Consider International Trends and Norms in Reforming the System

By Rocco V. Femia

Rocco V. Femia is a member of Miller & Chevalier Chartered and served as associate international tax counsel in Treasury’s Office of Tax Policy from 2003 to 2004.

Copyright 2009 Rocco V. Femia. All rights reserved.

On May 4 President Obama proposed sweeping changes to the U.S. rules for taxing the foreign business activities of U.S. multinationals. Those changes, the cost of which would be borne largely by a few hundred U.S. multinationals, were projected to increase overall corporate tax collections by upwards of 10 percent. Several of the proposed changes were derived from proposals put forward in 2007 by House Ways and Means Committee Chair Charles B. Rangel, D-N.Y., in the context of more fundamental, and revenue-neutral, corporate tax reform. There has been surprisingly little consideration of international trends and norms in assessing the merits of the proposed changes.

U.S. international tax rules need reform. They are needlessly complex. They create incentives to engage in inefficient, tax-driven practices, most notably the accumulation rather than repatriation of foreign earnings. The rules are difficult for the IRS to administer, and they raise little revenue. In most cases, taxpayers that can opt out of them do; thus, companies have inverted their corporate structures and removed their foreign business operations from the U.S. tax net altogether, and entrepreneurs are advised to structure start-ups as foreign-based companies from the outset.

The proposals under consideration appear to be a good-faith attempt to address some of those deficiencies. Overall, however, they represent a missed opportunity. They would exacerbate the complexity of the current system. In some cases, they would increase the perverse incentive to accumulate earnings offshore. In others, they would reduce U.S. taxpayers’ ability to manage
their foreign tax liabilities, thereby increasing foreign creditable taxes and potentially reducing U.S. tax collections. They would increase the incentive to remove foreign business operations from the U.S. tax net, perhaps prompting another round of legislation to further restrict this phenomenon.

Even when a proposal seems sensible in isolation (and it is difficult to defend any aspect of our international tax system in isolation), enactment of it would upset balances that have been struck in our system. Yes, under the current system taxpayers may optimize their foreign tax credit position by selectively repatriating earnings from some foreign subsidiaries and not others — but that is appropriate under any system that attempts to match taxes with associated earnings (the laudable objective of one of the proposals). And yes, the check-the-box rules do allow taxpayers to redeploy active business earnings among their foreign business operations without incurring U.S. tax under the antideferral rules. But that result has been allowed since 2005 by statute as a necessary patch on our increasingly outdated antideferral rules, and the administration has proposed extending this statutory treatment until 2011. In our system, two wrongs sometimes make an uneasy right, and addressing one without the other can lead to undesirable results.

A better starting point could be to ask what we want out of our international tax rules (and more generally, our corporate tax system). If we want a system for taxing the foreign business activities of U.S. multinationals in light of global economic forces, we could examine the policies our major trading partners have adopted in response to the same forces. In recent years our trading partners have abandoned efforts to tax the foreign business activities of their resident multinationals, reduced the rate of corporate tax on domestic business activities, and increased indirect taxes. Those policy trends should matter to U.S. policymakers for two reasons.

First, it is instructive to observe the reactions of our trading partners to the same economic forces facing the United States. Sometimes we can benefit from considering global trends that we did not initiate.

Second, the policies adopted by our trading partners have placed further downward pressures on the tax rates applicable to
foreign business activities. That has had the effect of setting a tax cost or “price” of operating in a given market for most (non-U.S.) businesses equal to the local tax burden. Businesses that face a higher tax under home country tax rules have a reduced ability to compete in that market. Perhaps in light of that, home countries have abandoned their taxation of foreign active business income, leaving host countries to benefit from any additional domestic corporate rate reductions. That cycle has repeated itself across the globe and has led countries to rely increasingly on taxes other than the corporate income tax.

Many policy responses could be considered in light of these developments. The most promising may be to consider either forgoing U.S. tax on active foreign business operations, as our major trading partners have done, or imposing current U.S. tax on active foreign business operations at a rate more in line with international norms. Either approach could be implemented in a manner that would simplify the rules, reduce or eliminate barriers to repatriation, and even raise revenue if coupled with true loophole closers.

Policymakers may instead prefer to focus on the preservation of our domestic tax base by discouraging U.S. multinationals from engaging in foreign operations. From that perspective, exempting active foreign business income from U.S. tax, or taxing it at a lower rate, would leave intact or even exacerbate the incentive to shift income (and, at times, related business activities) abroad.

In other words, adopting international norms for the taxation of foreign income without doing so for domestic income would throw into relief the relatively high tax cost of conducting U.S. business activities in taxable corporations. Perhaps, in the context of broader corporate tax reform, we should consider whether it is in the interest of the U.S. economy and its participants to maintain a tax rate on incorporated U.S. business activities that is higher than that of virtually all of our major trading partners. This is less a tax policy question than a political and economic policy question.

In the meantime, the least we can do is give due consideration to international norms and trends in developing international tax policy proposals.