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The Importance of Tax Deferral and A Lower Corporate Tax Rate

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Introduction

The Congress and Administration decided to postpone action on major changes in international tax rules until this year.[1] While the preoccupation with health care reform was undoubtedly a major factor, the concern that the Administration's proposals might undermine the competitiveness of U.S. companies operating abroad was also reported to be a major consideration.

The main tax provision targeted for repeal by critics in the Administration and the Congress is what's called deferral, the ability of U.S. multinational corporations to defer tax liability on active foreign earnings until those earnings are repatriated to the United States. Both the Obama Administration and Chairman Rangel have proposed to limit deferral of U.S. tax on active foreign earnings.

The premise underlying this policy shift is that taxing U.S. multinational corporations on their worldwide income would remove any incentive for firms to keep foreign earnings abroad. That is, it would remove any bias that favors foreign production over domestic production.

Key Findings

- *The United States is the only large economy that taxes corporate income worldwide with a tax rate exceeding 30 percent.*
- *During 2009, both Great Britain and Japan enacted territorial systems, giving their multinationals a major tax advantage over U.S.-based firms that are saddled with a worldwide system. Over 80 percent of developed nations now have territorial systems.*
- *Whether the U.S. moves to strengthen its worldwide system by repealing deferral or follows the international trend by adopting a territorial system, there will be unfortunate incentives created. In both cases, though, lowering our corporate tax rate will mitigate them.*
- *A reasonable upper-bound target might be a combined federal-state rate of roughly 25 percent, implying a federal corporate tax rate of roughly 20 percent.*

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1 *Wall Street Journal*, October 14, 2009, p.A19.

This approach, however, fails to recognize that, with the U.S. corporate tax rate as high as it is, U.S.-based multinational corporations operate at a distinct tax disadvantage, and deferral is the principal provision that makes the differential tolerable. Over the past two decades, our trading partners reduced their corporate tax rates repeatedly, growing the gap between their low rates and the high U.S. rate, increasing the importance of deferral immensely.

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Another tax reform trend abroad has been a shift towards territorial tax systems. In those systems, a country only taxes active income earned within its borders. As the U.S. approach of taxing worldwide income loses favor internationally, the Administration's preference for strengthening the worldwide approach threatens to further undermine the competitiveness of U.S. firms operating abroad. Over 80 percent of OECD nations now have territorial systems; only half of them had territorial systems a decade ago. During 2009, both Great Britain and Japan switched from worldwide to territorial systems. This has left the United States in the position of being the only large economy with both a worldwide system and a corporate tax rate exceeding 30 percent.

But whether the U.S. reforms its international tax system by following the territorial trend or by strengthening its worldwide system, all parties need to more fully recognize the importance of the high U.S. corporate tax rate. It is increasingly an outlier on the international scene, and tax reform proposals that do not reduce it will not substantially improve the position of U.S.-based firms.

How Does the U.S. Tax International Income?

Countries tend to base the taxation of active foreign earnings on one of two alternative approaches: a territorial system, or a worldwide system. Under a territorial system, tax is paid on income only where it is earned, regardless of where a taxpayer may reside.[2] Under a worldwide system, all income is subject to tax in the home country, regardless of where in the world the income is earned. Income earned abroad is, of course, usually subject to tax by the country where it is earned. On the principle that the same income should not be taxed by more than one country, foreign tax is generally creditable against domestic tax on foreign income up to the domestic tax rate.

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The U.S. system for taxing foreign earnings blends aspects of both a worldwide and territorial system. U.S. multinational corporations are taxed on their worldwide income. However, active earnings are generally not taxed until repatriated to the United States, at which time the U.S. corporate income tax must be paid minus credits claimed for foreign taxes paid. Thus, U.S. tax is generally deferred on active business income. The option of deferral combines with the high U.S. corporate rate to create an incentive for firms to hold their active income earned abroad overseas.

This system reflects the tension between two often conflicting policy goals. We do not

2 Certain passive or financial income from abroad, such as royalties, also is subject to tax in the country of residence.

want our tax law to favor foreign production over domestic production, and at the same time we do not want to put U.S. companies with foreign operations at a disadvantage when they compete abroad with foreign companies. The compromise that we have operated under for many years is to tax U.S.-based firms on their worldwide income, with double taxation mitigated by the foreign tax credit, but to permit them to defer tax liability on active earnings abroad until those earnings are repatriated to the United States.

