IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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ETI REPEAL SHOULD BE PASSED AND MOVED TO CONFERENCE

The House and the Senate are trying to move, however slowly, to resolve the international legal problems created by the World Trade Organization (WTO) ruling that the Extraterritorial Income (ETI) provision of the U.S. tax code constitutes an illegal export subsidy. Under the WTO ruling, the European Union (EU) has begun gradually to impose countervailing duties on selected U.S. exports, and these duties will increase each month up to a $4 billion annual rate until the United States repeals the ETI provisions.

The House is refining the revenue offsets to be added to the Ways and Means bill, and the Senate is working on procedures relating to the Finance Committee version, with an eye toward floor votes this month. It is important to get the bills to conference to resolve differences and to get this issue behind us.

Both bills repeal the ETI and adopt some additional revenue raisers. Both use the majority of the money to reduce tax rates on U.S. manufacturing, and both use much of the rest to ease and simplify the punitive and complicated U.S. tax treatment of foreign source income.

However, the structure of the Senate tax rate relief for manufacturing has an odd protectionist twist, and should be abandoned in favor of the House version. In addition, the House bill does a better job of putting U.S. firms on an equal footing with their foreign competition when operating in Europe and around the world.

Bills provide tax rate relief for manufacturing.

The House bill phases in a lower 32 percent corporate tax rate on U.S. source manufacturing income of firms of any size by 2007. It also phases in a 32 percent corporate rate for all corporations, manufacturing or not, with less than $20 million in income by 2012. The House bill also addresses certain unrealistic depreciation schedules, expands the size of companies exempt from the AMT and ends the 90 percent limitations on the use of net operating losses and foreign tax credits against the AMT.

The Senate bill provides a maximum reduction in the top corporate tax rate to 31.5 percent for manufacturing firms by excluding ten percent of U.S. source manufacturing income from tax (cutting 3.5 percentage points off the 35 percent corporate tax rate). Non-corporate manufacturers get the same exclusion. Note that the rate reduction only applies to U.S. source income.

In addition, however, the Senate bill's exclusion would be reduced for firms with foreign income. It could be taken only in proportion to the ratio of U.S. to global earnings of the company. For example, a firm with 60 percent U.S. income and 40 percent foreign income would get to exclude only 6 percent of its U.S. manufacturing income from tax. That would reduce its rate reduction to 2.1 percentage points, and its effective tax rate would be 32.9 percent. This further restriction in the rate cut, when the rate cut was already restricted to U.S. source income, would be a blatantly protectionist tax twist. It would mean that different companies within the United States would face different tax rates on the same activity, with companies that have foreign operations put at a competitive disadvantage in the United States.

Under the Senate bill, any expansion of foreign operations would result in an increase in the tax on U.S. operations, which would effectively increase the tax rate on the foreign activity. This is bound to trigger protests from our trading partners, because it would penalize any expansion of a multinational firm on foreign territory. If General Motors or Mercedes Benz were thinking of expanding a plant in Poland, both companies would face not only the Polish tax on their Polish plant, but an increased U.S. tax on their U.S. income, which would have to be considered as an added cost of expanding the plant in Poland. The Polish government would be bound to object.

Imagine the uproar if, for example, the United Kingdom informed every British company that its U.K. tax rate on its U.K. income would be 30 percent if it had no American subsidiaries, but would be 33% if it had plants in the United States. Would British Petroleum help develop the North Slope or refine and sell gasoline in the U.S. under such conditions? The United States Congress would howl in protest. Can we expect anything less if we do such a thing to others? Almost certainly, foreign governments would file another case with the WTO against such discriminatory tax practices.

A better approach, a three percentage point reduction in the corporate tax rate for all U.S. firms, offered by Senators Nickles and Kyle, was withdrawn. It is understandable that manufacturing is being given special attention, because it is the sector harmed the most by the long depreciation lives in the U.S. tax system. Nonetheless, having different corporate tax rates for different activities is distorting and not ideal. It would be better to reduce the corporate rate across the board, while correcting the depreciation problem by moving toward expensing, perhaps by extending the 2003 Tax Act's 50 percent expensing provision, which is due to expire at the end of this year.

