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Ten Reasons the U.S. Should Move to a Territorial System of Taxing Foreign Earnings

*By
Scott A. Hodge
President
Tax Foundation*

Introduction

There is a growing debate in Washington over how U.S. companies should be taxed on the profits they earn abroad. The outcome of this debate will determine how well U.S. workers and companies can compete in the ever-changing global economy.

Currently, the U.S. has a worldwide tax system, which means business income is taxed at the U.S. rate no matter where it is earned – at home or abroad.[1] However, companies can defer paying U.S. tax on active foreign income until it is brought home.

Ten Reasons the U.S. Should Move to a Territorial System of Taxing Foreign Earnings

1. *Parity. The U.S. system must be aligned with our global trading partners.*
2. *The experiences of Japan and Great Britain are lessons for the U.S.*
3. *The premise of the worldwide tax system – capital export neutrality (CEN) – is obsolete when subsidiaries have access to global capital markets and can self-fund their expansion with retained earnings.*
4. *The worldwide tax system violates the benefit principle of taxation.*
5. *The U.S. maintains a territorial tax system for foreign-owned companies but a worldwide system for U.S. companies. Moving to a full territorial system will level the playing field.*
6. *The compliance cost of the current system is excessively high relative to companies' foreign activities and the revenues raised from taxing foreign-source income.*
7. *Our current system traps capital abroad – the "lockout" effect.*
8. *Our high corporate tax rate and worldwide system makes it cheaper for companies to take on debt rather than use their own profits to fund their growth.*
9. *The current system dissuades global companies from headquartering in the U.S.*
10. *Eliminating deferral nearly killed the U.S. shipping industry.*

1 The same rules apply to individuals.

In order to prevent companies from paying taxes twice on the same dollar of income – once to the host country and a second time to the U.S. – our tax code gives companies a credit on their U.S. tax return for those foreign taxes. After paying taxes to the host countries, companies have two choices for the residual profits: bring them back to the U.S. or reinvest them in their foreign operations.

If they chose to bring the profits back home, they must pay the difference between the amount of tax paid to the foreign government and what would be owed under the U.S. rate of 35 percent for most large firms. In other words, if a company wanted to bring home $100 in profits from Great Britain, it would first pay the British tax rate of 26 percent (or $26) and then pay an additional $9 to the U.S. to bring the total rate of tax to 35 percent.

Instead, the company can reinvest those profits in its foreign operations and defer paying the additional U.S. tax indefinitely as long as the profits are working actively abroad. Critics of this process, known as "deferral," say that the system encourages companies to keep their profits offshore and avoid paying U.S. taxes on that income. Defenders of deferral say that it simply recognizes the well established principle that income should not be taxed until it is realized (or repatriated), and it puts U.S. firms on a level playing field with their foreign competitors who don't operate under a worldwide tax system. Others say our current international tax regime needs to be replaced with a territorial system that more closely resembles those of most other capitalist nations.

As U.S. lawmakers consider how to move forward, they face three distinct choices:

1. Maintain the current deferral system and international tax rules for taxing the foreign earnings of U.S. multinationals.
2. Eliminate deferral and move toward a pure worldwide system of taxation.
3. Move toward a territorial system and tax only those profits earned within the U.S. borders.

Based on the tax system changes being undertaken by our major trading partners, as well as the trends in economic research, lawmakers would do well to consider the following 10 reasons why our current international tax rules should be replaced with a territorial or exemption regime that exempts most foreign profits from U.S. tax.[2]

Reason #1. Parity. The U.S. system must be aligned with our global trading partners.

Over the past two decades or so, the majority of our major trading partners have been moving toward a fundamentally different model of taxing business income. The basic tenets of this new model are lower tax rates and the exemption of foreign earnings.

In the past four years alone, 75 countries have cut their corporate tax rates to make themselves more competitive. And, as the OECD reports, "there has been a gradual movement of countries moving from a credit [worldwide] to an exemption [territorial] system, at least in part because of the competitive edge that this can give to their resident multinational firms."[3]

The U.S. remains far behind on both of these trends. Not only do we have the second-highest overall corporate tax rate among the leading industrialized nations at over 39 percent – only Japan has a higher overall rate – but we are one of the few remaining countries to tax on a worldwide basis.

Our largest trading partners – Canada, Great Britain, and Japan – have already taken steps to make themselves more competitive. For example, Great Britain lowered its corporate tax rate on April 1 of this year from 28 percent to 26 percent as a first step toward the goal of a 23 percent rate in 2014. On January 1, Canada lowered its federal corporate tax rate from 18

2 This paper is not intended to support any specific territorial proposal, simply the broader concept of a territorial or exemption-based system.

