against U.S. businesses in the United States. American companies too must be strong—both inside and outside the United States—to maintain growth and market share.

Be There to Sell There

Relying solely on exports to penetrate foreign markets often does not suffice. Localized operations in foreign markets are 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. U.S. Commerce Department data verify that the function of most foreign operations of American companies is to support sales to foreign customers—90 percent of sales by foreign subsidiaries of American companies are into foreign markets rather than back into the U.S. market.

Localized operations, by increasing the market for a company's goods, can increase the demand for U.S. exports of goods and services, increase U.S. production, increase U.S. investment and increase wages and jobs for Americans.[7] On balance, foreign operations complement U.S. domestic investment and employment, rather than substituting for U.S. jobs.

46 percent of all U.S. exports of goods are accounted for by worldwide American companies.

One recent study found, for example, that an increase in sales by a company's foreign subsidiaries of 10 percent results in an increase in exports of goods from the United States by the American company of 6.5 percent.[8] Not surprisingly, the 22 million American workers employed by American companies with overseas operations account for a disproportionate share of U.S. exports of goods. According to U.S. Commerce Department data, 46 percent of all U.S. exports of goods—$596 billion in 2008—are accounted for by American companies with overseas operations.[9]

This complementary relationship means that as an American company expands its foreign operations, it typically expands its U.S. investment and U.S. employment at the same time. One study finds that as the average American company increases its foreign investment in plants and equipment by 10 percent, its investments in U.S. plants and equipment increase by 2.6 percent.[10] And, directly countering the argument that job gains abroad are at the expense of jobs at home, the study finds that a 10 percent increase in the number of foreign employees employed by a company's foreign subsidiaries is associated with a 6.5 percent increase in the number of the company's American workers. These percentage changes translate into meaningful increases in U.S. jobs as foreign operations expand.

Access to Natural Resources

Natural resource industries, including mining, oil and natural gas, must locate operations where the natural resources can be obtained. It is beneficial to the United States for foreign direct investment by American companies to develop these resource deposits.

Attractive Returns

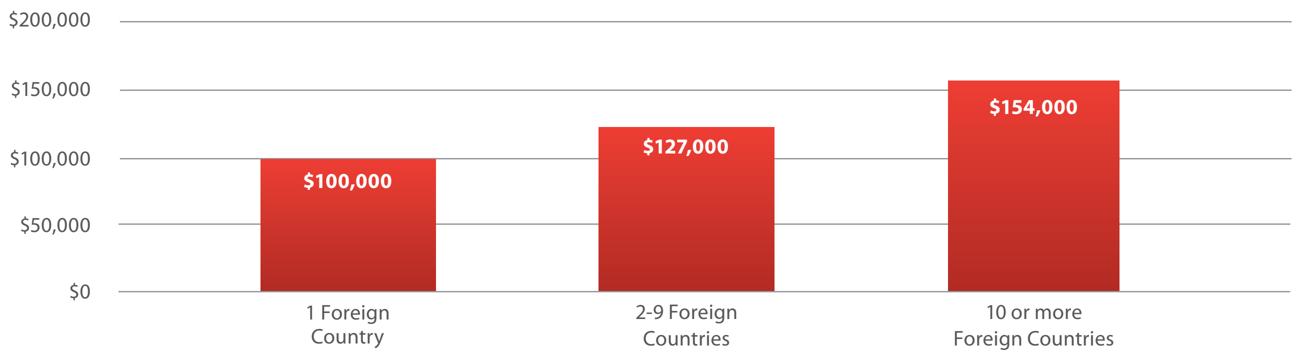
Foreign markets offer exceptional investment opportunities for U.S. investors. According to the U.S. Department of Commerce, U.S. corporate earnings from abroad amounted to $481 billion in 2009, 38 percent of total U.S. corporate profits. Foreign operations also result in higher wages for American workers. Domestic operations of U.S. multinational companies pay production workers 10 to 15 percent more, and non-production workers 5 to 7 percent more than comparable plants of U.S. companies without foreign operations.[11] In 2008, average compensation of American workers in American companies with foreign operations was $67,000.[12]

Competitive Costs

American companies can also take advantage of superior products and technologies through global operations. Global operations are critical to making products and services more attractive by reducing operational costs. A study by the Bureau of Economic Analysis finds that American manufacturing companies with foreign operations were 16 percent more productive than companies that operated only in the United States.[13] Further, this productivity advantage increases with the global scope of a company's operations. In 2008, American companies operating in 10 or more countries had 54 percent greater value added per employee than those companies operating in just one foreign country, and 21 percent greater value added per employee than companies that operated in two to nine foreign countries *(see Exhibit 5)*.[14] Higher worker productivity, in turn, is the key determinant of higher wages and a higher standard of living for American workers.

Exhibit 5: Labor Productivity of American Employees by Global Scope of Company Operation (Average value added per employee, 2008)

The productivity of American employees is greatest in those companies operating in more foreign countries



Source: Survey of Current Business, August 2010

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 allow American companies with valuable products, services and know-how to operate on a global scale. Because foreign competitors are adopting similar strategies, achieving global efficiencies is necessary for growth and survival.

