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There is no question that the U.S. is operating in a global marketplace. Corporations do not face competition only from other U.S. firms, but from firms in other countries. Yet, America's prohibitive and antiquated system of "worldwide" taxation is leading to less investment and job creation in this country.

Fifty years ago the concept of a worldwide system of taxation had little impact on the incentives of corporations. But today in a rapidly global economy the system of double taxing American's working overseas and corporate profits places the U.S. at a significant competitive disadvantage in terms of both capital and labor.

Under current tax rules, U.S. subsidiary firms operating in foreign countries must pay taxes to the host country on their profits. If the company later decides to bring the profits back into America, the company must generally pay the difference between the foreign taxes paid and the 35 percent United States rate.

This system distorts business investment decisions, by deferring taxation of foreign earnings. Rather than acting to maximize profit, U.S. multinational firms make decisions, such as what mode of selling computer software abroad, based on tax considerations.

Other countries have a "territorial" or dividend exemption tax system in which their domestic companies pay taxes in the country where the profits are generated and, if reinvested back into the home country, no additional tax is levied. Whether carried directly or through subsidiary corporations, income from active business operations

would be exempt from the home country's taxation.

America's tax system, therefore, strongly encourages U.S. multinational corporations to invest in foreign countries and not invest in America even if the funds could generate a higher rate of return in the United States.

President Bush's bi-partisan tax reform commission recommended implementing a territorial tax system as part of its final report released in November 2005. The simplified income tax (SIT) plan, would shift to a territorial income tax system with an exemption for active foreign-source business income. A similar proposal backed by the Joint Committee on Taxation was estimated to raise federal government revenues by \$54.8 billion from fiscal year 2005-2014.

Competitive Disadvantage by the Numbers

Given the global competitive disadvantage facing U.S. firms, the amount repatriations from foreign profits had steadily declined from 0.6 percent of GDP in 1979 to 0.3 percent in 2004. Larger amounts of foreign profits being reinvested overseas occurred at a time when total profits earned in other countries increased from 17.3 percent in 1994 to 26.6 percent in 2004.

Evidence from a large sample of foreign affiliates of American firms from 1982-1997 indicates that a one percent lower repatriation tax rate is associated with a one percent increase in dividends. Empirical studies confirm that repatriation taxes reduce aggregate dividend payouts by 12.8 to 15 percent, at a cost to companies of 0.7 to 1 percent of pretax foreign income.¹

One study calculated the efficiency loss associated with the efforts to avoid the U.S.

repatriation tax on dividends, concluding that shifting to a territorial system would lead to an estimated \$1 billion welfare gain per year.ⁱⁱ

As far as the federal treasury is concerned, a static estimate of revenue gain amounted to more than \$7 billion as a result of the full taxation of royalty, sales source, and interest income, along with the allocation of expenses to exempt dividend income.ⁱⁱⁱ

Under a territorial system, which would eliminate the double layer of taxation placed on repatriated earnings, U.S. companies will become more competitive in the global marketplace and will boost U.S. exports from American suppliers to foreign subsidiaries.

International Comparison

The concept of territorial taxation is not new. France and the Netherlands exempt all active dividends. Germany and Canada effectively operate under similar structures via extensive treaty networks that exempt the foreign-source income of multinational corporations based in their countries.

21 of the 30 OECD member countries have foreign dividend exemption systems. There are key differences between many of these systems and the SIT proposal outlined in the Presidential Advisory Panel on Federal Tax Reform commission's final report. While the proposal would offer incentives to repatriate funds from low-tax jurisdictions, there are a few problems with the proposal.

Specifically, SIT keeps the current antideferral rules that categorize various types of active foreign business income as "mobile" income, disallows some domestic expenses, and calls for higher taxes for individual shareholders on dividends attributable to the foreign-source income of U.S. corporations.^{iv}

Lessons of the Invest in USA Act

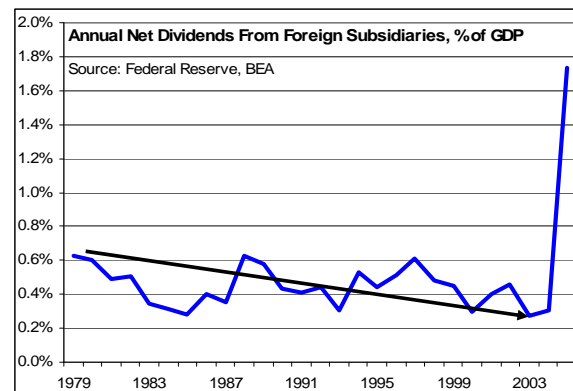
In October of 2004, President Bush signed the American Jobs Creation Act. One provision, the Invest in USA Act, serves as a real time experiment to evaluate the impact of U.S. international tax structure. The effects of this provision illustrated the damaging impact of current tax laws on U.S. competitiveness.