Two related trends have increased this tension. First, with the increased globalization of the world economy capital has become more mobile. With this increase in capital mobility, differences in tax systems have become more important. At the same time, and perhaps because of greater capital mobility, most countries (aside from the United States) have reduced their corporate tax rates, and, in some cases, substantially (see sidebar on page 5 for a discussion of the trend toward lower corporate tax rates).

The Importance of Deferral

As described above, tax deferral is simply a result of the United States's realization-based system: Active foreign earnings are deferred from taxation until the earnings are repatriated, that is, remitted back to the United States.[3] This feature distinguishes the U.S. system from a *pure* worldwide system where all foreign source income would be taxed currently (i.e., no deferral).

Deferral has the effect of relieving a substantial portion of the U.S. tax, in present value terms, on the income of foreign subsidiaries of U.S. companies. By lowering the effective tax on foreign earnings, deferral "favors" income earned in low-tax countries relative to the United States. Moreover, as corporate tax rates abroad have fallen while the U.S. rate has not,[4] the benefits of deferral have grown.

At the same time, deferral helps maintain the competitiveness of U.S. companies operating abroad. Consider a U.S. corporation operating in a country with a territorial system. The income of the U.S. subsidiary will be subject to the foreign country's corporate income tax. A foreign corporation operating in that same country will also be taxed on its earnings in that country. If the U.S. multinational corporation were taxed on a worldwide basis without deferral, the U.S. company would find itself at a disadvantage relative to its competitors because of the high U.S. corporate tax rate. Tax deferral, in effect, helps place U.S. companies on a more equal footing by lowering the U.S. tax on income earned abroad.

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How does this work in practice? Consider a foreign subsidiary of a U.S. multinational corporation competing with a German corporation in Poland where the corporate tax rate is 19 percent. The U.S. firm's Polish subsidiary pays the 19 percent Polish tax rate, and then it must pay U.S. federal and state taxes, taking a credit for Polish taxes paid. The combined federal-state U.S. tax rate is 39.1 percent (35 percent federal plus the average state rate of 4.1 percent after accounting for deductibility) so the additional tax paid in the U.S. is substantial. In contrast, the German subsidiary is subject to the German territorial regime. Thus, the German subsidiary only pays the 19 percent Polish tax rate.

Under the current U.S. tax system, the U.S. firm does not have to pay the higher U.S. tax rate until active foreign earnings are

3 It is also important to recognize that deferral is not unique to the U.S. system for taxing international income. Most countries that tax foreign earnings on a worldwide basis do not tax foreign earnings until such income is repatriated back to the home country. In the context of the current policy discussion, repeal or limitation of U.S. companies' ability to defer foreign earnings would move the U.S. against the international norm, not towards it.

4 In 1993, the top corporate statutory tax rate was increased from 34 percent to 35 percent. The top effective rate on certain production activities was reduced from 35 percent to 32 percent by the so-called manufacturing deduction enacted in 2004.

repatriated back to the United States. This helps level the playing field. However, without deferral it is easy to see why the U.S. firm might be disadvantaged: It faces a tax rate that is potentially *twice* that of its competitors in Poland.

This example can be generalized to all countries with territorial tax systems and lower tax rates than the United States. While this may not have been so much of an issue when the United States had a relatively low tax rate back in the late 1980s, its very high tax rate today (see sidebar on page 5) combined with the increasing number of countries moving to territorial systems means that U.S. companies will face more competition from foreign companies.

Two decades ago, roughly one-half of developed nations relied on worldwide tax systems, but today, as shown in Table 1, only a handful of worldwide systems remain. During 2009, both Great Britain and Japan enacted territorial systems.