The high productivity of companies with global operations leads to increasing productivity of the U.S. economy. A Federal Reserve Board study finds that American companies with international operations are responsible for more than three-fourths of the increase in labor productivity in the U.S. corporate sector between 1977 and 2000, and all of the labor productivity growth in the U.S. corporate sector in the late 1990s.[15]

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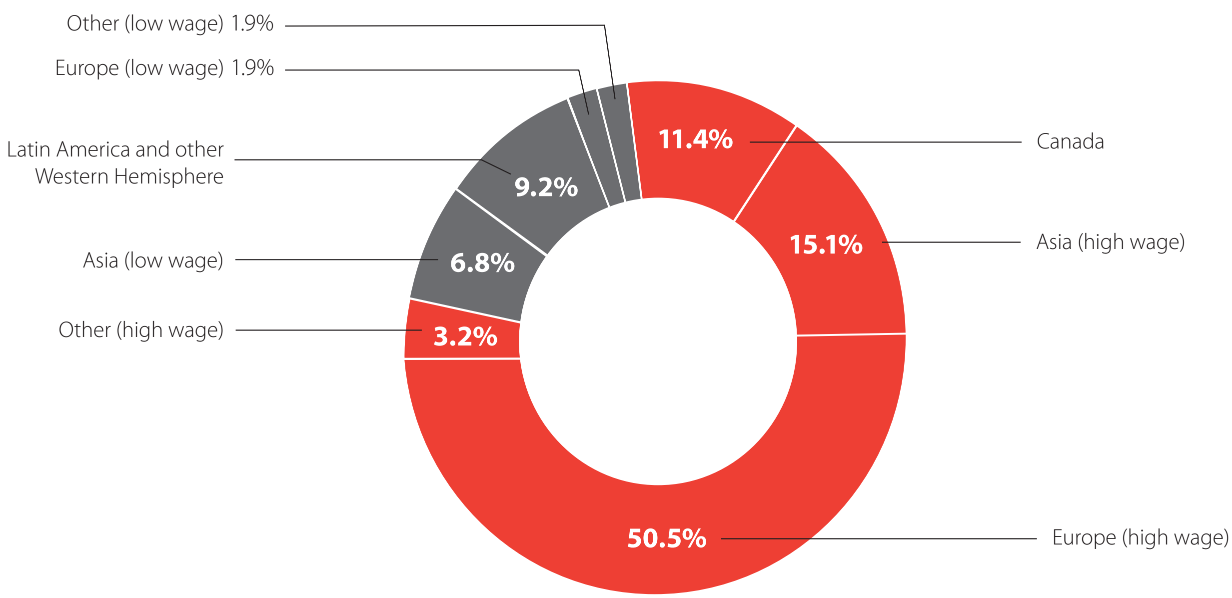
Foreign markets also support domestic research and development. Having access to foreign markets creates a larger base of sales over which to spread the costs of developing new products and processes. The R&D budgets of American companies with international operations create high-paying jobs in the United States—84 percent of R&D spending of American companies with international operations occurs at home and the principal cost is employee compensation. A 10 percent increase in foreign sales through a company's foreign subsidiaries is estimated to increase the American company's R&D spending in the United States by 5 percent.[16]

Deploying resources efficiently worldwide, however, does not typically require locating operations in low-wage countries. Labor productivity, customer services, local laws and other factors are as important as wage levels in determining where to locate activities. Majority-owned foreign affiliates of American companies located in countries with relatively high wage costs, such as much of Europe, Canada, Japan, Australia, Hong Kong, New Zealand and Singapore, account for 80 percent of all foreign affiliate sales *(see Exhibit 6)*. Similarly, more than 89 percent of the assets of the majority-owned foreign affiliates are located in countries with relatively high wages.

Exhibit 6: Most U.S. Investment Abroad is in High-Income Countries (Sales by Location, 2008)



Source: U.S. Department of Commerce, Bureau of Economic Analysis

High Wage Low Wage

However, as emerging countries such as Brazil, Russia, India and China (the so-called "BRICs") continue to grow faster than the developed world, increasing shares of sales and production will be located in these markets in the future. China today is the second-largest economy in the world, having surpassed Japan in 2010, and its economy is forecast to be larger than the U.S. economy within 20 years.[17] These same forecasts project the economies of the BRICs as a whole will be larger than the economies of the G-7 in less than 25 years.

U.S. Taxation of International Income

U.S. Taxation of International Income

Assessing the impact of the U.S. tax system on the competitiveness of American 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 principle of *deferral,* the *foreign tax credit* and related limitations and the *transfer pricing* rules by which the amount and location of earnings is determined for transactions between a U.S. parent company and its foreign subsidiaries. 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. Tax is generally assessed on active business earnings when they are remitted to the United States, with a tax credit provided to offset income taxes paid to the foreign country. The United States is one of the few advanced economies that taxes its companies on their active foreign earnings, with most others using territorial tax systems that largely exempt active foreign earnings from domestic taxation *(see Box—Territorial Tax Systems of Other Advanced Economies).*

Territorial Tax Systems of Other Advanced Economies

The major alternative to the "worldwide" tax system used in the United States is a "territorial" tax system, whereby a country typically imposes little or no additional home country tax on active trade or business profits earned abroad when those earnings are remitted home as a dividend to the parent company. Territorial tax systems are also referred to as "dividend exemption" or "participation exemption" systems.

Of the 34 member countries of the OECD, 26 follow a territorial approach, with the remaining eight countries exclusively using the worldwide approach *(see Exhibit 7)*. A 100 percent exemption applies in 18 of the OECD territorial countries, with the other territorial countries applying exemption rates between 95 and 97 percent. The 95 percent exemption typically results in a tax rate of 1 to 2 percent on the foreign dividend in these countries (e.g., in Germany, 5 percent of the dividend is subject to a 30 percent tax rate, resulting in a tax equal to 1.5 percent of the remitted income).

As an example of the operation of a territorial system, a U.K. multinational corporation operating through a foreign subsidiary in China generally pays the same total rate of tax on its earnings in China as do the Chinese subsidiaries of other multinational corporations that are headquartered in other territorial countries.

As a result, under territorial tax systems, all foreign operations located in a given country generally compete on a level playing field with each other, as well as with locally headquartered companies.