One advantage of the Senate bill is the repatriation provision allowing firms to receive dividends from subsidiaries excess of recent flows at a special 5.75% tax rate for one year. Firms would have to jump through the hoop of filing plans to identify a specific relationship between the repatriated foreign income and domestic investment, but the provision should help to realign balance sheets and reduce risk by lowering debt to equity financing ratios of U.S. operations.

Both bills reform international taxation.

The problems addressed by these reforms stem from the global reach of the U.S. income tax. In the absence of a sensible conversion to a territorial tax system, the United States needs to lower its corporate tax rate, which is now the second highest after Japan among OECD nations (national and subnational rates), ease restrictions on the foreign tax credit, permit full deferral of active foreign income until it is repatriated, and move toward expensing of investment, which would be of particular benefit to capital intensive industries such as manufacturing.

Both bills improve the tax treatment of multinational corporations, enabling them to compete more effectively abroad. The House bill goes further in that regard. It does more to put U.S. firms on an equal footing with foreign firms when operating in the EU. It more effectively simplifies international tax treatment and reduces double taxation by reducing income "baskets" from 9 to 2 (active and "passive"), fixes punitive interest allocation rules, ends the limits on the foreign tax credit under the AMT, treats portfolio and financial services income of global finance businesses and the transportation income of oil and gas pipelines as their "active" main lines of business (which they are), and accepts as active income the ordinary business use of commodities transactions to manage currency risk, among other changes. (Active income is eligible for deferral of U.S. tax if it remains abroad. "Passive" portfolio income is subject to subpart F restrictions on deferral and is subject to U.S. tax when earned.)

Other nations' companies can operate in the EU as if it were one country with one market, because their home country tax systems either do not tax foreign source income or tax it more leniently than does the United States. Under current law, a U.S. firm may face more add-on U.S. taxes on EU income if it has subsidiaries in several EU countries rather than in just one. If efficiency dictates having several distribution or production centers across that market, the added tax disadvantage puts the U.S. firm at a competitive disadvantage relative to other countries' firms in servicing customers in the EU or exporting from the EU to the rest of the world. The House bill would correct that bias. (Earlier proposals to eliminate country restrictions around the world were dropped to save money. The final House provisions are less sweeping than they were initially.)

Easing tax penalties on foreign source income boosts domestic output.

Reducing the tax rate on U.S. source business income obviously would make U.S. producers more competitive internationally and would expand economic activity in the United States. Some concerns may arise that, in contrast, reforming the tax treatment of foreign source income might encourage production abroad, and reduce U.S. output and employment. Such concerns are ill-founded and are based on a misconception of how investment decisions are made.

Making U.S. multinational companies better able to compete abroad does not cause them to shift production abroad that would otherwise be done here. Rather, it enables them to own and operate a business abroad that would otherwise have to be owned and operated by someone else. In a competitive industry (no monopoly, no key patent protection, no unique technology), profit margins are very small. A small tax difference, such as the add-on U.S. tax that U.S. headquartered firms face in many parts of the world, can make the difference between being able to service a market or losing the business to foreign competition. The foreign operations of the U.S. firm will not simply shift back to the United States and service the foreign market with U.S exports. Those operations will instead simply disappear, and the market will be taken over by the foreign competition. In addition, there are often significant economies of scale and management with integrated worldwide operations. U.S. subsidiaries abroad often purchase parts and services, and license technology, from their U.S. affiliates. If the foreign operations have to close, the foreign firms that step into the vacuum may have the same economies if they buy such parts and services from their own affiliates. The United States would lose the exports that it captures due to intra-company efficiencies within our multinationals.

