

INTERNATIONAL TAX REFORM

Position

RILA supports reform of the U.S. international tax rules to improve the competitiveness of U.S. businesses, including a growing number of retailers, participating in the global economy. Recent proposals in the Obama Administrations' Fiscal Year 2011 budget, however, raise significant concerns since they would threaten U.S. jobs and undercut the ability of U.S. businesses to compete against other foreign companies. In particular, RILA opposes the proposals to restrict the deferral of U.S. tax on foreign earnings and limit the use of foreign tax credits.

Recent Activity

In his Fiscal Year 2011 budget, President Obama included a number of proposals affecting the current international tax provisions of the Internal Revenue Code, revising similar proposals from the Fiscal Year 2010 budget.¹ While the budget does propose extending two important international tax benefits – the Subpart F active finance and look-through exceptions – the vast majority of the proposals are intended simply to raise revenues without regard for their effect on U.S. jobs or the competitiveness of U.S. companies that also operate abroad. These changes would generally be effective beginning in 2011.

The Obama Administration estimates² that the package of international tax changes would raise more than \$122.2 billion through 2020, although the Joint Committee on Taxation (JCT) scores the package at \$126.9 billion over ten years.³ Based on the Administration's estimates, the limitations on deferral and foreign tax credits would account for 70 percent of that revenue.

Action Needed

RILA urges Congress not to enact international tax changes – in particular the proposals to limit deferral and foreign tax credits – simply to raise revenues for unrelated policy purposes. Any such changes should be considered only in the context of overall reform of the U.S. system for taxing foreign earnings of U.S. companies. RILA and its members stand ready to assist Congress and the Administration in structuring U.S. international tax rules that will maintain the global competitiveness of U.S. businesses.

Background

In recent years, a growing number of U.S. retailers have expanded into the global marketplace through the establishment of both retail operations in other countries as well as subsidiaries that strengthen the supply-chain of goods and services they provide to their customers.

Despite having the second highest corporate tax rate, behind only Japan, the United States is one of the last major industrialized countries to tax all of the worldwide income of its citizens, including the domestic and foreign earnings of U.S. companies as well as the income earned abroad by foreign subsidiaries of U.S. multinationals. Typically, other countries tax their domestic companies on a territorial basis, with tax imposed only on the income earned within their borders and not on the earnings of their multinational companies' foreign subsidiaries that are located outside of their national borders.

Current U.S. tax law attempts to address the competitive advantage that foreign territorial tax systems pose for U.S. companies in two ways. First, under the so-called "deferral rule," U.S. companies are not taxed on income from the active business operations of a foreign subsidiary *until* that income is repatriated to the United States. The long-standing policy of the deferral rule allows U.S. multinationals to remain competitive against their foreign competitors, which are not subject to tax on their worldwide income at all. The deferral rule, however, applies only to foreign earnings derived from *active* business operations. The Subpart F rules, enacted in 1962, prevent U.S. multinationals from deferring tax on foreign income that is generally not related to active operations, such as interest and dividends from investments of their foreign earnings.

The Obama Administration's budget proposal would restrict the ability of U.S. companies to deduct interest expenses associated with foreign earning until such earnings were repatriated to the United States. The result would be increased U.S. taxes for businesses that can no longer deduct financing expenses, which can also relate to U.S. headquarter jobs and other selling, general and administrative expenses, allocated to foreign earnings that are necessarily reinvested abroad to maintain the company's global business operations. This proposal is made worse by requiring companies to allocate such expenses under the same flawed rules as currently apply to foreign tax credits, without the benefit of the worldwide interest allocation rule that Congress has repeatedly delayed, most recently until 2021 under the HIRE Act.⁴ Accordingly, the proposal would create additional disparities between the U.S. tax system and that of our major trading partners, further eroding the competitiveness of U.S. businesses.

Second, since 1917, the United States has allowed a U.S. company that repatriates the income of its foreign subsidiary to reduce its U.S. tax liability by any foreign taxes paid on that income through a "foreign tax credit," which reduces the potential for double taxation of the same income by the United States and a foreign jurisdiction. The Obama Administration's budget proposal would limit the availability of foreign tax credits by requiring companies to calculate them on a combined basis rather than by the taxes paid by each subsidiary making up the U.S. company's worldwide organization. Despite this combined approach, another Administration proposal (now enacted)⁵ requires companies to match their foreign tax credits with the associated repatriated income to prevent so-called "cross crediting," which was previously permitted. As a result, U.S. businesses now have to combine credits derived from high- and low-tax jurisdictions but are not able to apply the credits to the overall repatriated income, making it less likely that they would be able to avoid double taxation of their foreign earnings.

While the Obama Administration has put forth targeted international tax proposals, the Treasury Department under the Bush Administration released a study⁶ in December 2007 outlining three broad approaches to overhauling the corporate tax code. The first approach would replace the corporate income tax with a business activity tax (BAT) on gross receipts, minus the cost of goods and services purchased from other businesses, at a tax rate between 5 percent and 6 percent (to achieve revenue neutrality). The second approach would lower the corporate tax rate by eliminating the majority of current business tax deductions, and implement a territorial system for the taxation of U.S. companies' foreign earnings. Treasury estimated that to maintain revenue neutrality the rate could be lowered to 28 percent with full business-tax base broadening or 31 percent if accelerated depreciation was retained. The third approach offered a package of proposals, short of full reform of the tax code, aimed at specific areas of the business tax system that could be modified. While Treasury found that the BAT option would result in modest improvements in economic performance, the second option would require significantly lower business tax rates (e.g., 20 percent) or greater equipment expensing in order to achieve significant benefits to the U.S. economy and the competitiveness of U.S. companies.

Also at the end of 2007, former House Ways and Means Committee Chairman Charles Rangel (D-NY) introduced a \$1.3 trillion tax measure, the Tax Reduction and Reform Act of 2007 (H.R. 3970),⁷ which was partially offset by provisions similar to the Obama Administration's limitations on the deferral rule and on the use of foreign tax credits. Although the legislation did not receive a hearing or markup, it continues to serve as a marker for a broader tax-reform agenda.

Contact

For more information, please contact Mark Warren, vice president for tax and finance, at mark.warren@rila.org.

Additional References

- RILA Issue Brief: Tax Reform
- RILA Issue Brief: National Retail Sales Tax
- Promote America's Competitive Edge (PACE) – <http://pace4jobs.org/>

¹ U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals (Feb. 2010) at pp. 39-49 – available at: <http://www.treasury.gov/offices/tax-policy/library/greenbk10.pdf>.

² U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals (Feb. 2010) Table 1 – available at: <http://www.treasury.gov/offices/tax-policy/library/greenbk10.pdf>.

³ Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal, JCX-7-10R (Mar. 15, 2010) – available at: <http://www.ict.gov/publications.html?func=startdown&id=3665>.

⁴ Public Law 111-147 (Mar. 18, 2010) – available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ147.111.pdf.

⁵ Public Law 111-226, § 211 (Aug. 10, 2010) – available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h1586enr.txt.pdf.

⁶ U.S. Department of the Treasury, Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century (Dec. 20, 2007) – available at: http://www.treas.gov/press/releases/reports/hp749_approachesstudy.pdf.

⁷ Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong., 1st Sess. (Oct. 25, 2007) – available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h3970ih.txt.pdf.