Exhibit 7: OECD Home Country Method of Tax on Foreign-Source Dividends When Remitted Home

Method of Taxation	Countries		Dividend Exemption Percentage
Territorial Tax Systems	**OECD Countries with Territorial Tax Systems**		
Exempt foreign-source dividends from domestic taxation through territorial tax system[1]	Australia, Austria, Canada, Czech Republic, Denmark, Estonia, Finland, Hungary, Iceland, Luxembourg, Netherlands, New Zealand, Portugal, Slovak Republic, Spain, Sweden, Turkey, United Kingdom		100% exemption
	Norway		97% exemption
	Belgium, France, Germany, Italy, Japan, Slovenia, Switzerland		95% exemption
Worldwide Tax Systems	**OECD Countries with Worldwide Tax Systems**		
Worldwide system of income taxation with deferral and foreign tax credit	**Country**	**2010 Tax Rate[2]**	
	Chile	17.0%	0% exemption
	Greece	24.0%	0% exemption
	Ireland	12.5%	0% exemption
	Israel	25.0%	0% exemption
	Korea	24.2%	0% exemption
	Mexico	30.0%	0% exemption
	Poland	19.0%	0% exemption
	United States	**39.2%**	**0% exemption**

[1] In general, territorial tax treatment providing exemption of foreign-source dividends depends on qualifying criteria (e.g., minimum ownership level, minimum holding period, the source country and/or the source country tax rate).

[2] Refers to generally applicable tax rate, including surcharges, of combined central and sub-central government taxes.

Source: OECD tax database and PricewaterhouseCoopers, Worldwide Tax Summaries: Corporate Taxes, 2010/11

Of the eight OECD countries that tax worldwide income, the United States has the highest combined tax rate—including state taxes—at 39.2 percent. The other seven countries without territorial tax systems have much lower rates so that when foreign earnings are remitted home to companies headquartered in these countries, little or no additional home country tax may result after foreign tax credits. These countries, excluding Ireland (which has a 12.5 percent tax rate), also undertake little foreign investment (together accounting for less than 2 percent of the world's outward foreign direct investment in 2009). As a result, American companies operating abroad typically face the highest rate of tax on their remitted foreign earnings among competitors from all other advanced economies.

Deferral

Under U.S. tax law, American companies 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. This principle for determining when tax is due is called "deferral." This same principle is used in a domestic context for non-corporate shareholders who receive dividends on shares of stock they own in U.S. corporations; tax is owed by the shareholder on such dividends only when received from the paying company and not at the time the underlying income is earned by the corporation in which they hold shares.

Alternatively, if American corporations were taxed immediately by the United States on the active earnings of their foreign subsidiaries, i.e., without deferral, U.S. tax would be paid on foreign earnings whether or not they were distributed to the U.S. owners. This alternative would require tax payments from shareholders who have received no cash themselves. The current taxation of foreign earnings by the United States in the absence of deferral would reduce the rate of return earned by U.S.-owned foreign subsidiaries. This would raise the cost of capital for American companies relative to their foreign-based competitors. Foreign-based competitors could reinvest their foreign earnings without incurring additional tax, allowing them to grow faster.

Deferral is also the general practice of the seven other OECD countries that do not use a territorial approach to the taxation of active business income, as well as for OECD countries exempting less than 100 percent of foreign-source dividends (e.g., countries that exempt 95 percent of foreign-source dividends generally do not impose tax on active foreign business income until those earnings are paid as a dividend).

Expiring International Provisions

Two temporary provisions of the tax code provide exceptions to Subpart F for active business income which otherwise would be taxed on a current basis (thereby restoring the principle of deferral for such income). These temporary provisions are currently scheduled to expire after 2011. The Administration's FY2012 budget proposes that they be extended into 2012.

- **Active financing income:** Since 1997, deferral has been permitted for "active financing income," defined as certain income derived from the active conduct of banking, finance and insurance. Such income also generally was eligible for deferral prior to 1986. This provision treats active business income of financial companies in the same manner as active income of non-financial companies.

- **"Look through" rule:** Another temporary provision of the code, first enacted in 2006, permits deferral of tax on payments between related foreign subsidiaries where the underlying earnings from which the payments are made are not subject to current U.S. taxation by virtue of arising from active business income. As a result, this provision is said to "look through" the payment to the underlying type of earnings to determine whether it arises from active or passive income. This provision was enacted to provide American companies a greater ability to reallocate foreign earnings among foreign affiliates without incurring additional U.S. tax, and allows American companies to compete more effectively in foreign markets.

While deferral generally applies to most active foreign business income, certain income is taxable on a current basis. Under Subpart F of the Internal Revenue Code, originally adopted in 1962, Congress terminated deferral for certain income believed to be passive or susceptible of being moved out of the United States, defined as foreign base company income (FBCI) derived by U.S.-controlled foreign corporations.[18] 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.

The U.S. anti-deferral regime is far-reaching and extends to certain types of active business income. The current taxation of certain categories of active foreign earnings makes it more difficult for American companies to be competitive in foreign markets with foreign companies and foreign-based multinationals.

Tax Barrier to Repatriation—Even when foreign earnings are not needed for reinvestment abroad, the U.S. worldwide tax system discourages U.S. companies from repatriating this income because of the U.S. tax burden on these remittances. This extra tax can serve to "lock out" foreign earnings from use in the U.S. economy. This disincentive to repatriate foreign earnings has increased over the past two decades as foreign tax rates have fallen, reducing the foreign tax credit that can be claimed against the high U.S. tax rate. A temporary approach enacted in 2004 to address this repatriation barrier permitted taxpayers to elect for one year to bring back foreign earnings to the United States and qualify for a one-time 85 percent dividends-received deduction (for repatriations in excess of historic levels). The special deduction resulted in an effective rate of tax of 5.25 percent on qualifying dividends (i.e., 15 percent of the qualifying dividends were taxable at the 35 percent tax rate). This temporary incentive resulted in $362 billion in foreign earnings being brought back to the United States, of which $312 billion qualified for the special deduction.[19] However, as discussed below, more permanent solutions to these issues need to be addressed.