Under the Invest in USA provision, affiliates of U.S. corporations could return their foreign profits back to America for one year at a special tax rate of 5.25 percent.

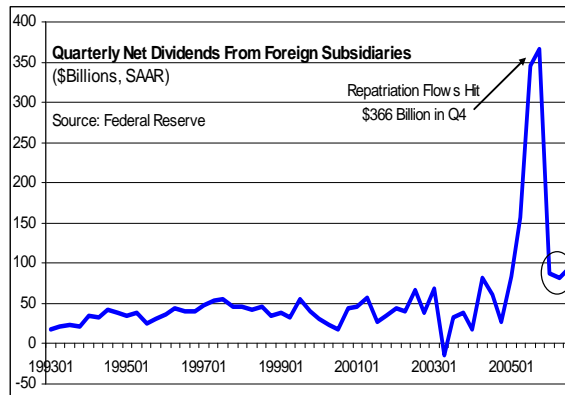
Over 400 companies seized the opportunity and announced plans to repatriate \$300 billion of foreign profits, more than double the repatriation forecast of the Joint Committee on Taxation (JCT).

Reversing the 25-year slowdown in repatriation flows, foreign subsidiaries of American companies repatriated \$238.2 billion back to the U.S in calendar year 2005, six times higher than 2004's \$34 billion of repatriations and more than four times higher than the previous record of \$50 billion set in 1997.

As a percentage of the economy, repatriation flows totaled 1.91 percent, up substantially from 0.3 percent in 2004 and even more remarkable given that repatriations had been declining while foreign profits of American companies were increasing.



Repatriation flows remained elevated in 2006, ending the year at \$82.5 billion, the second highest dollar amount on record. As American companies returned funds to the U.S., fueling investment and job creation, last year's repatriation flows were nearly double the historical average.



Although government revenue estimates anticipated a \$3.2 billion loss over 10 years. The actual impact was a gain of \$17 billion in corporate tax revenues for fiscal year 2005 and 2006, exclusive of the higher revenues due to economic growth as the funds are circulated through the economy.

The Invest in USA provision unequivocally demonstrated the antiquated nature of American's current international tax law. Rather than encouraging U.S. companies to accumulate cash balances in their foreign affiliates, the low repatriation tax rate offered a strong incentive to invest in the U.S. economy. The reduction in the tax rate and response by U.S. companies provides clear evidence on the need for reform of the destructive nature of U.S. international tax law.

Time for Reform has Arrived

The United States is one of the few industrialized nations with a worldwide tax system, which places American companies at a relative disadvantage to other countries. Concurrently, foreign corporate tax rates are being reduced continually to enhance competitiveness in the global economy and

America now has the second highest corporate tax rates in the industrialized world, second only to stagnant Japan.

Yet, politicians pandering to fear of outsourcing continue to defend the antiquated worldwide tax system, despite the fact that a territorial system will lead to more investment here.

Shifting to a territorial tax system would lower the cost of capital for domestic investment and eliminate inefficiencies in the corporate financial structures of American firms with foreign affiliates. As the one-year "experiment" demonstrated, lowering the tax burden on repatriated funds will encourage companies to reinvest in American jobs and economic growth. Now is the time to make the U.S. international tax system competitive in the global economy.

ⁱ Desai, Mihir A., C. Fritz Foley and James R. Hines Jr., "Repatriation Taxes and Dividend Distortions." *NBER Working Paper No. 8507*, October 2001 and Grubert, Harry, and John Mutti. "Taxing International Business Income: Dividend Exemption versus the Current System." Washington, DC: *American Enterprise Institute Press*, 2001.

ⁱⁱ Welfare gain based on 1996 activity levels. Grubert, Harry and John Mutti, "Taxing International Business Income Divident Exemption Versus the Current." Washington: *American Enterprise Institute Press*. 2001.

ⁱⁱⁱ Ibid

^{iv} Merrill, Peter, Oren Penn, Hans-Martin Eckstein, David Grosman, and Martijn Van Kessel. "Restructuring Foreign-Source-Income Taxation: U.S. Territorial Tax Proposals and the International Experience." *Tax Notes*, Vol. 111, No. 7, May 15, 2006.