3 Tax Policy Reform and Economic Growth, OECD Tax Policy Studies, No. 20, OECD Publishing (2010), p. 138.

percent to 16.5 percent. Next year the rate will fall to 15 percent. Japan was scheduled to cut its overall corporate rate by 5 percent until the tragic earthquake derailed the government's legislative agenda. Japan's move would have left the U.S. with the highest overall corporate tax rate in the industrialized world.

As important as differences in tax rates are, however, the method of taxing foreign profits matters as well. Canada, Great Britain, and Japan have all effectively moved toward a territorial or exemption form of taxing the foreign profits of their multination firms. Indeed, of the 34 OECD member nations, 26 have either a full territorial system or exempt at least 95 percent of foreign earnings from repatriation taxes. The U.S. remains the only country in the OECD with a worldwide system and a corporate rate above 30 percent.

Reason #2. The experiences of Japan and Great Britain are lessons for the U.S.

2a. The Japanese experience: A worldwide system combined with a high corporate tax rate was a disincentive to repatriating profits.

During the early part of the last decade, the earnings of overseas subsidiaries of Japanese companies grew at a fast pace, especially in Asian markets. According to the *Japan Times*, by 2005 "¥2.28 trillion worth of profits generated by overseas arms of Japanese firms remained outside the country…the accumulated amount stood at more than ¥12 trillion."[4]

As we are now seeing with U.S. companies, Japanese firms did not want to bring those profits home and subject them to the higher Japanese repatriation tax. By 2008, the Japanese Ministry of Economy, Trade and Industry (METI) became worried that "a decline in repatriation of foreign-source earnings would lead to less investment in Japan and have negative implications for the country's development of innovative technologies."

The Japanese government decided to move away from its worldwide tax system toward an exemption system that effectively shields 95 percent of repatriated foreign earnings from repatriation tax. By August 2009, reports the *Japan Journal*, major Japanese companies began repatriating overseas earnings to Japan.[5]

2b. The British experience: A worldwide system and a high-by-European-standards tax rate forced companies with large global sales to relocate to lower-taxed countries.

Britain's worldwide tax system produced a different set of consequences than Japan's. Because the European Union allows capital to move as freely between the member states as it moves among the 50 U.S. states, more than a dozen British multinational firms chose to move their headquarters to countries with more favorable tax climates to protect their foreign earnings from the U.K. tax code.

The common fact pattern for each of these companies was that they derived roughly 75 percent of their profits from outside the U.K., yet the British worldwide tax system subjected their foreign earnings to U.K. taxes. Even though the U.K. corporate tax rate was 28 percent at the time, it was still higher than the European Union average. Thus, the companies felt that the only way to protect the majority of their earnings from U.K. tax was to move to a low-tax country, such as Ireland, or a country with both lower taxes and a worldwide tax system such as the Netherlands or Switzerland.

Shocked by these trends, the British government began implementing changes to their international tax rules to make the system more friendly to global businesses. The recently released U.K. budget includes changes in the Controlled Foreign Company (CFC) rules for 2012 "towards a more territorial corporate tax system that reflects the global reality of modern

4 "Territorial tax system eyed for '09," *Japan Times,* May 10, 2009.

5 Morinobu Shigeki, "Repatriating Profits," *The Japan Journal*, January, 2010. http://www.japanjournal.jp/tjje/show_art.php?INDyear=10&INDmon=01&artid=cf1cbe4dc8f5aa5d9d49245bd6bcdbb9

6 HM Revenue & Customs, "Overview of Tax Legislation and Rates," March 23, 2011, p. A71. http://www.hmrc.gov.uk/budget2011/index.htm

business. The interim improvements are designed to make the current CFC rules easier to operate and, where possible, to increase competitiveness."[6]

On the day after the government released its budget, two of those expatriate firms announced that they would consider moving back to England.[7]

Reason #3. The premise of the worldwide tax system – capital export neutrality (CEN) – is obsolete when subsidiaries have access to global capital markets and can self-fund their expansion with retained earnings.

Our worldwide tax system is premised on the principle of "capital export neutrality" (CEN), which holds that if companies are taxed at the same rate on their domestic and international investments, they will make investment decisions solely on the economics of the activity without regard to the tax consequences.

This theory may have made sense when the U.S. was the dominant source of global capital and subsidiaries needed capital from their U.S. parents to survive and grow in an overseas market. However, CEN no longer works in today's global economy because U.S. subsidiaries have access to global capital markets and they can self-fund their growth through their own retained earnings as they mature. As a result, CEN (enforced by repatriation taxes) simply acts as a deterrent to U.S. companies repatriating the profits from those successful subsidiaries.