Table 1
Territorial vs Worldwide Treatment of Active Foreign Earnings

Territorial (Exemption)	Worldwide (Foreign Tax Credit)
Australia*	Ireland
Austria	Korea
Belgium	Mexico
Canada*	Poland
Czech Republic	United States
Denmark	
Finland	
France**	
Germany	
Greece*	
Hungary	
Iceland	
Italy**	
Japan	
Luxembourg	
Netherlands	
New Zealand	
Norway	
Portugal*	
Slovak Republic	
Spain	
Sweden	
Switzerland	
Turkey	
United Kingdom	

*Exemption by treaty agreement.
**Exemption of 95 percent.
Sources: President's Advisory Panel on Federal Tax Reform (2005) with modifications by the author; Lyon, Andrew. "Designing the U.S. Corporate Tax System for the 21st Century -- Some Real-World Considerations," in Proceedings of the 101st Annual Conference on Taxation, 2008, Washington, D.C.: National Tax Association, pages 272-275.

More Fundamental International Reforms

With the dramatic reduction in corporate tax rates abroad, which direction should the U.S. take: following the international trend by adopting a territorial/dividend exemption system, or making our worldwide system more pure by repealing deferral?

While a territorial system eliminates repatriation taxes, it generally results in the full taxation of royalties and the allocation of expenses to income… As the U.S. Treasury's 2007 Competitiveness Report notes, for example, territorial systems generally raise substantial revenue overall.

Consider a territorial tax system. As described above, a territorial system would completely exempt active foreign income from U.S. tax. U.S. companies would be placed on a completely level playing field with their foreign competitors, but foreign production in low-tax-rate countries would be favored over production here in the United States. While the incentives at one margin are improved, the incentives at work for the other margin are worsened.

At first glance, it might seem that the competitiveness of U.S. companies cannot be improved without also shifting the balance towards foreign production. However, combining a territorial system with a lower U.S. corporate tax rate would help alleviate the shift towards foreign production.

Now consider a pure worldwide system. As described above, a pure worldwide system would subject all foreign earnings to U.S. tax currently; that is, deferral would be repealed.

The U.S. Corporate Tax Rate is Increasingly Out-of-Line Internationally

The U.S. corporate tax rate has remained largely unchanged since its reduction from 46 percent to 34 percent under the Tax Reform Act of 1986.[1] In contrast, since 1988 the average corporate tax rate for OECD nations has fallen by 33 percent (weighted) and the tax rates for the larger G-7 nations has fallen by 35 percent (weighted).[2]

The gap between the U.S. and other countries continues to widen. Between 2008 and 2009, four OECD countries lowered their corporate tax rates: Canada, the Czech Republic, Korea and Sweden.

While in 1988 the U.S. corporate tax rate was 11.89 percentage points below the average G-7 rate (weighted), by 1998 the U.S. rate was just 5.36 percentage points below the average G-7 rate (weighted), and by 2009 the U.S. rate was 5.44 percentage points above the G-7 average (weighted) (see Table 2).[3]

Today, the U.S. combined federal-state statutory corporate tax rate is 39.1 percent, well above the weighted average of 31.01 percent for member nations of the OECD[4] (excluding the U.S.) and the weighted average of 33.65 percent for the larger G-7 countries (see Table 2).[5] Moreover, now the U.S. corporate tax rate is only exceeded by one OECD member nation, Japan.

An alternative policy approach to reforming the corporate tax base would be for the U.S. to simply lower its corporate rate. This would reduce the tax benefits of deferral and the tension between our contradictory desires to keep U.S.-based firms competitive and yet not to favor foreign production. The failure of the U.S. to keep pace with the falling corporate tax rate abroad has accentuated tensions in the U.S. system for taxing international income.

Table 2
Statutory Corporate Tax Rates for OECD Countries, 2009
(Combined Central and Subnational)

OECD Country	Statutory Corporate Tax Rate
Australia	30.0
Austria	25.0
Belgium	34.0
Canada	31.3
Czech Republic	20.0
Denmark	25.0
Finland	26.0
France	34.4
Germany	30.2
Greece	25.0
Hungary	20.0
Iceland	15.0
Ireland	12.5
Italy	27.5
Japan*	39.5
Korea	24.2
Luxembourg	28.6
Mexico	28.0
Netherlands	25.5
New Zealand	30.0
Norway	28.0
Poland	19.0
Portugal*	26.5
Slovak Republic	19.0
Spain	30.0
Sweden	26.3
Switzerland	21.2
Turkey	20.0
United Kingdom	28.0
United States	39.1
G-7 Weighted Average (Excluding U.S.)	33.7
OECD Weighted Average (Excluding U.S.)	31.0

Source: Organisation for Economic Cooperation and Development (www.oecd.org).