The fundamental rationale for the current U.S. system of taxing global income of U.S. based firms is called "capital export neutrality", or CEN. The idea, which seems very obvious, is that, if a company is going to put up a plant, the U.S. tax law ought to make the tax the firm will face the same if it builds the plant here or abroad, so that tax considerations do not distort the choice of location. If a foreign country has a low tax rate to encourage capital formation, a U.S. company might decide to locate there even if it is a bit less efficient to do so from a strictly economic standpoint. But if the company must pay an add-on U.S. tax to bring the combined foreign and U.S. tax rate up to normal U.S. levels, the company would choose to put the plant in the United States.

There are three flaw in the CEN analysis. The first is the assumption that the U.S. company is absolutely determined to put up a plant. Capital export neutrality is based on the assumption that there is a fixed amount of capital that is going to be formed by U.S. companies, regardless of the tax treatment, and that it might as well be located here as abroad. CEN makes no sense if the assumption of a fixed capital stock is false as tax rates increase. Since the desire of U.S. residents to own capital is in fact sensitive to tax rates, the assumption of a fixed amount of capital is in fact false, and CEN makes no sense.

Suppose that foreign firms can operate in a foreign market with a tax rate of, say, 30 percent, while a U.S. firm would face a combined foreign and U.S. 35 percent tax rate in that market. The U.S. firm's foreign subsidiary would be unable to compete for the foreign business unless it were several percent more efficient that the foreign firms. It would do the U.S. firm no good to return that production to the United States, where it would face the same 35 percent tax rate, and try to export the goods or services to the foreign market from the United States, because the U.S. firm would be equally uncompetitive from either location. In fact, with the added shipping costs, it might be less competitive. We cannot increase the amount of capital in the United States by raising tax rates on capital abroad. We can only raise the amount of capital in the United States by reducing taxes rates on capital in the United States.

The second flaw is to assume that the lower foreign tax rate gives the foreign country an unfair advantage in attracting additional investment, and that the additional investment is some how stolen from somewhere else. Businesses invest in any area up to the point where the returns, after-tax, just meet the minimum acceptable levels. Countries with high tax rates will have less capital per worker than countries with lower tax rates, other things equal. The added capital in the low tax country is not stolen from high tax countries, however. It is added capital that would not otherwise exist.

If other countries could somehow impose their higher tax rates on that lesser taxed capital, it would cease to exist. For example, France and Germany have been very bitter about the low, 12.5 percent Irish corporate tax rate, claiming that it has diverted capital from France and Germany. But if Ireland were to raise its corporate tax rate to French and German levels, the capital would simply disappear. It would not go "back" to France or Germany, because there is already as much capital there as can earn an acceptable after-tax return. (This does not mean that a particular business might not be relocated to France, just that it would displace some other bit of French-based capital to leave the French total unchanged.) If any one country (such as the United States) tried to raise the tax rate on investment by one if its companies in the low tax jurisdiction, the company would have to withdraw and let a foreign competitor do the investment instead. In addition, the added investment in a low tax jurisdiction would push the capital stock to the point that, in spite of the lower tax rate, its returns would be driven down to normal levels. Constraints on land, labor supply, resources, and transportation would ultimately render it only as profitable, at the margin, as capital elsewhere. Wholesale movement of capital can only occur when other factors, such as labor, are free to migrate with it. Land and mineral resources obviously cannot make such a move, and labor mobility is restricted in much of the world by immigration laws.

The third flaw in the CEN argument is that, in practice, it is not actually allowed to generate equality of tax treatment across the border. The adjustment to equalize U.S. and foreign tax rates is only applied in one direction, where the foreign tax rate is lower than in the United States. If the foreign tax rate is higher than in the United States, the firm does not get a tax credit for the excess of the foreign rate over the U.S. rate. Heads the Treasury wins, tails the company loses. This exposes the concept for what it really is, a rationale to squeeze additional revenue for the Treasury by violating basic laws of economics. It might have worked when the United States was the dominant economy in the aftermath of World War II, but it had to fail once the rest of the world recovered and their world-class companies got back on their feet. We have no monopoly on technical expertise, talent, ambition, or intelligence.

Conclusion.

The House and the Senate should move on their respective ETI repeal bills as soon as possible. In conference, the House corporate tax rate formula and international tax approach should be favored, with the Senate repatriation provision included.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.