The Japanese discovered this themselves. One Japanese scholar explained it this way:

> However, it did not take long for the "production efficiency theorem" [CEN] to lose its supporters in the face of such an argument that even under the credit method, so long as repatriation tax exists, foreign earnings accumulate to a point where foreign subsidiaries do not need additional input of capital, with the result that the credit method's effect of clearing impediments for the production efficiency becomes inoperative.[8]

In other words, our worldwide system and repatriation taxes have created a Berlin Wall that is doing more to keep profits out than keep capital in.

Reason #4. The worldwide tax system violates the benefit principle of taxation.

The U.S. should have no more power to tax profits earned in Canada than California has the power to tax profits earned in Wisconsin. The underpinnings of most international tax policy is the notion of source-based taxation. This holds that countries have the right to tax income that is generated within their own borders. One of the rationales of source-based taxation is the benefit principle, the idea that the taxes people pay should be linked to the benefits they receive from government.

Our worldwide tax system violates that principle by taxing companies on profits they earn in other countries, for which they have already paid taxes to those governments in exchange for certain benefits. Indeed, IRS data for 2007 – the most recent available – shows that U.S. companies paid nearly $100 billion in income taxes to foreign governments on taxable income of $392 billion. U.S. repatriation taxes are not only a second layer of tax on that foreign income; they have no direct connection with any direct governmental benefit received.

The flip side of this principle is that taxes should be related to the costs they impose on a government or jurisdiction. As economist Norman B. Ture pointed out in a Tax Foundation report in 1976, the production activities of foreign subsidiaries impose no costs on the U.S. government and, thus, should not be subject to U.S. tax:

7 Steve McGrath, "WPP, publisher may end tax exile," The *Wall Street Journal*, March 25-27, 2011.

8 http://www.nta.go.jp/ntc/english/research/ronso/01.htm#summary

> These costs are imposed solely within the foreign jurisdictions whose real production inputs are used. The mere fact that the foreign operation is undertaken by a U.S. company should have no bearing on the determination of the jurisdiction which should impose taxes: there is no more reason for the U.S. tax to apply to the foreign income produced by a U.S. company's subsidiary, division, branch, what have you, than there is for the U.S. to impose its tax on any company of another nationality operating in the foreign jurisdiction.[9]

For similar reasons, most states have what might be called territorial tax systems; that is, they tax companies only on the profits that are derived within the state. To be sure, states differ in terms of how they apportion corporate income based on factors such as sales, property and personnel. However, a growing number of states have moved toward single sales factor apportionment that taxes only income generated from in-state sales. Many state lawmakers typically view the single sales factor as an economic development tool to attract export-focused manufacturing firms.

Reason #5. The U.S. maintains a territorial tax system for foreign-owned companies but a worldwide system for U.S. companies. Moving to a full territorial system will level the playing field.

Foreign-owned subsidiaries pay U.S. corporate income taxes only on the profits they earn within the U.S. This can give foreign-owned firms a competitive advantage because (except for Japanese companies) they are operating out of lower-taxed countries and, thus, enjoy a lower overall cost of capital.

For example, let's compare the after-tax returns of a U.S. firm and a Canadian firm. Each firm operates only in the U.S. and Canada. The U.S. firm pays the 35 percent tax rate on both its domestic and Canadian earnings. Thus, its after-tax return on $100 of earnings is $65.

By contrast, the Canadian firm pays the 35 percent rate on its U.S. earnings and it pays 16.5 percent on its domestic earnings (the federal Canadian rate is 16.5 percent[10]), for an average tax rate of roughly 26 percent. This gives the Canadian company a $74 after-tax return on $100 of earnings.

Comparing the returns for each company, investors will see the Canadian firm as a more profitable and valuable investment over the U.S. firm. So the cost of capital will be lower for the Canadian firm than for the U.S. firm.

One scholar suggests that our worldwide system discriminates against young or "immature" U.S. multinational firms. Because their cost of capital is higher than an immature foreign multinational, the U.S. firm will undercapitalize its new foreign ventures, making them less competitive and less able to respond quickly to market opportunities.[12]

This tax inequity also puts U.S. firms at a disadvantage when they try to acquire businesses or assets abroad. Because their after-tax returns on investment must be higher, U.S. firms often have to bid more for an asset than do most foreign firms, such as a Canadian or Swiss firm, for the same asset.

Reason #6. The compliance cost of the current system is excessively high relative to companies' foreign activities and the revenues raised from taxing foreign-source income.

