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Summary: *Our current tax system puts U.S. companies at a disadvantage in their efforts to compete internationally. Remedies thus far have been a hodgepodge of international tax rules that often operate at cross-purposes, create perverse incentives, and incur the ire of international trade organizations. A reformed tax code including territorial taxation would better serve the vital interests of the United States.*

THE ROAD MAP TO TAX REFORM™

The International Components of Tax Reform:

Tax Policy that Serves the National Interest

By: Ernest S. Christian

Through a combination of historical accidents, serious policy mistakes, internal political constraints, and some fairly smart maneuvering by other nations, the U.S. administers an international tax policy that runs contrary to both logic and national self-interest. And because this policy is clearly out of step with the tax practices of most other countries, the U.S. must change its basic rules so it can join the rest of the world in subsidizing exports in a treaty-legal way.

For years the U.S. has been struggling to extricate itself from the clutches of its archaic worldwide taxing system and to alleviate the tax bias against its own exports. But because of the continuing political influence of those who view foreign trade with suspicion, the effort has been schizophrenic and largely ineffectual. Instead of changing the basic rules that comprise the source of the problem, the U.S. has created an extraordinary hodgepodge of international tax rules and exceptions that often operate at cross-purposes.

For example, U.S. owned companies that do business abroad can "defer" U.S. tax on their foreign-source profits only if they reinvest the profits abroad. If they bring the money home for reinvestment in the U.S. economy, they will have to pay a full and immediate U.S. tax.

In order to enjoy the benefits of deferral, companies must also forego opportunities to minimize the amount of taxes they pay to foreign governments which, in most cases, means that the company will pay more foreign tax than is necessary. Although the price is often high, the value of "deferral" is usually worth it to the large companies whose cash flow capacities permit them to keep all foreign-source profits abroad. But to the many smaller companies that need the cash and that must repatriate earnings, deferral is not an option. They must immediately pay U.S. tax on their worldwide income.

Even among large companies the current code causes incongruous results. A company with the financial capacity to perpetuate deferral can build a plant abroad and sell its products in foreign markets without paying U.S. tax. But if that same company were to build a plant here and export American-made goods to the same foreign market, it would have to pay a full and immediate U.S. tax. Not only does the current tax code favor large companies over small ones, it also favors foreign-made products over American-made ones.

The Elements of Tax Reform

From an international perspective, tax reform consists ideally of two inter-dependent components. The first is a territorial rule that excludes from tax the income that U.S. companies derive from activities conducted outside the U.S. An American company pays only the tax of the host country and is therefore on an equal footing with its local competitors. The second component is a set of complementary border tax adjustments. One adjustment imposes tax when companies outside the U.S. export into the U.S. market. The other excuses tax when companies inside the U.S. export to foreign markets.

Such a system provides an even-handed choice to U.S.- and foreign-owned companies that sell to the U.S. market. If either manufactures the goods in the U.S., it pays U.S. income tax on both manufacturing and sales activities. Or they may manufacture the goods abroad but sell them in the U.S., in which case they incur U.S. income tax on sales in this country and the U.S. collects an import tax. As far as U.S. law is concerned, the total tax cost associated with selling the goods in the U.S. market is essentially the same, regardless of whether a company manufactures the goods at home or abroad.

Because the U.S. tax is the same either way, neither foreign-owned nor American companies would gain a distinct U.S. tax advantage. A company may locate its plant in the U.S. and export abroad, in which case the border tax adjustment on outbound transactions would exclude the company's export income from U.S. tax. Or, a U.S. company may locate its plant in a foreign country in which the territorial rule excuses the company from U.S. tax on its foreign-source income.

Given the choice of staying home and still being able to make tax-free exports to foreign markets, most U.S. companies would probably manufacture in the U.S. And given the same choice, most foreign-owned companies would see the wisdom of locating a plant in the U.S. and using it as a base for tax-free export sales to markets all around the world.

Such tax adjustments are not new. All countries that maintain value-added tax (VAT) systems already exempt their own exports from tax, and impose import taxes when other countries export to them. Replacing America's current worldwide taxing system (which taxes the income of U.S. companies from their activities outside as well as inside the country) with a territorial system that taxes only their income from activities inside the U.S. is fully consistent with international standards.

How U.S. Companies Participate in Foreign Markets

U.S. companies compete in global markets in two ways. First, they produce products in the U.S. and sell them abroad. These exports may be tangible (automobile), intangible (patent), or service (an architect designs a building for Berlin). These are export transactions that produce U.S.-source income because the activity occurs within the U.S.

American companies also compete in global markets by conducting business activities abroad. A U.S. company sells its American-made product to its foreign subsidiary, which distributes the product in the foreign market. Because the distribution (and sometimes the production) occurs outside the U.S., this is foreign-source income.

