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The U.S. International Tax System at a Crossroads

*Barbara Angus, Tom Neubig, Eric Solomon, and Mark Weinberger**

I. AT A CROSSROADS

In what may seem like a relatively rare consensus, tax policymakers, tax practitioners, and taxpayers agree on one major issue: the U.S. international tax system must be reassessed. It is outdated, too complex, and increasingly proving to be ineffective in supporting the goals of either government or business.

The fundamental elements of the current system are the product of vigorous debate that took place almost 50 years ago. Since then, the laws have been augmented, patched, clarified, and otherwise tweaked. They have been amended to provide additional incentives, to address inequities, to close off negative unintended consequences, or simply to raise revenue. As a result, the system is an overcomplicated set of rules that has evolved largely without what could be considered appropriate analysis or debate regarding the long-term competitive effect or alignment with worldwide tax policy trends. This is neither unusual nor unexpected. This observation is not intended as a criticism of the process, but merely as a recognition of the practical and political realities.

Throughout this evolution of the U.S. international tax system, the way the world does business has been changing at an extraordinary pace. New industries have been created. New markets have opened. The flow of capital has shifted. New economic powers have arisen. These developments are transforming the landscape for businesses in the United States and around the world. As a result, U.S. tax policy decisions, which

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historically could be made without great concern about what was happening beyond our borders, can no longer be made in a vacuum.

Today the U.S. international tax system stands at a crossroads. Over the past decade, a variety of voices have called for a comprehensive review and modernization of the U.S. international tax rules. Most recently, the Obama administration advanced specific proposals for major changes in the international tax area.

The administration's first international tax proposals came with its fiscal 2010 budget, which was released in February 2009 and detailed in May 2009. The potential revenue effect of those proposals was estimated by Treasury as an aggregate tax increase of approximately \$150 billion over 10 years.¹ Central to this package of proposed international tax changes were three key proposals that would (1) curtail the U.S. system of deferral for foreign earnings by denying expense deductions on a current basis; (2) restrict the use of foreign tax credits to offset U.S. tax on foreign earnings; and (3) substantially eliminate the use of the check-the-box entity classification rules in structuring foreign operations. These proposals taken together would represent a substantial shift in the U.S. approach to taxation of U.S.-headquartered global businesses.

The administration recently released its fiscal 2011 budget proposals, which include many of the same proposals for international tax changes. The administration's current set of international tax proposals is modestly scaled back in revenue terms, with Treasury estimating an aggregate potential revenue effect of approximately \$122 billion over 10 years. Major modifications in this year's international tax proposals include the elimination of the proposal to curtail use of the check-the-box rules and the addition of a new proposal on the U.S. tax treatment of transferred intangible property. The proposals being advanced by the administration continue to represent changes that would have significant implications for U.S.-headquartered companies operating in the global marketplace.

As these international tax proposals are considered by Congress in the coming months, it is important to note that there has been something of a shift in the administration's tone in discussing international tax matters, which is encouraging. When the administration first unveiled its international tax proposals last year, the descriptions used strong language. In May 2009 Treasury Secretary Timothy Geithner described the proposed international tax changes as "ending loopholes that allow companies to

¹ Treasury's original estimate when the details of the international tax proposals were released in May 2009 was that the proposals represented an aggregate tax increase of approximately \$210 billion over 10 years. See DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS 28-40 (2009) (the Treasury green book). Treasury revised that estimate downward in August 2009 after the Joint Committee on Taxation released its revenue estimates of the administration's proposals.

avoid paying taxes.”² The Joint Committee on Taxation (“JCT”) used similarly strong language in its September 2009 report describing the administration’s proposals, referring, for example, to “distortion of investment choice” and “inappropriate minimization of currently taxable income.”³

More recently, in his testimony before the House Ways and Means Committee in February 2010 following the release of the administration’s fiscal 2011 budget, Secretary Geithner noted the need to “strike a balance” regarding the U.S. international tax rules and said, “We are concerned about the competitiveness of U.S. companies abroad.” He identified the administration’s goal as “to limit the role taxes play in business investment decisions,” which he indicated was to be accomplished by reducing “implicit tax incentives to move investment and jobs overseas.” He then stated the administration’s openness to discussing the best approach to achieve that goal.⁴

In response to the administration’s fiscal 2011 budget proposals, Senate Finance Committee Chairman Max Baucus, D-Mont., expressed support for addressing any inappropriate incentives through an overall tax reform effort. He described the goal of that reform in positive terms: “I intend to work in the Finance Committee to prepare for comprehensive tax reform that will meet the goals of making U.S. businesses more competitive globally and making America a more attractive location for business investment.”⁵

The administration’s international tax proposals and the response to them over the past year have made clear that, while all stakeholders agree that revisions to the international tax rules are in order, their agreement ends there. What form any changes should take, how extensive they should be, and, most importantly, what should be accomplished by implementing changes remain a subject of vigorous discussion.

The fundamental question is what would be the most advantageous international tax system for the United States in today’s increasingly

² Press Release, Dep’t of the Treasury, Administration Proposes Tax Cuts for Middle Class Families and Small Businesses, Closing Corporate Tax Loopholes: “Greenbook” Details Efforts to Build Prosperity, Increase Fairness of Tax Code (May 11, 2009), *available at* <http://www.ustreas.gov/press/releases/tg125.htm>.

³ STAFF OF THE JOINT COMM. ON TAXATION, 111TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT’S FISCAL YEAR 2010 BUDGET PROPOSAL—PART THREE: PROVISIONS RELATED TO THE TAXATION OF CROSS-BORDER INCOME AND INVESTMENT 10, 12 (Comm. Print 2009) [hereinafter, JCT REPORT].

⁴ Press Release, Dep’t of the Treasury, Treasury Secretary Timothy F. Geithner, Written Testimony, House Ways and Means Committee (Feb. 3, 2010), *available at* <http://www.ustreas.gov/press/releases/tg531.htm>.

⁵ Press Release, Senate Comm. on Fin., Baucus Comments on President’s FY 2011 Budget (Feb. 1, 2010), *available at* <http://finance.senate.gov/newsroom/chairman/release/?id=3a985d4f-045d-491c-af2a-5918cb58b2fc>.

globally integrated economy. The vital importance of this question demands diligent analysis and a comprehensive and thoughtful discussion. It is critical that the discussion not be influenced by rhetoric.

The scope of this debate should be broad. An analysis of the U.S. international tax system in isolation would not present the full picture. Rather, it is essential that policymakers consider the entire business tax system, including the corporate tax rate, as part of this discussion. It also is imperative that the analysis encompass a global view. With respect to both its tax rates and how foreign earnings are taxed, the U.S. business tax system is increasingly out of step with the tax systems of U.S. trading partners. Many countries have made significant changes in their tax systems in recent years. Policymakers should broadly examine these developments and all the factors that influenced these developments with a view toward the implications for the United States.