Reform Proposals—Proposals to reform the current U.S. system include adoption of a territorial tax system like those of other OECD countries, including making other revisions to Subpart F so as not to tax currently active business income, and making permanent the temporary active financing income and look-through exceptions to Subpart F to more closely resemble the tax systems of the rest of the world *(see Box—Expiring International Provisions)*. Reform proposals are discussed in more detail later in this report (see "Fundamental Reform—A Lower Rate, Territorial Tax System").

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 U.S. income tax were fully levied on this income without taking into consideration the foreign taxes already paid, 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 since 1918 has allowed 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." The foreign tax credit is intended to prevent double taxation of the home country, as opposed to credits designed to incentivize certain activities. As described earlier, many countries choose an alternative method of relieving double taxation by exempting foreign dividend earnings from taxation under their territorial tax systems.

The Foreign Tax Credit Calculation

Example: The basic operation of the foreign tax credit can be explained through this numerical example. Assume that an American company earned $1,000 in the United Kingdom and paid $260 of U.K. income tax. U.S. federal income tax on $1,000 would be $350, using the 35 percent federal corporate tax rate (step 1) *(see Exhibit 8)*.

Absent a foreign tax credit, $610 of income tax ($260 in the U.K. and $350 in the United States) would be collected worldwide on this $1,000—a 61 percent tax rate. However, the United States allows the company to take a $260 foreign tax credit for U.K. tax paid (step 2), reducing its U.S. tax to $90 (step 3).

Thus, worldwide tax on $1,000 of income earned in the United Kingdom would total $350 ($260 to the U.K. and $90 to the United States).[20]

Exhibit 8: How the Foreign Tax Credit Works

U.S. Company Earns $1,000 in the United Kingdom

U.S. Tax Before Credit	**$350**
Less credit for U.K. income tax	**-$260**
U.S. tax after credit	**$90**

Note: Total tax is $350: $260 to the U.K. and $90 to the United States.

The Limitations—The credit for foreign taxes may not exceed the U.S. tax on foreign-source income. This ceiling is the "foreign tax credit limitation."

> *Example:* To illustrate the limitation, suppose the foreign tax on $1,000 earned by a U.S. subsidiary is $400, instead of the $260 used in the previous example. In this case, the foreign tax credit is limited to $350—the amount of U.S. tax that would have been imposed on the foreign-source income (before the foreign tax credit). Thus, the U.S. company would pay $400 of tax worldwide ($400 to the foreign country), a greater amount than if the income had been earned in the United States.

The above examples simplify the actual operation of the foreign tax credit limitation rules. The foreign tax credit is calculated in the United States by first grouping similar categories of income together (called "baskets" in tax jargon) before determining the foreign tax credit limitation. Since 2007, foreign tax credit limitations have been calculated separately for a general category of income, passive income and certain other types of income.[21]

Carryovers—Foreign tax credits that are not used currently may be used in the first preceding year or 10 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 the foreign tax credit limitation rules and restrictive sourcing rules (described below) from using credits before they expire, which results in double taxation of foreign earnings.

Source Rules—For purposes of the foreign tax credit limitation, rules are needed to allocate worldwide income, expenses and taxes into U.S. and foreign categories.

Although the rules are complex and there are a number of important exceptions, in general, gross income is sourced to the place where the activity occurred that gave rise to the income, and it is reduced by directly related expenses. Other expenses that are not directly related to U.S. or foreign income are allocated and apportioned between domestic and foreign income. Consequently, a portion of U.S. interest, R&D and general and administrative expenses must be treated as foreign costs and apportioned to foreign amounts of income.

Source Rules Calculation

Example: Suppose that an American company earns $2,000 of income worldwide, with half in the U.S. and half in the United Kingdom. If this company were required to allocate $300 of U.S. interest expense against foreign-source income, the foreign tax credit limitation would be reduced from $350 (35 percent of $1,000 foreign-source income) to $245 (35 percent of $700 foreign-source income after reduction for allocated U.S. interest expense) *(see Exhibit 9)*.

Exhibit 9: How Source Rules Work

U.S. Company Earns $2,000 Worldwide

Income from U.S.	**$1000**
Income from the U.K.	**$1000**
(Less allocated U.S. interest expense)	**(-300)**
	$700
Foreign Tax Credit Limitation	**$245** (35% of $700)
U.K. Income Tax Actually Paid	**$260** (26% of $1000)
Amount of Double Tax	**$15**

Incomplete Crediting and Double Taxation—In the above example, the company's foreign tax credit would be $245, $15 less than the $260 of income tax actually paid in the United Kingdom, resulting in double taxation. The reason double taxation occurs is that no country—including the United Kingdom—allows a deduction for U.S. interest expense allocated to foreign-source income under U.S. rules. Under a provision enacted in 2004 and originally intended to take effect in 2009, the U.S. interest expense allocation rules were to be significantly modified so that most taxpayers would see a reduction in the amount of U.S. interest expense allocated against foreign-source income by taking into account amounts borrowed by foreign subsidiaries. This change has been delayed several times by subsequent legislation and is now not scheduled to take effect for another 10 years (2021).

Transfer Pricing Rules for Determining Income

U.S. tax law requires that taxpayers report income earned on cross-border transactions with related parties by setting appropriate internal prices for these transactions. Transfer pricing is simply the method by which these internal prices are determined. Under current law, transactions between a U.S. parent company and its foreign subsidiaries are required to use the same prices that the parent company and its foreign subsidiaries would use with unrelated companies. This principle of determining internal transfer prices using the same terms as would apply with unrelated companies is known as the "arm's-length" standard.

