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President Obama's International Tax Proposals Could Go Further

by
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The Obama Administration's 2011 budget proposals include revenues of $122 billion over ten years from "international tax reform." This set of proposals is similar to but narrower than the ones advanced by the Administration in May 2009, which would have raised $210 billion.

The two main proposals are substantially repeated from 2009. The first would indirectly limit the deferral opportunity for US-based multinationals (MNEs) by restricting the deductibility of interest expense that is allocated to deferred income. Under current law, US-based MNEs that earn foreign source active business income through their foreign affiliates (CFCs) can defer US tax on such income until the CFCs pay a dividend to their US parent corporation. At the same time, the US parent may deduct currently interest expense even if it is allocated to the deferred income of the CFCs. The same proposal was made in 2009 but applied to a broader category of deductions.

The second proposal restricts the ability of US-based MNEs to repatriate income from CFCs in high-tax jurisdictions while continuing to defer tax on income earned by CFCs in low-tax jurisdictions. Under current law, dividends paid by CFCs carry with them foreign tax credits that are calculated based on a formula that compares the amount of tax paid to the CFCs' earnings. The new proposal would calculate the tax paid and the amount of credit given based on the pooled earnings of all the CFCs of a MNE, including CFCs in low-tax jurisdictions. The result would be a higher US tax burden on the repatriated earnings. This proposal was also made in 2009.

These proposals are interesting because they seem to run counter to the prevailing international trend. In recent years, jurisdictions such as the UK and Japan that used to tax their

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MNEs on a worldwide basis have moved in the direction of territorial taxation by exempting dividends paid by CFCs to the parent corporation out of active business income but at the same time tightening their CFC anti-abuse provisions. Other OECD members such as Germany, France and Canada that have CFC regimes have always exempted dividends from active business income. By imposing indirect restrictions on deferral and increasing the tax burden on repatriations, the Obama Administration risks being perceived as putting US-based MNEs at a competitive disadvantage.[1]

However, in my opinion such a view is mistaken, for three reasons. First, there is no evidence that US taxation of the foreign source income of US multinationals puts them at a disadvantage. Second, our FDI partners tax foreign source income more than we do, and that will still be true if the Obama proposals are adopted. Third, even if we want to go further and tax US multinationals on all their foreign source income, we could use the OECD to coordinate such a move with our FDI partners so that no competitive disadvantage would result.

US multinationals have been making the competitive disadvantage argument since 1961, when President Kennedy first proposed to tax them on their overseas profits. At that time, US multinationals dominated the world. GM, to take a painful example, had over 40% of the US car market. Since then, other countries have grown, and US multinationals face more competition. But there is absolutely no empirical evidence that any of the myriad changes to our taxation of foreign profits of US multinationals since 1961 has made any difference to their ability to compete. US multinationals succeed when they create products or services the world wants to buy, and they fail (like GM) when they do not.

Nor is it true that our FDI partners tax their multinationals more lightly. They do refrain from taxing dividend distributions from foreign income, but they restrict this to income that was either taxed overseas or that has a real connection to the country it was earned in. We, on the other hand, tax dividends but give a credit for foreign taxes, so that in most cases US-based MNEs do not pay tax on foreign source dividends. And we permit our multinationals to defer taxation on a much broader range of income than our foreign competitors. For example, US banks and insurance companies are free to set up shop in Caribbean tax havens and not pay tax on their earnings there, while our competitors would tax these earnings unless you could show a real connection to the country they are supposedly earned in. As a result, our multinationals pay less tax on their foreign profits than their competitors, and this will not change if the Obama proposals are adopted.

The Obama proposals could have gone much farther. They envisage raising $58 billion over ten years from partially taxing foreign profits, while adopting the Kennedy Administration proposal to tax all foreign profits would have raised $250 billion. But even that supposedly radical step could be achieved if we were willing to coordinate it with our FDI partners, most of whom adopted their rules to tax foreign income following our lead. Such coordination is possible, as shown by the OECD adoption of a binding treaty that embodies the principles of the Foreign Corrupt Practices Act (before the OECD treaty, US-based MNEs were the only ones subject to FCPA and were at a competitive disadvantage).

US multinationals currently earn a third of their overseas profits in three low-tax countries (Bermuda, the Netherlands, and Luxembourg). Eight of the top ten locations for US multinational profits have an effective tax rate of less than 10%. The Obama proposals represent

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[1] Matthew J. Slaughter, "How to destroy American jobs: Obama's proposals for increasing the tax burden on U.S.-based multinationals would harm our most dynamic companies," *Wall Street Journal*, Feb. 3, 2010.

a very cautious first step toward making US multinationals pay their fair share of the tax burden, and toward leveling the playing field with small US businesses that are subject to the full 35% tax and that are our principal job creators. Congress should enact them as soon as possible.

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The Vale Columbia Center on Sustainable International Investment (VCC), led by Dr. Karl P. Sauvant, is a joint center of Columbia Law School and The Earth Institute at Columbia University. It seeks to be a leader on issues related to foreign direct investment (FDI) in the global economy. VCC focuses on the analysis and teaching of the implications of FDI for public policy and international investment law.

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