NEED TO KNOW

AMERICANS FOR PROSPERITY FOUNDATION

INTERNATIONAL CORPORATE TAXES: THE "TERRITORIAL" VS. "WORLDWIDE" SYSTEM

The United States holds a dubious distinction—at 39%, the nation's combined state and federal corporate tax rate is the highest in the developed world (8). There are a number of reasons why such a high tax rate on business activity is harmful (2). But one reason it bites especially hard is due to the way our federal government taxes international business income. Under current law, no matter where in the world American companies earn income, they are taxed at the high U.S. rate, leaving U.S. companies at a disadvantage

HOW DOES THE CURRENT SYSTEM WORK?

Under a pure "worldwide" international tax system, U.S. companies that earn profits abroad would have to pay both taxes to the foreign country at its tax rate and taxes to the U.S. government at the difference between the foreign country's tax rate and the U.S. tax rate, almost always leading to a larger tax bill. The U.S. system, however, has an important caveat: companies can indefinitely "defer" this extra layer of tax so long as their foreign income is not returned ("repatriated") to the U.S.

Unfortunately, this encourages companies to keep their money overseas instead of bringing it back home to invest in the U.S. economy. Recent estimates show that more than a trillion dollars of "undistributed foreign earnings" are currently sitting abroad as a result (4).

Here is an example: imagine that an American company called SHOECO sells sneakers in both the U.S. and in Ireland. If SHOECO's subsidiary in Ireland earned $100 profit, it would be taxed at Ireland's low 12.5% rate-a tax bill of $12.50. However, if that subsidiary wanted to bring that income back to the U.S. to hire more American workers or expand operations at home, SHOECO would have to make up the difference between Ireland's 12.5% corporate tax rate and the U.S. government's 35% federal rate. This would raise the total tax bill from $12.50 to $35. Remember, an Irish company operating side-by-side with SHEOCO would only pay the $12.50.

Here SHOECO would have three options: pay the expensive U.S. tax to repatriate the income, keep its income in Ireland, or move to Ireland all together. In the real world companies tend to pursue one of the latter two options, reducing economic activity and job growth here in the U.S.

THE ADVANTAGES OF A "TERRITORIAL" SYSTEM

Most other developed economies use a "territorial" system for international taxation. Under this system, the U.S. would only tax income earned in the U.S. and would exempt all overseas income from extra U.S. taxes. In the case of SHOECO, income earned by its Irish subsidiary would still be taxed at Ireland's corporate tax rate, but there would be no additional tax to bring that income home to the U.S.

QUICK FACTS

- As of October 2015, the United States has the highest corporate tax rate in the industrialized world (8).
- The current U.S. international tax regime has "locked out" well over $1 trillion in funds earned overseas that could be reinvested here at home to create jobs.

NOTABLE & QUOTABLE

"[D]o away with the worldwide structure and implement a territorial tax system like those in most other industrialized nations. This would provide a companies competing in markets at home and abroad."

\- **Edward Rapp**, Caterpillar Inc. (1).

This approach has several advantages (5). Most importantly, it allows U.S. businesses to compete on a level playing field with their foreign competitors and removes the barriers companies currently face to bringing home foreign income to the U.S.

THE 2004 REPATRIATION TAX HOLIDAY

We can get a rough idea of the impact of moving to a territorial system by looking at past experience. In 2004, the American Jobs Creation Act provided a temporary one-year "holiday" from repatriation taxes-in effect, the U.S. used a territorial system temporarily. Businesses seized the opportunity and that year brought home more than $300 billion in additional foreign earnings that were otherwise trapped abroad because of high repatriation taxes. Moreover, they put that money to work in the American economy by investing in capital and R&D, hiring and training employees, and paying dividends to shareholders (6).

JOBS HERE OR ABROAD?

Opponents generally argue that a territorial system encourages businesses to shift jobs and production overseas, chasing the lower corporate tax rates in foreign countries. But this argument relies on the assumption that increased production and employment in foreign countries are a substitute for (completely displace) job creation here at home.

In fact, often the opposite is true: foreign business activity is actually a compliment to (increases) domestic business activity. SHOECO, for example, might produce and sell more sneakers in Ireland, but that could require more R&D or administrative jobs at its headquarters in the U.S. SHOECO's U.S. shareholders would also benefit when the company's stock rises in response to the increased shoe sales—those shareholders (which could include pensioners across the country) would use that increased wealth to invest and spend more in the U.S.

A recent study by economists from Harvard and the University of Michigan illustrates this point. They found that when American firms increased their foreign operations by 10%, instead of cutting domestic employment they actually increased it by 3.7% on average (7). In short, more jobs abroad often times means more jobs here as well.

Endnotes:

1. House Committee on Ways and Means, Business Leaders in Support of a Territorial Tax System (online at http://waysandmeans.house.gov/UploadedFiles/Intl_quotes.pdf) (accessed May 16, 2012).
2. ii. Scott A. Hodge, The Countdown is over. We're #1, Tax Foundation, Fiscal Fact No. 294 (April 1, 2012) (online at http://www.taxfoundation.org/news/show/28081.html).
3. Scott A. Hodge, Ten Benefits of Cutting the U.S. Corporate Tax Rate, Tax Foundation, Special Report No. 192 (May 11, 2011) (online at http://taxfoundation.org/publications/show/27269.html).
4. David Faber, Undistributed Foreign Earnings on the Rise, CNBC (May 25, 2011) (online at http://www.cnbc.com/id/43152232/Undistributed_Foreign_Earnings_on_the_Rise).
5. Scott A. Hodge, Ten Reasons the U.S. Should Move to a Territorial System of Taxing Foreign Earnings

6i. John R. Graham et al., Barriers to Mobility: The Lockout Effect of U.S. Taxation of Worldwide Corporate Profits (August 25, 2010) (online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1316576).

7. Mihir A. Desai et al., Domestic Effects of the Foreign Activities of U.S. Nationals
8. http://taxfoundation.org/article/corporate-income-tax-rates-around-world-2015

Americans for Prosperity Foundation's "Need to Know" informational series explores current events and recent scholarship on public policy isues from a free-market economics perspective. A full list of "Need to Know" briefings is available at www.AmericansForProsperityFoundation.org/NeetToKnow.