Arm's-Length Standard—The United States has long championed the use of the arm's-length standard. It has been—and continues today as—the foundation of U.S. and OECD transfer pricing guidelines. The arm's-length standard is a mainstay of corporate income tax policy because it uses the prices that businesses set in transactions with unrelated parties and, thus, best reflects the underlying economics of business operations. It is also the standard used to resolve double taxation issues in all U.S. and numerous foreign tax treaties.

The international use of the arm's-length standard allows for agreement by countries with potentially conflicting interests to use a well-accepted, economically realistic principle for determining the source of income in cross-border transactions between related parties.

If a foreign country followed a different system for determining transfer prices—for example, in an effort to increase tax collected on a local subsidiary of an American corporation—double taxation would result because income earned by the U.S. parent, properly taxable by the United States under the arm's-length standard, would also be subject to tax in the foreign country under this different system. Similarly, double taxation would also result if the United States diverged from the arm's-length standard—for example, taxing a U.S. parent on income that is properly income of a foreign subsidiary. For this reason, it is important that the United States and other countries employ internationally consistent rules in determining transfer pricing.

The transfer pricing system is regularly reviewed and rigorously enforced by the Internal Revenue Service through documentation requirements, audits, advance pricing agreements and the rule-making process.[22] Foreign governments also enforce and monitor transfer pricing to ensure that they collect tax on the proper portion of profits earned in their jurisdictions. While transfer pricing can be complex, there is general consensus among OECD countries that the arm's-length standard provides a better process than alternatives to determine appropriate transfer prices for transactions between related companies.

Analysis of U.S. International Tax Rules

Analysis of U.S. International Tax Rules

U.S. rules for taxing foreign-source income have become increasingly complex and unwieldy at a time when international operations have become essential to the competitiveness of American companies, their American workers and the U.S. economy. The worldwide system of taxation used by the United States for taxing foreign-source income disadvantages American companies competing in the global marketplace. Contrary to the arguments of some, U.S. tax rules do not favor foreign investment. U.S. rules toward foreign investment are far more onerous than those of other advanced economies.

U.S. rules for taxing foreign-source income disadvantage American companies in the global marketplace.

U.S. Rules Limit Competitiveness of American Companies

When American companies operate abroad, they generally face a higher level of tax on earnings remitted home than do their foreign competitors. The extra tax raises the cost to the company of remitting its foreign earnings to the United States; and, by raising the hurdle rate of return on foreign investments, U.S. rules can create a competitive barrier to American companies trying to reach foreign customers. This loss in global market penetration, in turn, can result in a more slowly growing U.S. economy.

As shown in the example on the next page, for operations within the European Union, a foreign-based multinational can earn an average after-tax rate of return that is 26 percent higher than an American company on a comparable investment ($76.8/$60.8) *(see Box—U.S. Worldwide Tax System Uncompetitive with Territorial Systems)*. Even when the American company is the most efficient producer, the difference in tax treatment faced by the American company may make it non-competitive.

American companies can face a tax rate on their remitted foreign earnings a full 16 percentage points higher than the rate faced by their foreign competitors.

The extra tax also makes it more difficult to expand abroad through acquisitions or to make strategic acquisitions of new technologies since competing foreign companies can generally afford to pay more for the target company and still earn their desired rate of return. In the case of an acquisition of an existing foreign operation, under this assumed foreign rate of tax, a foreign multinational acquiror can pay up to 26 percent more than an American acquiror and earn the same or higher after-tax rate of return.

Owing to the disadvantageous tax rules applying to American companies' foreign operations, one study finds that when a U.S. company merges with a foreign company, the U.S. tax treatment of foreign earnings makes it 8 percent more likely to be the target of an acquisition rather than the *acquiror,* after controlling for other factors.[23] As a result, the acquiring foreign corporation can expand outside the United States without being subject to the worldwide tax rules that would apply if the American company were the acquiror. The high U.S. tax rate exacerbates the disadvantage of the U.S.

When an American company merges with a foreign company, the U.S. tax treatment of foreign income makes the American company 8 percent more likely to be the target of an acquisition rather than the acquiror.

worldwide tax system, and continuing rate reductions in the rest of the world further magnify this effect. While tax rules are just one of many factors affecting mergers and acquisitions, cross-border mergers in which American companies were the target of a foreign acquisition averaged $114 billion per year between 2000 and 2009, 42 percent greater than the $80 billion per year in which American companies were the acquiror of a foreign target.[24]

U.S. Worldwide Tax System Uncompetitive with Territorial Systems

Consider an American company seeking to expand operations in the European Union (EU). The average EU corporate tax rate, including state and local taxes, was 23.2 percent in 2010, just slightly higher than the U.K.'s planned 23 percent rate for 2014.[25] Assuming this average tax rate, a foreign multinational company headquartered in a territorial country will face this tax on its active foreign earnings and will owe no additional home country tax when it remits its earnings home.

By contrast, an American company facing this average tax rate on its EU earnings can earn the same after-tax return on its investment as the foreign-based multinational only if it *never* remits its earnings to the United States. If it does remit its foreign earnings, the American company will face an additional 11.8 percent federal tax (35 percent less a foreign tax credit of 23.2 percent) and additional state income taxes averaging 4.2 percent (after accounting for the deductibility of state income taxes). The total tax rate facing the American company on its earnings is 39.2 percent, a full 16 percentage points higher than the rate of tax paid by its foreign competitor on remitted earnings *(see Exhibit 10)*.