The suggestion is not that the United States should simply follow the path that other countries have taken. Rather, policymakers should fully consider what implications developments outside our borders have for the determination of what is most effective for the United States today. At the same time, policymakers should not make the mistake of assuming that other countries will follow the U.S. lead in terms of tax policy. Developments over the past decade make clear that U.S. trading partners will make choices in furtherance of their national economic interests that are different from the choices the United States has made to date. The United States should do what any country should do: ensure that its tax policy fosters a competitive global environment for its home country businesses.

As at any crossroads, there will be differing views about the right path to take. There are many parties involved, with sometimes conflicting points of view. However, everyone should agree that making a decision without considering all the underlying facts and broader perspectives, and without fairly weighing both benefits and risks, would be imprudent.

The current U.S. international tax system, the administration's international tax proposals, and other potential international tax reforms all have ramifications for U.S. businesses, American workers, and the U.S. economy that must be fully discussed and understood. This report focuses on some of the most important facts and perspectives that should be considered as part of that discussion. This process starts by asking, at a minimum, questions like these:

- 1) How have the dynamics of the global economy changed?
- 2) What role should differences between the U.S. tax system and those of other countries play in determining an advantageous international tax policy for the United States?

- 3) What are the tax policy choices that would best support the needs of the U.S. government and business in today's world?
- 4) What are the potential consequences of placing additional tax burdens on foreign investment by U.S.-headquartered global companies?
- 5) How do the U.S. transfer pricing rules fit into the U.S. tax system and integrate with the rules of U.S. trading partners in today's global economy?

In addressing these questions, one thing that taxpayers and tax policymakers of both political parties can agree on is that the tax laws should not disadvantage American businesses, workers, or consumers. In fact, the focus should be on improving the overall standard of living for Americans by providing good employment opportunities with businesses that are thriving in today's global economy. As policymakers approach their challenge of crafting an advantageous international tax system for the United States, they should maintain a clear focus on what is best for the U.S. economy and the American people.

II. THE GLOBAL ECONOMIC LANDSCAPE

The dynamics of the global economy have changed dramatically since 1962, when key elements of the current U.S. international tax system were constructed.

Enormous changes have occurred in the global economy in the nearly 50 years since the policy decisions that underlie the current U.S. international tax system were made. As tax policymakers consider reform of the U.S. international tax system, they must first understand what has changed, why it has changed, and how the dynamics of today's globally integrated economy affect efforts to design an advantageous system for the United States going forward.

The world economy in 2010 is vastly different than it was in 1962. The U.S. economy represents a smaller share of the world economy. In addition, the U.S. economy is increasingly more integrated and interdependent with the rest of the world economy. The composition of the world economy has also changed. Traditional manufacturing has declined in relative size, while technology, services, financial innovation, and intangible assets have grown. These developments are reflected in how U.S. headquartered global companies operate. These developments affect in fundamental ways the analysis of what is the most advantageous international tax system for the United States.

A. The Shifting Economic Balance

The United States held a dominant position in the world economy in

1962, when key features of the current international tax rules were developed. In 1962 the U.S. share of world GDP was 38 percent. By 2007, this share had fallen to 21 percent, which represents a decline of approximately 40 percent.⁶

While the U.S. economy continues to grow (with an annual GDP growth rate of 4.2 percent during the past 10 years), many developing countries are experiencing more rapid growth. This is partly attributable to faster population growth in those countries. Their per capita GDP is growing faster, reflecting improvements in their educational, market, and political systems. In response to these shifting dynamics, U.S. companies are increasing their investments and activities in developing countries to capture a share of their high growth rates.

The rise in the contribution to world GDP from developing economies (Brazil, China, India, and the other emerging economies) is a phenomenon that began in the past decade. Between 1980 and 2000, the advanced economies' share of world GDP was stable at roughly 64 percent. During this period, advanced economies were growing at the same average rate as developing economies. Since 2000, however, the developing economies' share of world GDP has been increasing. Between 2000 and 2007, the developing economies have contributed more than half (53 percent) of world GDP growth. The International Monetary Fund projects that the developing economies will contribute 72 percent of world GDP growth between 2007 and 2014. The developing economies are projected to exceed half of the world's total GDP before 2014.

Table 1. World Real GDP Shares: Advanced and Developing Economies							
Region	1980	1985	1990	1995	2000	2007	2014*
Advanced economies (including the United States)	64%	64%	64%	64%	63%	56%	49%
United States	22%	23%	23%	23%	23%	21%	18%
Developing economies	36%	36%	36%	36%	37%	44%	51%
World	100%	100%	100%	100%	100%	100%	100%
*Projected estimates.							
Source: International Monetary Fund, World Economic Outlook.							

Businesses today are selling and operating in more foreign countries than ever because of the high rate of economic growth in the developing countries. Vibrant markets for consumer products and capital investment are found in fast-growing economies, such as China and other emerging

⁶ The 38 percent represents the U.S. share of nominal GDP for 1962, while the 21 percent represents the U.S. share of real GDP in 2007 (data on the share of real GDP for 1962 is not available). Although the U.S. share of world GDP has declined, the United States remains one of the richest countries, with per capita GDP of \$47,400 in 2008, compared with a per capita GDP of \$43,000 in other advanced countries and \$5,500 in developing countries.

economies. For example, mobile telephone handset sales in emerging markets surpassed those in advanced markets in 2005 and were 63 percent of phones sold in 2007.⁷

Historically, U.S. foreign direct investment was largely focused on developing countries with available natural resources and, in some cases, on locations with lower labor costs. However, because of the emergence of middle-income households in many of these countries, these countries increasingly have a role in the global economy as buyers of goods rather than just as sellers of resources and labor. U.S.-headquartered global companies have facilities and employees in these growing markets to meet the growing demand for goods and services.

The changing position of the U.S. economy within the world economy and the rise of new economic powers from developing countries are also reflected in the geographic composition of the *Fortune* Global 500 companies.

Table 2 highlights how the *Fortune* Global 500 companies have shifted over the past decade:

- In 2009, 28 percent of these top global companies were headquartered in the United States, down from nearly 36 percent in 2000.
- In 2009, 32 percent of these top global companies were headquartered in countries other than the G-7 countries, up from 16 percent in 2000.
- In 2009, 58 of the top 500 global companies were headquartered in Brazil, Russia, India, or China, up from 16 in 2000. This represents a 360 percent increase in less than a decade.
- It is worth noting that the 2009 adoption by Japan and the United Kingdom of territorial taxation approaches, discussed further in the next section, came after a decade during which their relative roles as global headquarter locations declined sharply.