When capital investment and labor are in the U.S. and the customers are abroad, the benefits of export trade are obvious. New customers abroad permit sales to exceed the domestic demand for consumption and investment goods. As the amount of GDP increases, so do aggregate wages and returns to capital, thereby increasing U.S.-source income. When U.S. businesses produce and/or distribute goods abroad, they make foreign direct investment or FDI. If foreign operations are limited to distribution, FDI is small. But if production and distribution are overseas, FDI is large.

When U.S. companies conduct operations abroad, both the foreign nation and the U.S. economy benefit. Customer base expands and foreign-source income rises. Moreover, direct investments and operations by U.S. companies in foreign markets lead to increased exports of American-made goods and to more (not less) jobs in the high-paying sectors of the U.S. economy. This symbiotic relationship between exports to a foreign country and business operations in that country highlights the importance of having a neutral tax system that allows U.S. companies to choose the combination that will maximize sales in foreign markets to the ultimate benefit of U.S. labor and capital.

While foreign operations in the U.S. are conducted the same way, the impact of taxes is quite different. Generally, the income foreign companies derive from producing and distributing within the U.S. is partially or wholly exempt from home-country income taxes and is not subject to value-added taxes. In addition, their domestic-source income from home-country activities is exempt from a major portion of their home country's tax burden and is never taxed in the U.S. In contrast, when U.S. companies produce goods and services for export, their domestic-source income from activities in the U.S. is fully taxed by the U.S. Moreover, when those products enter the foreign country, they are taxed again by the country of destination.

How Taxes Distort Choices, Reduce Returns, and Misallocate Resources

Under current U.S. law, consumed income is taxed less that saved income. This encourages Americans to consume as much as possible. Also under current law, imports are exempt from the taxes that are imposed on the manufacturers of American-made products for sale in the U.S. or for export. This combination of encouraged consumption and subsidized imports guarantees to produce some degree of trade imbalance. Once started, such distortions tend to perpetuate and enlarge themselves.

When taxes intervene, they usually reduce the return to labor and capital. If a $10 tax is imposed on a company, it must either reduce wages or dividends by $10 (which penalizes workers or investors) or raise prices by $10. Yet every $10 increase the company receives has already been taken away by the tax and nothing remains for employees or shareholders.

Taxes can also reduce the amount of goods produced by labor and capital. Higher tax rates can reduce the value of employee efforts, making them less inclined to produce. The same is true of capital investment. Low after-tax returns can make entrepreneurial investment no longer worth the risk. And because taxes can have uneven impacts (taxing some income sources more heavily than others), they can have a deleterious impact on economic output.

The U.S. practice of taxing an American-owned company on its worldwide income can be highly disadvantageous to American interests. U.S. companies already compete against foreign companies who operate under territorial systems of taxation that permit them to exclude from their home-country tax large portions of the income they earn in the global marketplace. Moreover, when taking into account the taxes the other countries impose on U.S. companies when they export into foreign markets, the failure of the U.S. to border-adjust for imports works against U.S. interests and becomes much harder to defend as a policy.

Even under existing treaty obligations and interpretations dating back to the 1960s and 1970s, the U.S. can make its tax system border adjustable without having to enact a European VAT or any form of sales or transactions tax. Instead, it need only make its corporate income tax neutral as between labor and capital in order to be able to exclude its export sales from tax, as the Europeans and others already do.

A Practical Example

A tax system designed to address the international components of reform is H.R. 134, a comprehensive proposal that includes a reformed personal tax too. H.R. 134 recognizes the benefit to the U.S. economy when U.S. companies compete and win in the global marketplace. It then equips them with the kind of tax system that will be most conducive to that success.

The Simplified USA Tax in H.R. 134 in the 106th Congress

Business Level Tax

Rate: 7.65% on first $150,000 and 12% on excess

Tax Base: Sales Revenues from Domestic Operations (-) Exports (-) Purchases of Inventory (-) Purchases of Equipment & Services

Payroll Tax: Tax Credit for Employer-Paid Payroll Tax

Imports: 12% Tax on Imported Inventory, Equipment & Services

Note: No Deduction for Wages Paid, Dividends Paid or Interest Paid

Wages ↙ ↘ Interest, Dividends & Sales of Stock

Individual-Level Tax

Rates: Progressive Rates of 15, 25, and 30%

Tax Base: Wages + Interest + Dividends + Sales of Stock and Other Assets (-) Deductions

Savings:

(1) Universal Roth IRA — No Deduction Allowed for Contributions, but previously-Taxed Principal and Earnings on Principal Are Not Taxed when Withdrawn from USA Roth IRA. No Limit on Contributions and No Restrictions on Withdrawals.

(2) Deduction for '401(k), etc. —Preserves Limited Deductions Allowed under Current Code for '401(k), Other Employer-Sponsored Qualified Plans and Deductible IRAs.