Exhibit 10: After-Tax Net Income on Remitted Foreign Income for American Company and Competing Foreign-Based Multinational

U.S.-owned Foreign Subsidiary		Foreign-owned Foreign Subsidiary	
Income	**$100.0**	Income	**$100.0**
Less		*Less*	
Local Foreign Tax	**$23.2**	Local Foreign Tax	**$23.2**
U.S. Tax	**$16.0**	Home Country Tax	**$0**
Net Income	**$60.8**	**Net Income**	**$76.8**

Note: Local foreign tax reflects average national, state and local tax in European Union countries in 2010. U.S. tax assumes 39.2 percent overall tax rate (35 percent federal income tax and average state taxes of 6.47 percent, which are deductible from federal taxes), and assumes foreign tax credit for local foreign income taxes paid.

Restrictions on Deferral

The previous example shows the disadvantage American companies face when they remit foreign earnings to the United States. The same disadvantage arises when an American company earns certain active foreign business income that is taxed currently under the Subpart F rules described earlier. These rules treat certain income of U.S.-foreign subsidiaries as having been distributed for tax purposes even though the U.S. parent company receives no distributions.

Unlike many other countries, the U.S. anti-deferral regime applies to several categories of active income, including sales and services activities of foreign "base" companies and certain oil-related activities. Without temporary exceptions to the Subpart F rules, active income from financial services and certain payments between related foreign subsidiaries would also be taxed currently.

Limitations on Foreign Tax Credit Raise Cost of Investments in the United States

To compute the foreign tax credit limitation, U.S. companies must source their income, expenses and foreign taxes into multiple categories. These rules have a number of anti-competitive impacts that can raise the cost of undertaking investments in the United States:

- American companies must allocate domestic R&D expense against foreign-source income, which can reduce foreign tax credits. By contrast, foreign companies with U.S. subsidiary operations are not subject to a similar requirement. The United States is unusual in requiring allocation of domestic R&D against foreign-source income, and these rules can have the effect of increasing the cost of R&D in the United States.

- Foreign companies can borrow and invest in America through their U.S. subsidiaries at a lower income tax cost than American companies. The United States requires American companies to allocate domestic interest expense to foreign-source income, once again creating the possibility of double taxation. In such cases, American companies face a higher cost of borrowing to finance purely domestic investments than do foreign companies with U.S. subsidiary operations, which 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 was recognized by Congress in 2004 legislation that was originally scheduled to take effect in 2009. However, subsequent legislation has delayed the effect of these new rules until 2021.

Higher Tax Compliance Costs for Foreign-Source Income

American companies pay much more per dollar of economic activity to figure their U.S. tax on foreign income than on domestic income. One 1995 study found that foreign activities account for 39 percent of costs incurred by American companies to comply with federal income tax laws, even though only 21 percent of their assets and 18 percent of their employment is located abroad *(see Exhibit 11)*. While there has been some simplification of international tax rules since 1995, additional complexities have also been introduced, in particular in legislation enacted in 2010.

Researchers have found no such compliance cost differential for European firms.[26] The extra compliance costs are similar to a special tax on foreign-source income paid by U.S. companies, but not by their European-based competitors.

The complexity arises from numerous rules in determining the foreign tax credit and other compliance functions created by U.S. rules that limit deferral.

High Statutory and High Effective Rates of Taxation

Although there is increasing recognition that the United States has a higher *statutory corporate tax rate* than other OECD countries, it is less well known that the *effective tax rate* of American corporations is also generally higher than that of companies headquartered outside the United States. Further, given the continuing reforms taking place around the world, U.S. effective rates are likely to become increasingly higher relative to those of our competitors unless the United States undertakes a reduction in its corporate income taxes.

The United States has high statutory and high effective corporate tax rates.

Statutory tax rates govern the taxation of taxable income after all deductions and, thus, are very important for many business investment decisions. Effective tax rates, in contrast, measure the rate of tax relative to alternative measures of income. "Book" effective tax rates, for example, measure tax payments relative to financial statement income. Both statutory and effective tax rates are important for assessing the overall impact of the U.S. corporate tax system on American companies.

A comprehensive cross-country study of financial statement information conducted by PricewaterhouseCoopers for Business Roundtable finds that among the companies on the Forbes Global 2000 list for 2010, U.S.-headquartered companies had an average financial statement effective tax rate of 27.7 percent over the 2006-2009 period, compared to an average rate of 19.5 percent for their foreign-headquartered counterparts. Companies headquartered in the United States had the sixth highest financial statement effective rate of the 59 countries that are home to companies on the Forbes Global 2000 list. The U.S. effective tax rate was higher than all countries except for Japan (38.8 percent), Morocco (33.9 percent), Italy (29.1 percent), Indonesia (28.1 percent) and Germany (27.9 percent).[27]

Another study examining financial statement effective tax rates by accounting researchers Kevin Markle and Douglas Shackelford finds that worldwide American companies had the second highest effective tax rate among multinationals from all countries over the 2005-2009 study period.[28] Markle and Shackelford estimate the effective tax rate of U.S. multinationals to be 30 percent, with Japan having the highest effective rate at 39 percent. Effective tax rates for multinationals based in other G-7 countries were 26 percent for Canada, 28 percent for France, 29 percent for Germany and 26 percent for the United Kingdom.