⁷ Tarmo Virki, *Weak Economy to Sap Handset Market Growth*, CIOL NEWS, Aug. 27, 2008 at 6, available at <http://www.ciol.com/News/News-Reports/Weak-economy-to-sap-handset-market-growth/27808109633/0/0>.

Table 2. Headquarters Locations of Fortune Global 500 Companies, 2000 and 2009						
Country	2000			2009		
	Total Revenue (billions)	Number of Companies	Percent of Companies	Total Revenue (billions)	Number of Companies	Percent of Companies
United States	\$4,681	179	35.8%	\$7,544	140	28.0%
Japan	\$2,991	107	21.4%	\$2,980	68	13.6%
Germany	\$1,317	37	7.4%	\$2,239	39	7.8%
France	\$972	37	7.4%	\$2,166	40	8.0%
China	\$200	10	2.0%	\$1,661	37	7.4%
United Kingdom	\$765	38	7.6%	\$1,583	27	5.4%
Netherlands	\$391	10	2.0%	\$1,044	12	2.4%
Italy	\$364	10	2.0%	\$639	10	2.0%
Korea	\$242	12	2.4%	\$603	14	2.8%
Switzerland	\$293	11	2.2%	\$666	15	3.0%
Total Top 10	\$11,804	451	90.2%	\$21,166	402	80.4%
Other	\$792	49	9.8%	\$4,069	98	19.6%
Total Global 500	\$12,596	500	100.0%	\$25,175	500	100.0%
G-7 countries*	\$10,929	420	84.0%	\$17,513	338	67.6%
BRIC countries*	\$201	16	3.2%	\$2,519	58	11.6%

*The G-7 countries are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

*The BRIC countries are Brazil, Russia, India, and China.

Sources: Fortune Global 500; Ernst & Young LLP.

Nani Beccalli-Falco, president and CEO of GE International, reflected on the evolution of global competition, stating: "When we used to do our competitive analysis, it tended to include only American, German or British names. Today, it's a company from China, another from India."⁸

B. Increased Economic Interconnectivity

The U.S. economy has never been a closed economy, but for most of its history its size and geographic isolation permitted significant growth from internal development. One measure of global integration is the sum of U.S. exports and imports as a share of the U.S. economy. In 1962 the sum of U.S. exports to other countries (5 percent) and U.S. imports (4 percent) totaled 9 percent of U.S. GDP. In 2008 U.S. exports and imports totaled 31 percent, for an increase of more than 340 percent. This reflects the global nature of both U.S. production (exports) and consumption (imports). Today close to one-third of the U.S. economy is integrated with international trade through exports and imports.

International trade through exports and imports is only one dimension of the increase in global interconnectivity. For many U.S.-headquartered global companies, foreign sales represent more than half of their total sales, with this percentage projected to increase in the future as sales growth is expected to come from the expanding markets outside the United States.

The continued success of U.S.-headquartered global companies in penetrating foreign markets depends not just on exports but also on the U.S. company having a local presence. U.S.-headquartered companies establish local operations in foreign countries for myriad business reasons, including

⁸ Ernst & Young LLP, REDRAWING THE MAP: GLOBALIZATION AND THE CHANGING WORLD OF BUSINESS 6 (2010).

logistical reasons (reduction of transportation costs, perishable products, need for just-in-time production), customer reasons (tailoring of products to particular market demands, provision of accompanying services), and legal reasons (avoidance of tariff barriers, satisfaction of local content requirements).

U.S.-headquartered companies with a significant local presence typically use a local subsidiary. Local subsidiaries are used for operational reasons, including management reporting, limiting liability risks, and limiting local tax risks, and for legal reasons, including satisfaction of requirements for government contracts and trade zone opportunities. Local subsidiaries also are used for market presence reasons. Local customers often will not take a foreign company seriously until it has a local entity with local officers. Moreover, a local subsidiary that can contract in its own name represents a better business partner for local customers and local suppliers. Having a local subsidiary provides the business with the important intangible of being part of the local community. This is important in establishing and maintaining relationships with suppliers, workers, and customers.

U.S.-headquartered companies also use local joint ventures to achieve quick access to growing foreign markets. Through a joint venture, a U.S. company can partner with an existing local business and enhance the market presence of both participants. For example, a U.S. company may bring to the venture its superior technology but needs the know-how of the local partner in tailoring the product to the local market. In other situations, the U.S. company may invest in a local business to ensure a strong local customer base.

It should be noted that there is a connection between exports by U.S.-headquartered companies and the operations these global companies establish locally to best serve the growing foreign markets. U.S. exports are an important source of supply for U.S. companies operating globally (and similarly are a supply source for foreign companies that have U.S. operations). Goods exported from U.S.-headquartered companies to their foreign affiliates and from U.S. affiliates of foreign-headquartered companies to their parent companies totaled 30 percent of all U.S. goods exports in 2005.⁹

The penetration into foreign markets by U.S. headquartered global companies is reflected in total foreign direct investment, which has nearly tripled over the past 30 years. The total stock of foreign direct investment by U.S. companies grew from 7.7 percent as compared with U.S. GDP in 1980, to 21.7 percent as compared with U.S. GDP in 2008.¹⁰

⁹ ECONOMIC REPORT OF THE PRESIDENT, 90 (Feb. 2008), *available at* http://www.gpoaccess.gov/eop/2008/2008_erp.pdf.

¹⁰ U.N. CONFERENCE ON TRADE AND DEVELOPMENT, *WORLD INVESTMENT REPORT 2008* UNCTAD/WIR/2008, U.N. SALES NO. E.08.II.D.23 (2008), *available at* <http://www.>

If U.S.-headquartered global companies are less able to capitalize on emerging market opportunities, U.S. investors will find foreign companies active in those markets to be more attractive as investment opportunities. U.S. investors can seek geographical diversification indirectly through investment in U.S.-headquartered companies with significant foreign direct investment or through portfolio investment in foreign companies. Portfolio investment, including U.S. households' investment of their retirement accounts and other financial assets, is increasingly invested in foreign corporate securities.

C. Growth in Services and Intangible Assets

Another change in the global economy since 1962 is the type of economic activity taking place globally. While traditional manufacturing-type activities remain an extremely important component of the economy, an increasing share of world economic growth is attributable to services and intangible assets.

