

## 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 2010 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, limit the use of foreign tax credits, and constrain the business-entity classification rules for foreign entities.

### Recent Activity

On February 26, 2009, President Obama released his Fiscal Year 2010 budget, which includes a number of proposals affecting the current international tax provisions of the Internal Revenue Code.<sup>1</sup> 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 estimates<sup>2</sup> that the package of international tax changes would raise more than \$209.9 billion through 2019, although the Joint Committee on Taxation (JCT) scores the package at \$159.3 billion over ten years.<sup>3</sup> Based on the Administration's estimates, the limitations on deferral, foreign tax credits, and business-entity classification would account for more than 81 percent of that revenue.

### Action Needed

RILA urges Congress not to enact international tax changes – in particular the proposals to limit deferral, foreign tax credits or business-entity classification – 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 expenses (other than research and development costs) 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 expenses, often relating 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 and that the House health care reform bill proposes to repeal. 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, the Administration would also require companies to match their foreign tax credits with the associated repatriated income to prevent so-called "cross crediting," which is permitted under current law. As a result, U.S. businesses would have to combine credits derived from high- and low-tax jurisdictions but not be 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.

Similarly, since 1997, U.S. companies have been permitted to elect to treat certain of their foreign subsidiaries as "disregarded entities," with the income and expenses of such subsidiaries flowing up to its parent company. This regime, commonly referred to as the "check the box" rules, provides simplicity and certainty for U.S. companies in structuring their international operations and managing foreign taxes on their earnings abroad. The Obama Administration's budget proposal would limit the availability of the check-the-box rules and allow subsidiaries to be disregarded only when they are organized in the same country as their parent (the U.S. headquartered company and its first-tier subsidiary would be exempt). A significant, and presumably unintended, consequence of this proposal is that it would likely increase the amount of taxes that U.S. companies would owe to foreign governments without having a significant effect on their tax liability to the U.S. government.

While the Obama Administration has put forth targeted international tax proposals, the Treasury Department under the Bush Administration released a study<sup>4</sup> 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, 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),<sup>5</sup> 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 Chairman Rangel's broader reform agenda.

While President Obama's Fiscal Year 2010 budget includes the changes to the U.S. international tax rules discussed above to help pay for other policy priorities, the Fiscal Year 2010 congressional budget resolution (S. Con. Res. 13)<sup>6</sup> did not assume the Administration's proposals.

---

## Contact

For more information, please contact Mark Warren, vice president for tax and finance, at [mark.warren@rila.org](mailto:mark.warren@rila.org).

## Additional References

- RILA Issue Brief: Tax Reform
- RILA Issue Brief: National Retail Sales Tax

---

<sup>1</sup> U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (May 2009) at pp. 28-40– available at: <http://www.treas.gov/offices/tax-policy/library/qrbk09.pdf>.

<sup>2</sup> U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (May 2009) Table 1 – available at: <http://www.treas.gov/offices/tax-policy/library/qrbk09.pdf>.

<sup>3</sup> Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal as Described by the Department of the Treasury, May 2009, JCX-28-09 (June 11, 2009) – available at: <http://www.jct.gov/publications.html?func=startdown&id=3558>.

<sup>4</sup>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](http://www.treas.gov/press/releases/reports/hp749_approachesstudy.pdf).

<sup>5</sup> 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](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h3970ih.txt.pdf).

<sup>6</sup> S. Con. Res. 13, 111th Cong., 1st Sess. (April 29, 2009) – available at: [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111\\_cong\\_bills&docid=f:sc13enr.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:sc13enr.txt.pdf).