Exhibit 11: Higher U.S. Tax Compliance Costs for Income Earned Abroad

Survey of Large U.S. Corporations

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

Source: M. Blumenthal and J. Slemrod, (1995) Other researchers using different methodologies to measure the effective tax rate also find the U.S. rate to be substantially higher than the rate of most other countries. A World Bank study finds the U.S. effective tax rate for a small or medium-sized business to be the third highest in the OECD at 28 percent, about 11 percentage points higher than the average in the rest of the OECD.[29] A study by Kevin Hassett and Aparna Mathur finds high effective tax rates on new investment in the United States, with the U.S. rate being second highest to fifth highest in the OECD, depending on the measure used. In this study, the U.S. rate is higher than the average in the rest of the OECD by 6.5 percentage points to 8.5 percentage points.[30] Similarly, a study by Canadian researchers finds the marginal effective tax rate on new investment in the United States to be the highest in the OECD—about 7.5 percentage points higher than the average for the other members of the G-7 and more than 16 percentage points higher than the average for the rest of the OECD.[31]

One data point that would seem to support the claim of a lower U.S. effective corporate tax rate is that the amount of corporate income tax revenue in the United States as a percentage of GDP is below the OECD average. For example, between 2005 and 2007, corporate taxes as a share of GDP averaged about 3.2 percent in the United States, compared to about 3.8 percent in the rest of the OECD.[32] However, the United States has a substantially greater share of businesses—including larger businesses—that operate in forms not subject to corporate level taxation—including sole proprietorships, partnerships and S-corporations—than do other OECD countries.[33] In total, about half of business income in the United States is earned by businesses that are taxed directly under the individual income tax system rather than the corporate tax system. As a result, comparisons of corporate tax collections with other countries that have a smaller share of business income outside the corporate tax system can be misleading. Accounting for the share of business income in the corporate sector, the United States has a high effective corporate tax rate compared to other OECD countries.

Impact of Corporate Tax on Growth and Domestic Wages

With significant international mobility of capital, as evidenced by the considerable amount of cross-border investment, the impact of U.S. corporate tax rules on economic growth and domestic wages can be significant. Recent research by the OECD concludes that the corporate income tax has the most adverse impact on economic growth of any tax.[34]

In a 2005 study, the Congressional Joint Committee on Taxation compared individual income tax reductions and corporate income tax reductions and concluded that a reduction in the corporate income tax had the greatest impact on increasing long-term economic growth, due to increased capital investment and increased labor productivity.[35]

High rates of tax on corporate income discourage investment, reduce worker productivity through a smaller capital stock and cause wages to decline since workers are less productive.

Because of the effect of the corporate income tax on capital investment and wages, a significant part of the corporate income tax is more appropriately viewed as a tax on labor—and not primarily a tax on the owners of capital, including shareholders.

A study by the Congressional Budget Office estimates that 70 percent of the burden of the U.S. corporate income tax is borne by American workers in the form of lower wages, with the remaining 30 percent borne by Americans through a reduced rate of return on their savings.[36]

Other OECD countries generally rely on income taxes to a smaller extent than the United States as a source of revenues, with a greater share collected through general consumption taxes. The United States is the only OECD country without a national-level consumption tax.[37]

Administration's FY2012 International Tax Proposals Would Adversely Impact American Companies

U.S. tax rules for foreign earnings already provide a significant disadvantage for American companies competing in the worldwide marketplace. Tax proposals included in the Administration's budget released in February 2011 would increase the tax costs of operating in foreign markets and would have unintended consequences that would reduce the international competitiveness of American companies.

The proposals include policies to:

- **Limit the ability to claim current deductions for U.S. interest expense:** The proposal would disallow a current deduction for a portion of U.S.-incurred interest expense when a company does not remit all foreign earnings to the U.S. parent. Disallowed deductions would be suspended into the future and, in some cases, lost entirely. The proposal would raise the cost of borrowing to finance U.S. domestic plants and facilities for worldwide American companies, thereby discouraging these domestic job-creating activities.

- **Limit the ability to claim foreign tax credits:** (1) Under present law, the foreign tax credit on foreign earnings remitted from foreign subsidiaries is based on the actual foreign tax paid on these earnings. The proposal would reduce the foreign tax credit to an average rate of foreign tax paid on total foreign earnings, including foreign earnings not subject to current U.S. tax. By reducing the foreign tax credit available on dividend remittances, the proposal would further discourage bringing these earnings back to the U.S. economy. (2) Under present law, taxpayers subject to special income taxes (so-called dual capacity taxpayers) cannot claim a foreign tax credit for a tax payment unless they can prove that such taxes are, in fact, income taxes (under U.S. definitions) and that no portion of these amounts are for some other governmental benefit (such as a mineral royalty). Under the Administration's proposal, even where a taxpayer could meet these enhanced burdens, it would still be denied treatment of such taxes as "creditable" income taxes, thereby resulting in double taxation.

- **Repeal deferral for "excess" profits earned abroad:** The proposal would tax worldwide American companies on certain so-called "excess" profits earned by a foreign subsidiary when intangible property had previously been transferred to the subsidiary, including transfers fully in compliance with the arm's-length standard. The proposal would discourage U.S. companies from undertaking R&D and developing intangible assets in the United States because "excess" income earned from the transfer of these assets could be subject to immediate U.S. taxation.

At the very time that the home countries of our major foreign competitors are moving forward with tax plans to enhance the international competitiveness of their companies and workers, the Administration's proposals would move in the opposite direction, further undermining the ability of American companies and their workers to compete.

Fundamental Reform— A Lower Rate, Territorial Tax System

Fundamental Reform—A Lower Rate, Territorial Tax System

It is clear that the current U.S. corporate tax system is uncompetitive and is reducing the potential of the U.S. economy and workers. The U.S. tax system is an outlier relative to the tax systems of our trading partners, imposing a high rate of tax and a worldwide system of taxation that causes American companies to be less globally competitive. This results in less investment in the United States and a more slowly growing economy with fewer job opportunities for American workers. Changes in tax policy that provide a level playing field for American companies can create the proper conditions for more robust job creation in the private sector, increased capital formation, greater exports and sustained economic growth to provide a higher standard of living for American workers.

"The current tax code saps the competitiveness of U.S. companies. Tax reform should make the United States the best place for starting and building businesses. Additionally, the tax code should help U.S.-based multinationals compete abroad in active foreign operations and in acquiring foreign businesses."