The provision of services often is closely connected with the production and sale of goods. For example, a company that manufactures surgical suites (complete operating and examination rooms) in the United States and exports them to an emerging market will provide significant services in the foreign market to train hospital personnel in the use of the equipment in the suites. The same connection between manufacturing and the provision of related services also occurs in the information and communications technology sectors. The IT sector exports a wide range of products, including semiconductors, servers, and mainframes, and these companies must be on the ground in markets around the world in order to offer the critical service contracts that support those products. Producers of consumer goods, such as personal computers and telephones, similarly provide significant services in addition to the tangible goods they export.

According to Prof. Matthew Slaughter of Dartmouth's Tuck School of Business, the successful export of U.S. produced goods often must be accompanied by employees in other countries providing services related to those goods: "U.S. multinationals in many service lines of business simply must establish on-the-ground foreign affiliates to access foreign customers. And these service oriented businesses constitute the majority of multinational activity."¹¹

Another important part of the rise in services is the U.S.-led advance in the provision of consumer-oriented financial services in locations around the world. The U.S. capital markets have served to provide additional

unctad.org/Templates/Page.asp?intlItemID=3199&lang=1. Foreign direct investment by foreign companies into the United States also has grown. Foreign direct investment into the United States grew from 3 percent of GDP in 1980 to 15.7 percent of GDP in 2008.

¹¹ MATTHEW J. SLAUGHTER, BUS. ROUNDTABLE, HOW U.S. MULTINATIONAL COMPANIES STRENGTHEN THE U.S. ECONOMY (2009).

capital to emerging markets. U.S.-headquartered financial services companies are on the ground in developing countries, providing basic financial services needed by new businesses and new consumers that are emerging in those countries. U.S.-based financial services companies represent 20 percent of the 140 Fortune Global 500 companies that were headquartered in the United States in 2009. The provision of financial services in a foreign market requires a local presence with in-country employees, for both regulatory and business management reasons.

Moreover, the provision of local financial services in many cases is directly tied to U.S. export sales. To make the export sale, a manufacturing company must be able to provide the foreign customer the financing needed for the purchase. These services require the combined effort of local employees facing the customer and support functions performed in the United States.

Technology has contributed to the significant growth of global markets and to the increased productivity that underlies rising standards of living around the world. The United States has led in the development of new technologies and the resulting new products and services. For example, U.S.-headquartered companies have led in the IT advances that have been critical to the development of businesses in all industry sectors around the world. Today companies from emerging market countries such as India and China are beginning to play a growing role in the IT sector.

Research and development has been critical to the success of U.S.-headquartered global companies. R&D will be even more critical in the future in the increasingly global marketplace. With improvements in education systems around the world, the source of new ideas is widespread. Moreover, R&D often is done locally because of the need for local expertise to develop technology targeted to local market demands. For example, in many developing countries, customers use mobile devices as their only computer; thus, there is a tremendous need for software that runs on these devices. Because the software industry in the United States has developed primarily around personal computers, the expertise in mobile software development is stronger in countries where mobile device usage is dominant. At the same time, global companies must be able to leverage their investment in R&D through deployment of that R&D around the world.

Patents, copyrights, brand names, new business processes, and other R&D expenditures are growing in importance in the 21st-century economy. The value of intangible assets was only 62 percent of the value of fixed assets (equipment and buildings) in the 1960s. By 2003 that percentage had risen to 136 percent.¹² Often, much of a company's value comes from its

¹² Carol Corrado, Charles Hulten, & Daniel Sichel, *Intangible Capital and Economic Growth*, Table 2 (Fin. and Econ. Discussion Series, Fed. Reserve Bd. Working Paper No. 2006-4, 2006).

people, ideas, processes, and other intangible assets. The development of intangible assets is more and more a global effort, with global companies having multiple research centers and a growing number of cross-border joint ventures. The rise of services and technology has meant that the flow of capital has become more mobile as well. Capital is no longer just foreign direct investment in bricks and people. It increasingly consists of investment in intangible assets, including ideas in the form of patents, copyrights, trademarks, and R&D.

D. Globalization and Business Decision-Making

Business decisions are based on what is happening in the global markets and on government policies. Businesses grow where markets grow, so it should not be surprising that global companies are increasing their presence in fast-growing developing markets. With 72 percent of the world's GDP growth between 2007 and 2014 projected to be in developing markets, and with more than half of total world GDP projected to be in those same markets by 2014 (see Table 1 on p. 7), global companies will naturally focus much of their investment in those markets. Two-thirds of companies surveyed for a recent Ernst & Young report on the business implications of globalization say that they will expand into international markets over the next three years specifically to increase their sales.¹³

With an increasingly global customer base, global companies will use supply chains involving multiple subsidiaries in different countries to optimize sourcing, production, and distribution globally. The evolution of specialized production processes and just-in-time inventory systems means that global companies have suppliers and facilities in multiple countries. Larger products often are made with components from many different countries, rather than being constructed in a single facility or a single country. These modern business models are the most efficient way to develop global products and services and serve global markets.

Many global companies are establishing regional headquarters in several different parts of the world to be close to the markets and to better manage their increasingly substantial foreign operations and employee populations. In some cases, typical headquarters functions are shifted to the regional headquarters or other specialized locations.¹⁴ Global companies are strategically selecting the best geographic location for their global IT function, their global finance and treasury function, their marketing departments, and their R&D facilities.

It should also be noted that with the emergence of significant companies in developing countries, a high percentage of foreign direct

¹³ Ernst & Young, *supra* note 8, at 8.

¹⁴ Mihir A. Desai, *The Decentering of the Global Firm*, THE WORLD ECONOMY 1274 (2009).

investment comes from the acquisition of existing companies rather than the establishment of new facilities.¹⁵ The acquisition of a small technology company in Israel or Chile with a promising advance is the type of foreign direct investment made today by many U.S. and foreign companies. This international expansion through acquisition represents an increment to the U.S. acquirer's existing operations and generally contributes to U.S. domestic growth as well, as will be further discussed later in this report.

III. THE GLOBAL TAX LANDSCAPE

The growing differences between the U.S. tax system and those of other countries affect the global business landscape and should be considered in determining an advantageous international tax system for the United States.

With opportunities for growth heavily focused outside the United States, U.S.-headquartered global companies are increasingly focused on successfully serving foreign markets. With global competition coming more and more from non-U.S. global companies, the relative taxation of the foreign activities of U.S.-headquartered companies becomes a more important factor.

The United States needs an international tax policy that takes into account all the dynamics of the 21st-century global economy, reflecting the current state and future developments in global markets, global business operations, and other countries' taxation of global businesses.