1 The Tax Reform Act of 1986 also repealed the investment tax credit. In 1993, the top statutory federal corporate tax rate was increased from 34 percent to 35 percent.

2 Weighting the statutory corporate tax rate by gross fixed capital formation accounts for differences in the size of the respective nations' economies. Such weighting is customary when making such comparisons. For example, see U.S. Department of the Treasury, *Approaches to Improve the Competitive of the U.S. Business Tax System for the 21st Century*, December 20, 2007, Chart 1.1 (p.11).

3 The same trends hold for member nations of the OECD. In 1988, the U.S. had a corporate tax rate 9.98 percentage points *below* the OECD average (weighted), but by 1998 the U.S. rate was only 2.41 *below* the OECD average (weighted), and by 2009, the U.S. was 8.08 percentage points *above* the OECD average (weighted).

4 The calculations are for the 22 OECD nations for which data are consistently available for the full 1982 through 2009 period. The average weighted tax rates are weighted using gross fixed capital formation. The weights for 2007 though 2009 were based on 2006 figures.

5 Some have criticized the focus on the statutory corporate tax rate in making international comparisons, but these trends are emblematic of more fundamental changes in corporate tax systems among developed nations. A recent analysis of effective marginal tax rates, which accounts for the major features of each country's business tax system — the corporate tax rate, the depreciation system, investor-level taxes, and other considerations — reached similar conclusions.

This would treat domestic and foreign production the same, but it would place U.S. companies operating in low-tax countries at a competitive disadvantage. However, combining a worldwide system with a lower U.S. corporate tax rate would help mitigate the effect of repealing deferral on the competitiveness of U.S. firms.

From this perspective, there are clear tradeoffs in moving in either direction. But the theme that emerges is that the harmful economic effects of either approach can be addressed by lowering the U.S. corporate tax rate. Indeed, the high corporate tax rate may well be more of an issue than the choice between the territorial and worldwide systems.

There are other important economic decisions that distinguish the choice of territorial or worldwide taxation. For example, where companies should exploit intangibles, locate income and expenses, and the form of finance are all influenced by the choice of a territorial or worldwide system. Either approach involves tradeoffs with the best policy depending upon the relative economic importance of the various decisions.

While a territorial system eliminates repatriation taxes, it generally results in the full taxation of royalties and the allocation of expenses to income. Royalty income is currently highly sheltered from tax because companies are able to use excess foreign tax credits to shield royalties from tax. As the U.S. Treasury's 2007 Competitiveness Report notes, for example, territorial systems generally raise substantial revenue overall because royalty income is, in effect, brought back into the tax base.

A territorial system may increase the role of taxes in the crucial decision of where companies locate income and expenses, putting additional pressure on transfer pricing and choices regarding the form of finance. In contrast, a worldwide system is more neutral across these dimensions, but at the current U.S. corporate tax rate a pure worldwide system would severely undermine the competitiveness of U.S. firms.

Moving Forward with Fundamental Corporate Tax Reform

Two questions arise for fundamental corporate reform: (1) How low does the United States need to set its corporate tax rate to allay the competitiveness concerns under a worldwide system or to address the distortionary effects of a territorial system, and, (2) Could such a reduction be financed within the corporate income tax base?

