Business Roundtable℠

Facts About Tax

International Tax: A Primer

U.S. tax rules significantly affect the ability of globally engaged American companies to compete in foreign markets. These rules include a provision known as "deferral," which is a key pro-competitive international tax rule for American companies.

What does "deferral" mean?

- The United States generally does not tax an American company on the active foreign income of its separately incorporated foreign affiliates *until* those earnings have been paid, typically as a cash dividend to the parent company.
- Because the parent company may delay payment of U.S. tax until it has received the foreign income as a dividend, this method of taxation permits deferral of U.S. tax.
- Deferral provides a measure of comparability between taxes on the foreign operations of American and foreign-based international companies. All OECD members and other major developed countries that tax the worldwide earnings of their international companies permit some form of deferral.
- This method of taxation mirrors the tax treatment of individual shareholders in a domestic corporation who are not taxed on the income the corporation earns until it is paid by the corporation to the shareholder as a dividend.
- In addition, continuing the above comparison to individual shareholders in a domestic corporation, even though the individual shareholder is not subject to tax on the earnings of the domestic corporation until receiving a dividend distribution, the domestic corporation is subject to current U.S. tax on its U.S. income. In the foreign context, the foreign subsidiary is subject to current taxation on its earnings in the country in which it operates. Earnings not paid out as dividends by the foreign subsidiary are reinvested to expand foreign operations.

Worldwide systems of taxation

- U.S. tax rules follow a principle of "worldwide taxation," under which a U.S. company is subject to U.S. tax on its worldwide income no matter where the income is earned. This includes the income of any separately incorporated foreign affiliates. As described above, U.S. taxation of the active income of a U.S.-owned foreign subsidiary is generally deferred until those earnings have been paid to the U.S. parent.
- Because foreign countries also tax the profits arising from the foreign operations of American companies, the United States provides a foreign tax credit for the income taxes paid to foreign governments by the parent company and its foreign affiliates in order to prevent double taxation.
- Countries not following a system of worldwide taxation with deferral use an "exemption" or "territorial" system, under which the active earnings of foreign subsidiaries are exempted from tax in the home country of the parent company.
- 28 of the 34 OECD member countries follow an exemption system of taxation, while just five others follow the United States in using a worldwide system of taxation with deferral.

- In considering a U.S.-owned foreign subsidiary competing against a foreign-owned foreign subsidiary operating in the same country, the U.S. system of worldwide taxation with deferral generally results in the U.S. subsidiary paying the same rate of tax on its operations as paid by the foreign-owned subsidiary while those earnings remain reinvested. This permits globally engaged American companies to compete against foreign-based companies taxed under either deferral or exemption systems.

The United States imposes some limits on deferral

- The U.S. does not permit deferral for certain types of foreign income under subpart F of the Internal Revenue Code. Such income (so-called "subpart F income") is deemed automatically distributed to the U.S. parent and immediately subject to tax. Subpart F income includes passive income (e.g., dividends and interest) as well as certain active income earned by foreign subsidiaries.
- For instance, when a U.S.-owned foreign subsidiary operates a centralized distribution facility for sales to bordering countries, income earned on such sales is not eligible for deferral if the property was originally imported from another subsidiary within the parent group. This rule handicaps U.S. companies with distribution facilities serving multiple countries as they must pay additional tax compared to their foreign competitors. This additional tax burden may make U.S. exports non-competitive in certain markets.
- Other countries that have limitations on deferral generally do not extend these limitations to active business income due to the harmful effects on competition from the higher effective rate of tax resulting from the acceleration in tax payments. No other country has restrictions on deferral for active income as extensive as the United States.

Further limitations on deferral would disadvantage U.S. companies and their employees

- Further limitations on deferral would increase U.S. tax on the foreign earnings of U.S. companies and competitively disadvantage U.S. companies at the expense of foreign-based companies. Foreign companies would continue to be eligible for deferral or exemption in their home countries and be subject to current tax only in the host country location.
- Further limitations on deferral would impose higher taxes on globally engaged American companies, allowing their foreign-based competitors to reinvest more, expand faster, and sell their products at lower prices than their U.S.-owned competitors.
- Over time, globally engaged American companies would be unable to profitably compete against foreign corporations, leading to reduced employment and lower wages for American workers at U.S. companies.

For a list of source documents and additional research, please see the Business Roundtable fact sheet, "Further Reading on International Tax Issues."

Let's maintain the foundation for sustained economic growth.
Business tax policy must promote U.S. international competitiveness.

300 New Jersey Avenue, NW Suite 800 • Washington, DC 20001 • www.brt.org

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