Discussing international tax reform, Congressman Richard E. Neal, D-Mass., Chairman of the House Ways and Means Subcommittee on Select Revenue Measures, spoke of the importance of understanding the reasoning behind, and potential impact of, developments outside the United States:

There's no question that we have to compare how the U.S. fits into the global economy when we debate our tax rules. Clearly, when deferral was first contemplated, now decades ago, the U.S. was the dominant world player. Now we're being challenged from all quarters, and Congress thought deferral was an appropriate policy decades ago, and we should continue to discuss why that was so, and whether or not it's still relevant.¹⁶

Congressman Neal recognized the need to look beyond the U.S. shores in

¹⁵ Volker Nocke & Stephen R. Yeaple, *Mergers and the Composition of International Commerce* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 10405, 2004) ("In fact, almost all of the literature has implicitly assumed that FDI takes the form of greenfield. Yet, empirical evidence shows that firms engaging in FDI have entered foreign markets mainly by purchasing existing foreign firms rather than by building new plants.").

¹⁶ Congressman Richard E. Neal, Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, Remarks during a Tax Council Policy Institute webcast (Jul. 23, 2009).

determining the most advantageous international tax system for the United States. Policymakers should not consider the U.S. international tax system in isolation. Rather, they should look at how the U.S. system compares with the systems of both current trading partners and the emerging economies that will be major trading partners in years to come. The United States should have a tax system that makes the United States attractive both as a location in which to base a business that will invest around the globe and as a location for investment from businesses that are based in other parts of the world.

In making this comparison, consideration should be given to how the entire U.S. business tax system compares with the business tax systems of current and emerging trading partners. The growing differences between the U.S. approach to taxation of cross-border activity and the approaches of other countries are exacerbated by the widening disparity between the U.S. statutory corporate tax rate and the statutory corporate tax rates of other countries. Thus, policymakers should consider how these differences affect the environment in which U.S. global businesses operate and what that means for the determination of an advantageous tax system for the United States.

A. U.S. Divergence From Global Tax Trends

The United States uses a worldwide tax approach, under which U.S.-headquartered global companies are subject to U.S. tax on all their income, regardless of where it is earned. In contrast, most other countries today use a territorial tax approach. Under a territorial approach, companies are subject to tax in their home countries on their home-country income and generally are not subject to home-country tax on business income earned abroad.

Of the countries that are the top 10 locations for headquarters of global companies (as discussed in the prior section and shown in Table 2), only three have worldwide tax systems. Only the United States has a worldwide tax system with a corporate tax rate higher than 25 percent.¹⁷ Moreover, it is striking that China lowered its statutory corporate tax rate on foreign companies from 33 percent to 25 percent in 2008 to further encourage foreign investment, even though many companies were already increasing their investments in China to capitalize on its rapid economic growth.

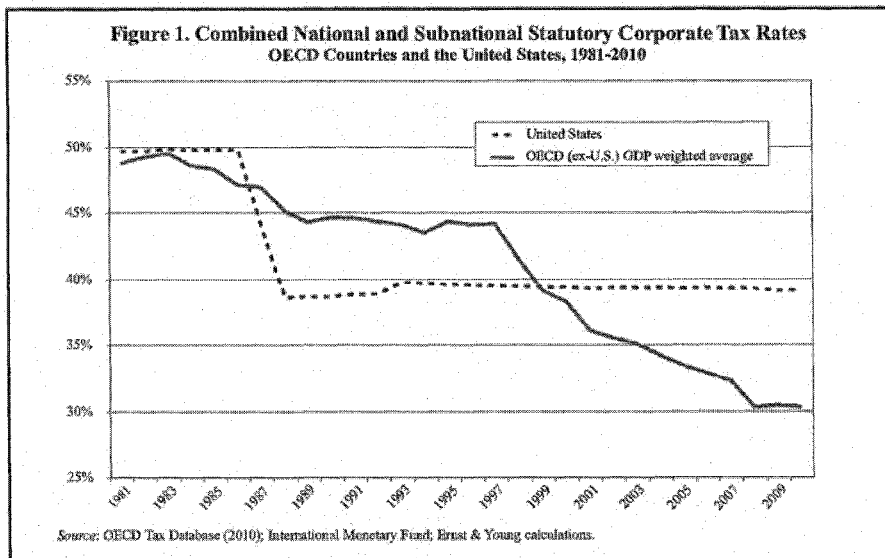
¹⁷ Some of the emerging-market countries may need to reconsider the taxation of the new global companies headquartered there as the numbers and size of those companies grow. For example, Brazil, Russia, India, and China currently have worldwide tax systems. Also, while China's statutory corporate income tax rate is 25 percent and Russia's is 20 percent, the statutory corporate tax rate in both Brazil and India is 34 percent.

Table 3. International Tax Approaches of Top 10 Headquarters Locations of Global Companies		
Country	2010 Statutory Corporate Tax Rate	Taxation of Foreign-Source Income
<i>Countries With Worldwide Tax Regimes</i>		
United States	39.1%	Worldwide with deferral and foreign tax credit
China	25%	Worldwide with deferral and foreign tax credit
Korea	22.0%	Worldwide with deferral and foreign tax credit
<i>Countries With Exemption Tax Regimes</i>		
Japan	49.7%	95% dividend exemption enacted in 2009
France	34%	95% dividend and branch exemption
Germany	33.0%	95% dividend exemption
Italy	31.4%	95% dividend exemption
United Kingdom	28.0%	100% dividend exemption enacted in 2009
Netherlands	25.5%	100% dividend and branch exemption
Switzerland	21.2%	100% dividend and branch exemption
^a Reflects combined national and subnational statutory corporate tax rates.		
Source: <i>Fortune Global 500</i> , Ernst & Young LLP.		

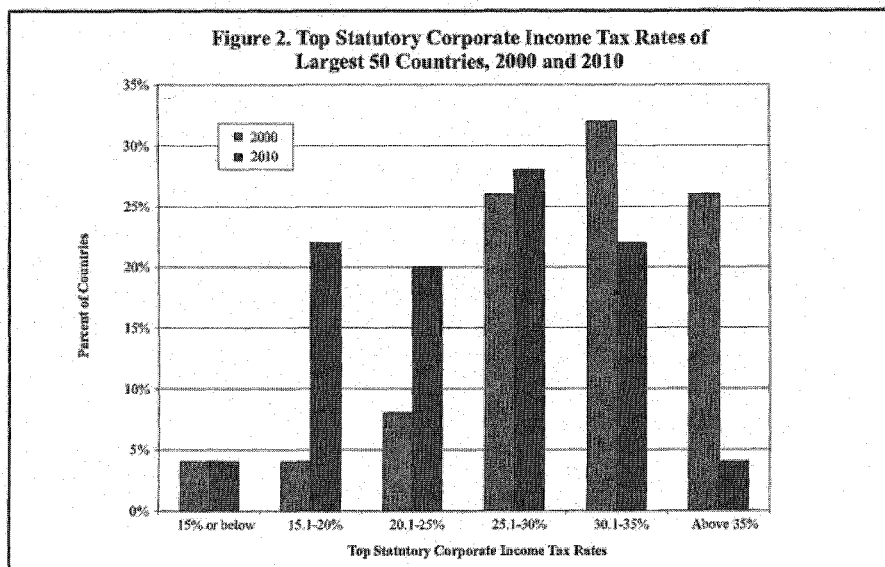
Most recently, both Japan and the United Kingdom in 2009 replaced long-standing worldwide tax systems with systems based on a territorial approach. Japan made this change principally to facilitate the repatriation to Japan of the earnings of foreign subsidiaries of Japanese companies. The United Kingdom made the change because of concern that the existing U.K. worldwide tax system put U.K.-headquartered companies at a disadvantage in the global marketplace to such a degree that U.K. companies were contemplating, and in some cases had already undertaken, departures from the United Kingdom. These 2009 shifts by Japan and the United Kingdom are the latest developments in a trend away from worldwide taxation.