President Obama's National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*

Since 1988, the average OECD corporate tax rate (excluding the United States) has fallen by 19 percentage points. Over the same period, the U.S. federal rate increased by one percentage point. The combined federal and state corporate tax rate in the United States is now 14 percentage points higher than the OECD average and 16 percentage points higher than the average of the European Union. At the same time, the United States is the only G-7 country, and one of the few OECD countries, that has not adopted a territorial tax system to allow foreign earnings to be brought back for reinvestment in the domestic economy with little or no additional home country tax. The U.S. system is globally uncompetitive at a time when international competition has never been greater for American companies.

National Commission on Fiscal Responsibility and Reform. The President's National Commission on Fiscal Responsibility and Reform—chaired by Erskine Bowles and Alan Simpson—recommended corporate tax reform in their report to improve the competitiveness of American companies.[38] The recommendations included: (1) reducing the federal statutory corporate tax rate from 35 percent to a range between 23 percent and 29 percent, and (2) adopting a territorial tax system like those of our trading partners to help American companies compete in foreign markets. The Commission report noted that the failure to adopt these reforms would lead to a loss of U.S. competitiveness, reduced investment in the United States by both American and foreign corporations, reduced innovation in the United States and the sale of American businesses to foreign headquartered multi-nationals. Lower statutory rates and a territorial tax system were also recommendations of President Obama's Export Council.[39]

The Need for a Competitive International Tax System. The adoption by the United States of significantly lower corporate tax rates and a territorial tax system would serve to level the playing field for American companies. Lower rates would increase the attractiveness of the United States for investment, and a territorial system would allow foreign earnings of American companies to be brought home for reinvestment in the U.S. economy without the "lock-out" effect of current law. Expansion abroad by American companies is vital for establishing export platforms for U.S.-produced goods and expanding the scope of domestic investments in R&D and other activities. A territorial system would also reduce the likelihood that American companies would be acquired by their foreign competitors simply because their foreign competitors could grow their operations more tax-efficiently.

In considering the design of a territorial tax system for the United States, it is important to follow the general practice of our trading partners so as to provide a level playing field for American corporations. These systems generally provide for 100 percent, or in some cases 95 percent, exemption from tax for dividends paid from active foreign earnings. In particular, the territorial tax systems of other OECD countries—by design or practice—generally do not deny deductions for overhead activities that indirectly relate to the foreign operations. Further, while some countries tax passive foreign income on a current basis, such income in practice generally is defined more narrowly than current U.S. Subpart F rules, thereby permitting a more complete exemption for active business income.[40]

R&D and Innovation. Further, in recognition of the importance of R&D and other innovative activity in spurring economic growth—and given the international mobility of intangible capital—many countries seek to provide incentives for the creation and retained ownership of intellectual property (IP). A recent OECD study places the United States 24th out of 38 OECD and advanced-emerging economies in terms of the competitiveness of its R&D incentives.[41] While this OECD study only measures the tax incentives provided for R&D, a number of countries also provide incentives to encourage the domestic ownership of IP through "innovation boxes," which provide for reduced rates of tax on royalty income generated by IP. Eight OECD countries currently have such special tax regimes for intellectual property. The United Kingdom recently announced its intention to adopt such a regime for patents effective in 2013. As economic growth is increasingly dependent on leading through innovation, the United States must take action to stay ahead.

Capital Formation. Greater capital formation through increased investment in plants and equipment results in increased worker productivity and higher wages for American workers. In addition to increasing the total amount of capital used by workers, new investment also allows new productivity-enhancing technologies to be incorporated in the production process. Without continuing new investment in the United States, the use of these state-of-the-art technologies will lag their use in other countries, and American workers will be less competitive. A pro-growth tax system that encourages capital investment in the United States is key to improving living standards for American workers.

Continuing Focus on Competitiveness in the Rest of the World. The rest of the world is continuing to make their corporate tax systems more competitive.

- Japan has proposed a 5 percentage point reduction in its corporate tax rate effective in 2011.
- The United Kingdom has announced it will lower its corporate tax rate from 28 percent to 26 percent in 2011, and it has proposed further annual reductions in the next three years to bring the rate down to 23 percent in 2014.
- Canada has reduced its federal rate in stages from 22 percent in 2007 to 18 percent in 2010; it has fallen still further to 16.5 percent in 2011 and is scheduled to reach 15 percent in 2012. Reductions by many Canadian provinces in their tax rate lead to still further overall declines.
- Other OECD countries have proposed or enacted corporate rate reductions as well.
- Similarly, the adoption of territorial tax systems by the United Kingdom and Japan in 2009 removed a barrier to the remittance of foreign earnings for use in their domestic economies and eliminated disadvantages their multinationals faced when competing in foreign markets.

It is now time for the United States to undertake corporate tax reform to enhance the growth of the U.S. economy and provide for an increased ability of American companies to be internationally competitive.

Conclusion

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 American companies compared to their foreign counterparts. With growing world economic integration, the shortcomings of U.S. international tax policy are now magnified.

U.S. tax rules can make the United States an unattractive place to locate the headquarters of a multinational corporation. This has led to a variety of cross-border transactions that result in U.S.-based companies becoming foreign-headquartered companies. Following such a transaction, 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. New startups can also avoid the U.S. worldwide tax system by incorporating outside the United States, and there is evidence of an increasing number of initial public offerings taking this form.[42] These transactions are one visible negative consequence of an uncompetitive U.S. tax system, but there are other less visible consequences as well. The most pernicious is a more slowly growing U.S. economy as a result of less internationally competitive American corporations.

The time has come to consider fundamental changes to the U.S. tax system. The need for American corporations and workers 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.

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