According to President Obama's Economic Recovery Advisory Board, the so-called Volker

9 Norman B. Ture, "Taxing Foreign Source Income: The Economic and Equity Issues," *Tax Foundation Government Finance Brief* No. 25, May 1, 1976, p. 6.

10 The average Canadian provincial rate is roughly 10 percent. For simplicity's sake, the example uses only federal tax rates.

11 Joint Committee on Taxation, "Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment," June 25, 2008, p. 11.

12 Terrence R. Chorvat, "Ending the Taxation of Foreign Business Income," *Arizona Law Review,* Winter 2000. 42 Ariz. L. Rev. 835.

13 Marsha Blumenthal and Joel B. Slemrod, "The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications," *International Tax and Public Finance*, 2: 37-53 (1995), p. 41.

commission, the U.S. corporate tax system costs companies more than $40 billion to comply with. One study found that at least 40 percent of the overall tax compliance costs faced by large U.S. companies is due to the international provisions of the corporate tax code, despite the fact that just 24 percent of their profits were from foreign sources.[13] In dollar terms, the cost of complying with these international tax provisions equaled 8.5 percent of companies' foreign-source income and was high compared to the actual revenue raised by the U.S. from taxing foreign-source income.

By contrast, European firms do not report a big disparity between complying with their domestic tax rules and complying with their international rules. The authors speculate that this is due to the large number of European firms that reside in countries with exemption-based tax systems. It seems reasonable to assume that moving to a territorial system will greatly reduce the compliance costs for U.S. companies.

Reason #7. Our current system traps capital abroad – the "lock-out" effect.

A significant amount of economic research has shown that the willingness of multinational firms to bring home foreign profits is highly sensitive to the level of repatriation tax rates. In a 1990 study, for example, Hines and Hubbard found that a one percent decrease in the repatriation tax is associated with a four percent increase in dividend payments by foreign subsidiaries. In a 2001 study, Desai et al. determined that "repatriation taxes reduce aggregate dividend payouts by 12.8 percent."[14]

A 2007 study by Foley et al., found that repatriation tax burdens induce firms to hold more cash abroad.[15] They determined that "the median firm facing above average [repatriation] rates holds 47% of its cash abroad, but the median firm facing below average rates holds only 26% of its cash abroad. This figure suggests that repatriation tax burdens increase foreign cash holdings relative to domestic cash holdings."[16] It should be no surprise, thus, that by most accounts U.S. multinational firms are holding as much as $1 trillion in foreign earnings abroad, in part because of the high toll charge to bring the money back in the U.S.

But in a finding that should particularly worry U.S. lawmakers, Foley et al. found that "technology intensive firms appear to be particularly sensitive to repatriation tax burdens," as well as those with "strong growth opportunities," and those with high levels of R&D expenditures.[17] Thus, the "new economy" firms that contribute substantially to economic growth are those that are most dissuaded from reinvesting their foreign profits back into the U.S.

In another study looking at the lockout effect of repatriation taxes, Graham et al. surveyed over 400 tax executives at firms with foreign source income about their response to the 2004 one-time tax holiday on foreign earnings – the American Jobs Creation Act. These executives reported that over 60 percent of the repatriated funds came from cash holdings, supporting the findings of Foley et al. that companies hold large cash balances overseas in order to avoid the repatriation tax.[18]

Reason #8. Our high corporate tax rate and worldwide system makes it cheaper for companies to take on debt rather than use their own profits to fund their growth.

One of the more interesting findings of the Graham et al. study is that 44 percent of

14 Reviewed in: John R. Graham, Michelle Hanlon, and Terry Shevlin, "Barriers to Mobility: The Lockout Effect of US Taxation of Worldwide Corporate Profits," September 15, 2008, p. 2.

15 C. Fritz Foley, Jay C. Hartzell, Sheridan Titman, Garry Twite, "Why Do Firms Hold So Much Cash? A Tax-Based Explanation," February 2007, p. 3.

16 Ibid. p. 19.

17 Ibid. p. 16.

18 Graham et al. p. 4.

19 Ibid. p. 5.

companies reported borrowing money in the U.S. rather than repatriating foreign profits in order to avoid the additional tax.[19] Moreover, "nearly 20 percent of the respondents noted that their company had invested the foreign earnings in financial assets with a lower rate of return than they could have earned in the U.S. All of this evidence is consistent with a significant lockout effect from the U.S. tax policy that taxes the worldwide income of U.S. multinationals."[20]

Studies have shown that even under normal circumstances, companies have a greater incentive to take on debt in countries with high corporate tax rates – such as the U.S. – than in low-rate countries because debt payments are deductible and, thus, help lower their effective tax burdens. Indeed, according to Federal Reserve data, nonfinancial corporate debt in the U.S. totaled nearly $7.4 trillion in 2010, an increase of 24 percent since 2006. Remarkably, in 2008, corporate debt exceeded the federal government's publicly held debt by $600 billion.