The depth of the U.S. economic relationship with Japan and the United Kingdom, coupled with the significance of these two countries in the global economy, makes their changes particularly noteworthy. However, the breadth and consistency of this trend toward territorial taxation are also important. Countries that have adopted territorial taxation have done so at different stages in their economic development and at different points in the economic cycle. This trend implicitly reflects a recognition by U.S. trading partners, both advanced and still-developing countries, that their businesses must be able to succeed in markets outside their home borders.

In addition to this divergence in the approach to taxation of foreign-source income, the U.S. corporate tax system has become out of step with global corporate tax rate trends. Over the past decade, statutory corporate tax rates around the world have declined significantly. During the same period, the U.S. statutory federal corporate tax rate has remained unchanged at 35 percent. (See Figure 1, which reflects the combined U.S. federal and state corporate tax rate.)



The U.S. statutory corporate tax rate is now the second highest among the 50 countries that are largest by GDP. Ten years ago, 13 of the top 50 countries had statutory corporate tax rates above 35 percent. Today only Japan and the United States have statutory corporate tax rates that high. Today 37 of the top 50 countries by GDP have statutory corporate tax rates at 30 percent or below.



Tax policy economists are increasingly focusing on statutory and average tax rates, rather than marginal effective tax rates, when analyzing the locational effects of corporate taxation on global companies. Prof. Michael Devereux of Oxford University's Centre for Business Taxation found that countries compete for investment based on average tax rates.¹⁸ He suggests that location of activity is most affected by average effective tax rates (while the level of investment is most affected by marginal effective tax rates).¹⁹

Some commentators have suggested that the United States has a relatively low average effective corporate tax rate.²⁰ However, a recent academic study comparing average reported corporate tax rates across global companies headquartered in the United States and other countries found that the United States has a relatively high average effective corporate tax rate. According to new research by Kevin Markle and Douglas Shackelford of the University of North Carolina, U.S.-headquartered global companies have an average effective tax rate above that of corporations headquartered in most countries that are major U.S. trading partners. According to this research, only global companies headquartered in Japan and Germany have higher average effective corporate tax rates.²¹

¹⁸ Michael P. Devereux, Ben Lockwood, & Michela Redoano, *Do Countries Compete Over Corporate Tax Rates?* 31 (Centre for Econ. Policy Research, Discussion Paper No. 3400, 2002).

¹⁹ Michael P. Devereux, *The Impact of Taxation on the Location of Capital, Firms and Profit: A Survey of Empirical Evidence*, 14 (Oxford University Centre for Business Taxation, Working Paper No. 0702, 2006). Treasury reported the U.S. marginal effective tax rate on equity-financed equipment at 24 percent in 2005, which was slightly higher than the 20 percent unweighted average of the OECD countries. The reported marginal effective rate on U.S. debt-financed equipment was lower than the average OECD marginal rate. See OFFICE OF TAX POLICY, U.S. DEP'T OF THE TREASURY, *APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY* (2007) [hereinafter TREASURY, *APPROACHES TO IMPROVE*]. As noted in the text, marginal effective tax rates are more relevant to the level of investment than to the location choices of global firms.

²⁰ Earlier studies that reported U.S. average effective corporate tax rates as relatively low may be somewhat misleading because of the constraints inherent in the data that were used in those studies. For example, a 2007 Treasury study computed average effective corporate tax rates across countries by comparing total corporate taxes paid as a percentage of GDP. This approach does not account for the fact that the United States has almost 50 percent of its business activity in partnerships, proprietorships, and other entities, such as subchapter S corporations, mutual funds, and real estate investment trusts, that are not subject to the U.S. corporate income tax. Because this noncorporate business activity is included in the calculations, the average effective corporate tax rate that was computed for the United States using this approach is artificially low. See U.S. DEP'T OF THE TREASURY, *TREASURY CONFERENCE ON BUSINESS TAXATION AND GLOBAL COMPETITIVENESS BACKGROUND PAPER* (2007).

²¹ Kevin Markle & Douglas A. Shackelford, *Corporate Income Tax Burdens at Home and Abroad* 34 (Mar. 9, 2009), available at <http://www.law.northwestern.edu/colloquium/tax/>

Table 4. Average Effective Corporate Tax Rates of Domestic and Multinational Corporations, 2003-2007 for Selected Countries		
Headquarters Locations	Domestic	Multinational
Japan	40%	38%
Germany	28%	32%
United States	31%	29%
United Kingdom	27%	27%
France	27%	26%
Canada	26%	26%
Australia	28%	25%
India	24%	19%
China	23%	19%
Note: Average corporate tax rates include both federal and sub-federal income taxes in the home country plus income taxes in other countries.		
Source: Markle and Shackelford, "Corporate Income Tax Burdens at Home and Abroad," Mar. 9, 2009, Table 2, col. 4.		

The research reflected in Table 4 is based on 2003-2007 data and thus does not reflect Germany's corporate tax rate reduction since 2007 or the 2009 adoption of territorial tax systems in Japan and the United Kingdom, which further reduce those countries' average corporate tax rates. Nonetheless, the research indicates that U.S.-headquartered global companies already had relatively high average corporate tax rates as of 2007, when the corporate tax rates of non-U.S. global companies were still declining.