While it is beyond the scope of this report to suggest at what corporate tax rate the various tradeoffs would be appropriately balanced, a reasonable starting point might be a reduction of the corporate tax rate to the average that prevails among our major trading partners.[5] This would appear to be in the range of 26 percent to 31 percent, the average that prevails amongst OECD member nations and the larger G-7 economies. Thus, a federal corporate income tax rate in the range of 20 percent to 25 percent, when combined with the 6 percent state corporate tax rate that prevails, on average, would appear to be appropriate.[6]

The substantial tax competition that exists at the international level, as evidenced by the dramatic reduction in corporate tax rates over the past two decades, also needs to be considered when deciding on the target rate for the United States. Thus, if the United States were to substantially reduce its corporate tax rate, some other countries would likely follow suit. In anticipation of this likely trend, the target rate for the United States may well be set somewhat below the current averages. Thus, one could speculate that a reasonable upper-bound target might be a combined federal-state rate

5 Using 2002 data, Altshuler and Grubert (2006) estimated that a burden neutral worldwide system could be implemented at a 28 percent corporate tax rate. Note that since 2002, corporate tax rates abroad have fallen by 11 percent for the G-7 and 12 percent for the OECD.

6 Another consideration is whether the tax rate applied to the earnings of firms in the non-corporate sector would also need to be lowered. Generally, a reasonable policy objective might be to keep the overall effective rate of tax on investment in both the corporate and non-corporate sectors close to parity, after taking into all features of the tax system, including the form of finance and the double tax on corporate profits. It would seem that a modest reduction in the tax rate applied to the net income of flow-through entities would be warranted.

of roughly 25 percent, implying a federal corporate tax rate of roughly 20 percent.

How much would such a 15 percentage point reduction in the federal corporate income tax rate cost? Under normal economic circumstances, the corporate income tax raises roughly $350 billion per year. With the current definition of the tax base, a one percentage point reduction in the corporate tax rate would cost roughly $15 billion annually or $150 billion over the ten-year budget window.

Assuming that revenue-neutral reform is politically imperative, where could this revenue come from? The first place to look might be a broadening of the corporate tax base. That is, we could eliminate various tax provisions that narrow the tax base and require a higher tax rate on those who pay tax. Unfortunately, such base broadening does not yield sufficient revenue. The Treasury Department's 2007 Competitiveness Report found elimination of virtually all special tax provisions, except for accelerated depreciation, would generate roughly $650 billion in revenues, which only allowed the corporate tax rate to be lowered to 31 percent.

Some additional revenue would arise from the international tax changes that, in effect, broaden the business tax base by either shifting to pure worldwide taxation, which eliminates deferral, or to a territorial system, which would fully tax royalties and require the allocation of expenses to income. These changes might allow the corporate tax rate to be lowered by 1 or 2 additional percentage points. But an obvious point is that eliminating many of the politically popular special business tax provisions is highly unlikely and the so-called international tax base broadeners might well be diluted through the political process.

Conclusion

One conclusion becomes exceedingly clear: Lowering the U.S. corporate tax rate to a level that would be economically meaningful requires substantial additional revenue from outside the corporate income tax base. As pointed out by Altshuler and Grubert (2006), such dramatic changes would likely require a shift between the individual and business sides of the income tax. As they point out, such a rebalancing can be justified due to the increase in capital mobility resulting from the globalization of the world economy and the associated difficulty of taxing capital income.

Another aspect of fundamental reform is the trends that are emerging abroad. As discussed above, not only has there been a dramatic reduction in corporate tax rates, but there has also been a shift toward territorial systems. Although the worldwide approach was once dominant, five out of every six OECD nations now have territorial systems. Both Great Britain and Japan recently switched from worldwide to territorial systems. This means that the United States remains the only large economy with both a worldwide system and a corporate tax exceeding 30 percent. It is the combination of the high U.S. corporate tax rate and the shift abroad towards territorial systems that is especially problematic to the competitiveness of U.S. companies.

While the Obama Administration and the Congress consider changes to the international tax system, they need to not only consider how the tax system affects the incentive for foreign production over domestic production, but also the competitiveness of U.S. companies operating overseas. Tax deferral is a crucial feature of the current tax system that helps place U.S. companies on a more level playing field with their foreign competitors.

More fundamental changes to the U.S. system for taxing international income point to the problem of the very high U.S. corporate tax rate. Moving to either a pure worldwide system or a territorial system is problematic in the face of the high U.S. corporate tax rate. Lowering the corporate tax rate will likely involve a rebalancing of the revenue paid by the business and household sectors. This change can be viewed in a positive light given the increased globalization of the world economy and increased capital mobility.

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