It is safe to assume that as the gulf widens between the U.S. corporate rate and the global average tax rate, that firms will take on increasingly more debt in this country while accumulating more cash in low-tax countries. Thus, cutting the U.S. corporate tax rate and eliminating repatriation taxes would not only reduce the incentives for accumulating domestic debt, it would encourage companies to use their own foreign earnings to expand their domestic operations.

Reason #9. The current system dissuades global companies from headquartering in the U.S.

When given a choice of where to locate, newly formed global countries do not choose to locate in the United States because they do not want to expose their non-U.S. profits to our high rate and worldwide tax system.

While the Daimler-Chrysler merger was perhaps the most famous case of a merged entity being headquartered abroad, a more recent case is the proposed purchase of the New York Stock Exchange by the German exchange Deutsche Börse AG. The irony for both the U.S. and Germany is that the new holding company for the combined Deutsche Börse AG/NYSE Euronext group will be registered in the Netherlands, not the U.S. or Germany.[21]

One of the reasons, of course, is that the Netherlands has a corporate tax rate of 25.5 percent compared to Germany's combined federal and sub-national rate of 30.2 percent and the U.S. combined rate of 39.2 percent. The Netherlands's territorial system is also more generous than Germany's, with a 100 percent exemption for foreign earnings, as opposed to Germany's 95 percent exemption.

There are numerous other examples of newly formed global firms incorporating outside of the U.S. One such example was Accenture, the consulting firm that was spun out of the now defunct accounting firm Arthur Anderson. Since Accenture has partners across the globe, it made sense for the newly incorporated firm to be headquartered outside of the U.S. to protect the earnings of those international partners from U.S. tax.

Cutting the corporate tax rate and moving to a territorial system would greatly improve the attractiveness of the U.S. as a location for headquarters and startups.

Reason #10. Eliminating deferral nearly killed the U.S. shipping industry.

The experience of the U.S. shipping industry provides a real-life experiment on the effects of repealing deferral and forcing companies to compete globally from a strict worldwide tax system. The Tax Reform Act of 1986 effectively repealed deferral for U.S. ship owners. The impact this had on the American shipping industry was immediate and severe.[22]

20 Ibid.

21 http://www.taxfoundation.org/blog/show/27055.html

22 Ken Kies, "A Perfect Experiment: 'Deferral' And the U.S. Shipping Industry," *Tax Notes*, September 10, 2007, p. 997.

According to a report conducted for the Maritime Administration:

> [B]etweeen 1986 and 1991 the U.S.-owned foreign flag fleet dropped from 17 million deadweight tons to 12 million deadweight tons. In 1986 there were 429 U.S.-owned, foreign flag ships in the international bulk shipping markets, by 2000 that fleet had declined to 273 ships. The number of U.S.-owned foreign-flag tankers also declined dramatically over the same period: from 246 tankers to 126 tankers.[23]

The American Jobs Creation Act of 2004 restored deferral to U.S. ship owners, allowing the industry to rebound from its two-decade-long decline. Since deferral was reinstated, U.S. firms have acquired foreign shippers and the number of U.S.-owned foreign-flag ships has grown in recent years. According to the Maritime Administration, the largest growth in U.S. privately owned vessels between 2004 and 2009 has been in the dry bulk (47.6 percent), container (32 percent), and offshore supply ships (33 percent).[24]

Conclusion

As President Obama said in his State of the Union Address, Washington's goal should be to make the U.S. a competitive place to do business in and do business from. The U.S. corporate tax system undermines both of these goals. The recent moves of our major trading partners toward lower corporate tax rates and territorial-type tax systems have further widened the gulf between the U.S. and the new global model of business taxation.

Thus, the key to making the U.S. more competitive globally is to put our tax system on par with our major competitors. This means dramatically cutting the U.S. corporate tax rate while moving toward a territorial system for taxing foreign earnings.

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Editor, Alicia Hansen

Tax Foundation
National Press Building
529 14th Street, NW, Suite 420
Washington, DC 20045-1000

(202) 464-6200

www.TaxFoundation.org
TF@TaxFoundation.org

23 "An Evaluation of Maritime Policy In Meeting the Commercial and Security Needs of the United States," prepared by IHS Global Insight, Inc., for United States Department of Transportation Maritime Administration, January 7, 2009, p. 31.

24 "U.S. Water Transportation Statistical Snapshot," U.S. Department of Transportation Maritime Administration, February 2011, p. 20.