The average corporate tax rate reported in the study for U.S.-headquartered companies includes both U.S. federal and state income taxes, plus taxes incurred in other countries where the U.S.-headquartered business operates. Statements have been made that U.S.-headquartered companies pay only approximately 2 percent in taxes on their foreign-source income.²² However, this does not reflect the full range of taxes paid on that income. This new study shows that when all taxes—federal, state,

documents/Shackelford.pdf. This more recent study uses financial statement data for corporations and thus effectively excludes noncorporate business activity from the computation. In the Markle and Shackelford study, the average effective corporate tax rate is computed based on financial statement data, with total worldwide income tax expense divided by total worldwide net income before income taxes. Because the data set covers five years and involves companies from different industries and of different sizes in terms of total assets, the authors ran a regression to hold those variables constant to make an analytically appropriate comparison of effective corporate tax rates across countries and between multinational companies and domestic-only companies. The analysis is based on companies with positive net income and positive tax expense. The authors report that the relative results are similar if current, rather than total, income tax expense is used. It should be noted that effective corporate tax rates vary by company and range significantly above and below the average rate.

²² President Barack Obama, Remarks on International Tax Policy Reform (May 4, 2009), available at http://www.whitehouse.gov/the_press_office/Remarks-By-The-President-On-International-Tax-Policy-Reform.

and foreign—are taken into account, U.S.-headquartered companies had total effective tax rates of close to 30 percent on their worldwide financial statement net income.

It also should be noted that Markle and Shackelford report that U.S.-headquartered global companies have an average effective tax rate (29 percent) that is very similar to that of U.S. domestic-only corporations (31 percent). Contrary to some claims, their study indicates that U.S.-headquartered global companies, as a whole, do not bear significantly lower corporate taxes than domestic-only U.S. companies on their total corporate income.

B. Effect of Tax Disparities on Global Business

This landscape of territorial taxation and lower corporate tax rates is the environment in which U.S.-headquartered global companies must operate. The growing disparity between the U.S. corporate tax system and the corporate tax systems of major U.S. trading partners can have a significant effect when a U.S.-headquartered company is competing with a foreign-based company for market share both in that particular foreign country and in other foreign countries.

The U.S.-headquartered global company with an operating subsidiary in a local foreign country is subject to U.S. tax on the earnings from those operations, either on a current basis or on a deferred basis when the earnings are repatriated to the United States. The U.S. company is entitled to a credit, subject to detailed limitation rules, for the local foreign taxes paid on those earnings, which offsets a portion of the U.S. tax that otherwise would be due. For example, a U.S. company with a Chinese operating subsidiary would be subject to Chinese tax on the earnings of that subsidiary and also would be subject to U.S. tax on those same earnings either when repatriated to the United States or on a current basis. The U.S. tax would be reduced by the amount of Chinese tax paid. If the U.S. company repatriates its foreign earnings, which would provide the maximum flexibility regarding the use of those earnings, the total tax borne by the U.S. company on the foreign earnings would include both the local tax and U.S. tax up to the U.S. corporate tax rate. Alternatively, the U.S. company may be influenced by the tax system to keep its earnings offshore indefinitely, which may not be the highest and best use for those funds. This is referred to as the potential “lockout effect” of the current U.S. international tax system. This lack of flexibility to deploy funds optimally can represent a cost for U.S.-based companies.

In contrast, a local foreign company generally pays only the local foreign country tax on its earnings from its local operating subsidiary. Moreover, in many cases the competition in a foreign country comes not from a local company, but from a local subsidiary of a company headquartered in a third country. In that case, if the third country has a

territorial tax system, the third-country company is subject to no or limited additional home-country tax on its earnings from its operating subsidiary in the local country. For example, a German company with a Chinese operating subsidiary would be subject only to Chinese tax on the earnings of its subsidiary but would not also be subject to significant German tax on those earnings. Thus, for both local foreign-country companies and third-country companies, the local corporate tax rate largely determines the tax treatment of their local operating earnings.

Table 5 provides a simple illustration of the effect of these tax disparities, comparing the total tax burden and after-tax profit on an investment in a Chinese subsidiary by a parent company based in the United States, based in a major U.S. trading partner, or based in China.

Table 5. Comparison of Investment in China by U.S.- and Foreign-Headquartered Global Companies					
	Income	Local (China) Tax	Headquarters Country Tax on Dividends ^a	Total Tax	Net Income
U.S. parent ^b	\$100	\$25	\$100	\$25.0	\$65.0
Japanese parent	\$100	\$25	\$15	\$26.5	\$73.5
German parent	\$100	\$25	\$12	\$26.2	\$73.8
French parent	\$100	\$25	\$13	\$26.3	\$73.7
U.K. parent	\$100	\$25	\$0.0	\$25.0	\$75.0
Chinese company	\$100	\$25	\$0.0	\$25.0	\$75.0
a. Assumes headquarters country recognizes income of Chinese subsidiary when dividends are repatriated.					
b. Includes only federal (not state) income tax on dividends.					

This illustration shows that the U.S.-headquartered global business would have a greater tax burden on its investment in China and therefore lower after-tax earnings to reinvest in the United States.

An evaluation of the implications of this illustration requires consideration of the goals in addressing tax disparities. A level playing field would mean that the tax treatment of an investment in China would be the same without regard to the location of the headquarters of the business that makes the investment. More broadly, a level playing field for domestic and global companies headquartered in the United States and in other countries would mean that the tax treatment of an investment anywhere in the world would be comparable no matter which company makes the investment.

C. Considering Reforms That Reduce Disparities

Proposals that would increase the U.S. tax burden on the foreign income of U.S.-headquartered global companies, including the administration's international tax proposals, are in contrast to the global trend toward reducing taxes on foreign income of their home companies through the reduction of the corporate tax rate and the use of territorial

taxation. Although the administration has expressed interest in potentially reducing the U.S. corporate tax rate,²³ its current tax proposals do not include a reduction.

A more comprehensive approach to tax reform would consider the U.S. corporate tax rate together with the international tax system for the United States. Given that the United States has a statutory corporate tax rate that is the second highest among the top 50 countries by GDP and that is substantially higher than those of the global-headquarters countries that still have worldwide tax systems, U.S. policymakers should consider the merits of a system for taxing business income that is more in step with the prevailing trends around the world.

This process begins with an objective comparison of the U.S. tax system with the tax systems of other countries. In making this comparison, it is necessary to look beyond mere summaries and to focus on the operational detail and practical effect of the systems being considered. This includes an assessment of the territorial systems currently used by major U.S. trading partners as compared with the U.S. approach to taxation of foreign earnings.

Some commentators have asserted that territorial tax systems impose a greater domestic tax burden on foreign earnings than the current U.S. tax system. Others equate a territorial tax system with the exemption from domestic tax of all foreign earnings. Neither assertion is a fair reflection of the territorial tax systems in operation in major trading partners. However, these extreme and opposite views of territorial taxation underscore the importance of understanding the specifics of other countries' tax systems in order to compare their effect on locally headquartered companies with the effect of the U.S. tax system on U.S.-headquartered global companies.