Other Deductions: Deduction for Exempt Amount & Deductions for Home Mortgage Interest, Charitable Contributions & Secondary Education

Payroll Tax: Credit for Employee-Paid Payroll Tax

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First, it says that foreign-source income of U.S. persons should not be taxed. Second, in the case of an export sale, both the manufacturing and the sales profits should be treated as foreign-source income—as if the product had been manufactured and sold abroad. Third, when a U.S. company succeeds in a foreign market, it should be encouraged to bring its profits home, without penalty, for reinvestment in the U.S. Moreover, the U.S. tax burden should no longer be concentrated solely on U.S. labor and capital as it is today. Instead, foreign companies that participate in the U.S. market should be brought into the U.S. tax base and be required to share in the U.S. tax burden.

H.R. 134 adopts a territorial system whereby all foreign-source income of U.S. citizens and companies is excluded from U.S. tax. American companies could make foreign direct investment and operate in overseas markets (either through a branch, a U.S. subsidiary, or a controlled foreign corporation) without incurring U.S. tax on profits and without regard to whether those profits are reinvested abroad or repatriated to the U.S. All foreign-source interest, dividends, and royalties would be excluded from U.S. tax as well.

Under the fully territorial regime contained in this model, U.S. companies would be subject only to the taxes of the host country where they compete in foreign markets and would be, for the first time in history, on equal tax footing with their competitors. Because U.S. companies would pay no U.S. tax on their foreign-source income, the foreign tax credit would be repealed.

An import tax is the other critical function of H.R. 134. Like the export exclusion, the first function of the import tax is to permit the territorial system to be enacted and to function without creating a tax haven. If a U.S. company moved a plant offshore and sold back to the U.S., it would pay an import tax equal to the U.S. business tax rate but without any deductions. Therefore, there would be no U.S. tax incentive for the company to move abroad.

The other function of the import tax involves trade. Because import taxes have been associated with VATs, import adjustments have been considered tariffs designed to make foreign goods more expensive. Rather than keeping foreign-made goods out or causing U.S. purchasers to pay more for them, the primary function of the proposed import adjustment is to expand the U.S. tax base to include the foreign-based companies that sell into the U.S. market. In effect, they end up bearing part of the U.S. tax burden.

Territorial versus Worldwide Taxation

All countries do not have the same tax systems. If they did, the result would be exactly the same to every national treasury and to all businesses regardless of a territorial or a worldwide system. Absolute uniformity of taxation across national boundaries would make taxes a neutral competitive factor not only within a market but across markets as well.

In the imperfect world of reality where tax systems vary greatly, territoriality may not achieve uniformity of taxation across all markets but it will produce uniformity of taxation within the same market. In contrast, the worldwide tax system does not achieve neutrality of taxation within a foreign market and, in fact, is not intended to do so. Today's foreign tax credit is so limited that the U.S. worldwide tax is a non-neutral factor to the disadvantage of U.S. companies.

Without question, territoriality gives the U.S. government the least opportunity to interfere with the way U.S.-owned companies compete in foreign markets. Both the foreign tax credit and deferral are creatures of the worldwide tax system and both have forced U.S. companies to conduct their business abroad in ways that have made them less competitive.

Territoriality facilitates foreign direct investment, and anytime U.S.-owned companies gain wealth by means of exploiting a foreign market, the nation is wealthier and everyone is better off. But what happens to U.S. output and jobs when a U.S. company manufactures and sells products in a foreign market? Basically, foreign direct investment by U.S. firms also enhances their U.S. operations and domestic job-creating capacities. Foreign operations can use U.S.-made components. When penetrating a foreign market with direct investment, export sales to that market usually increase as well. Foreign direct investment by U.S. companies is complementary to, not a substitute for, U.S. production and jobs.

Importing a Tax Base and Cutting Taxes for Americans

Tax reform can mean a massive tax cut for U.S. labor and capital. Currently labor and capital bear the entire burden of the U.S. income tax, and labor alone carries the weight of payroll taxes. If part of that tax was replaced by an import tax primarily borne by foreign labor and capital, the U.S. would have gained an additional tax base of wages, interest, and dividends received by foreigners who produce (outside the U.S.) the goods and services that they export into the U.S. market.

Let's assume that the U.S. replaces the current corporate and personal incomes taxes with a business and personal tax similar to the model of H.R. 134. Now assume the bill imposes a 10% import tax, a good portion of which would be borne by foreign labor and capital. The model tax would raise the same annual amount for the treasury as the current income tax, and yet reduce the tax burden on Americans by at least $100 billion a year.

There are many reasons for tax reform, but the most powerful politically may be the may be the tax cut inherent in tax reform.

This study is a summary of IPI Policy Report # 166, *The International Components of Tax Reform: Tax Policy that Serves the National Interest,* by Ernest S. Christian, Chief Counsel, Center for Strategic Tax Reform

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IPI *Quick Study* is published by the Institute for Policy Innovation (IPI), a non-profit public policy organization.

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