D. Understanding Other Countries' Tax Systems

The first step in examining another country's territorial tax system is to assess the scope of the exemption for foreign-source income provided under the particular system. Most of the territorial tax systems in U.S. trading partners are dividend exemption systems under which dividends from foreign subsidiaries, and in some cases income from foreign branches, are exempt from domestic tax. But other categories of foreign-source income, such as interest, royalties, and export sales income, may be subject to domestic tax.

Businesses in these countries structure their operations with these factors in mind. That structuring includes, for example, the ownership of intangible assets, which determines whether income from the use of those

²³ President Barack Obama, Remarks at the Business Roundtable Quarterly Meeting (Feb. 24, 2009), available at <http://www.whitehouse.gov/the-press-office/remarks-president-business-roundtable>.

assets may be repatriated as exempt dividends or as taxable royalties. Moreover, other aspects of a country's tax system, including preferential treatment of income from intangible assets, are also relevant.

In this regard, a 2007 Treasury analysis of territorial tax approaches notes that a territorial tax system with full taxation of royalty income could create incentives to locate intangible assets and R&D activity outside the home country.²⁴ As this example illustrates, the full picture should be considered in evaluating the effect of a particular tax system.

Like the U.S. worldwide tax system, some countries' territorial tax systems have special rules that distinguish between active and passive income. These rules can limit the scope of the dividend exemption by denying the exemption in cases when the foreign subsidiary's income is passive and subject to low foreign tax. However, in assessing these territorial systems and comparing them with the U.S. international tax system, one should assess the implications of these limitations with a focus on the practical effect on the typical operations of global businesses headquartered in these countries.

For example, while some European territorial regimes have exceptions from their exemptions for certain low-taxed foreign income, these exceptions typically do not apply to earnings from another country within the European Union, and the exemption generally is available to those EU earnings (unless some kind of artificial structure is involved). Moreover, when an exception does apply, home-country tax typically would be deferred until the foreign earnings are repatriated. Only in limited circumstances would foreign earnings be subject to immediate home-country tax without regard to repatriation. These rules should be carefully considered in any detailed assessment of how the U.S. international tax system compares with territorial systems of U.S. trading partners. In particular, these exception rules should be compared with the U.S. subpart F rules, which capture a broader range of business income and which impose immediate U.S. tax without regard to repatriation.

Also, like the U.S. foreign tax credit regime, some countries' territorial tax systems have special rules on the treatment of expenses. For example, some countries have rules that limit interest deductions based on capitalization standards. In other cases, countries may use a 95 percent exemption, rather than a 100 percent exemption, as a proxy for taking into account expenses associated with earning exempt foreign income. Again, one should assess the actual operation of any such rules to determine the practical effect on a global company headquartered in these countries. These limitation rules should be carefully considered in assessing these territorial tax systems and comparing them to the current U.S. international tax system, particularly the U.S. expense allocation rules, which apply for

²⁴ TREASURY, APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY, *supra* note 19.

foreign tax credit limitation purposes and which capture a broader range of expenses.

A review of the new Japanese dividend exemption system shows the breadth of the Japanese tax exemption for income of foreign subsidiaries. Under the new rules, a 95 percent exemption is provided for dividends from a foreign subsidiary if the subsidiary is at least 25 percent (or less, as provided by treaty) owned by a Japanese parent and the shares have been held for at least six months before the dividend is determined. Under specified limitation rules, the dividend exemption may not be available for a foreign subsidiary established in a jurisdiction that has a tax rate at or below a threshold rate of 25 percent.²⁵ However, this limitation does not apply if the foreign subsidiary is engaged in an active business. Thus, dividends from foreign subsidiaries engaged in active business activities are eligible for the exemption. The new Japanese territorial system also does not require any disallowance of deductions for expenses, instead restricting the dividend exemption to a 95 percent level.

In considering how the U.S. international tax system compares with other countries' systems, it is important to note that territorial systems do not have the lockout effect that is a significant source of concern regarding the U.S. tax system. Companies headquartered in a country with a territorial tax system can freely repatriate earnings without causing an additional tax burden (or causing only a small additional burden in the case of countries with a 95 percent exemption). Indeed, as noted above, encouraging the repatriation and local Japanese investment of foreign earnings was a principal motivation for Japan's recent decision to shift from worldwide taxation to a territorial tax approach.

As attention turns to tax reform in the United States, policymakers should recognize the importance of how the structure of the U.S. international tax system and the U.S. corporate tax rate compare with those of other countries. The determination of an advantageous system for the United States will require careful consideration of the actual effect of the international tax systems that apply to the foreign companies that compete with U.S. headquartered companies.

IV. THE TAX POLICY CHOICES

International tax reform should be based on the tax policy choices that would best support the needs of the U.S. government and business in today's world.

The administration's international tax proposals would represent substantial changes to the existing international tax system, which would

²⁵ This threshold tax rate for qualification for the dividend exemption has been proposed to be reduced from 25 percent to 20 percent in pending legislation, which would further expand the applicability of the Japanese exemption for foreign dividends.

have significant implications for U.S.-based businesses operating in the global marketplace.

Much of the argument in support of these international tax proposals focuses on “protecting” the international tax system. However, the current international tax regime in the United States cannot be considered a single policy to be protected. Rather, it reflects a combination of different policies that have evolved over nearly five decades. Given the enormous changes in the global economy since key elements of the international tax system were constructed almost 50 years ago, there is no reason to believe that the particular combination of policies reflected in the current system is the appropriate set of policies for today.

Changes to the U.S. international tax rules should not be undertaken piecemeal. Nor should they be pursued in isolation. Consideration of changes to the international tax rules requires a comprehensive reassessment of the entire U.S. business tax system, coupled with an evaluation of how the U.S. system interacts with the tax systems of major trading partners.

The importance of these issues and the need for a thorough examination has been recognized by senior leaders of both congressional tax writing committees. When the administration’s proposals were first unveiled in 2009, Senate Finance Committee Chairman Baucus acknowledged both the need for international tax reform and the need for tax policies that further competitiveness:

The President’s proposals highlight an important point—our corporate international tax system needs reforming. . . . [F]urther study is needed to assess the impact of this plan on U.S. businesses. I want to make certain that our tax policies are fair and support the global competitiveness of U.S. businesses. These policies must be designed to encourage economic growth and create good-paying jobs Americans need right now.²⁶

In response to the February 2010 release of the administration’s latest budget proposals, Chairman Baucus echoed his earlier comments and reinforced the importance of pursuing opportunities abroad to strengthen the American economy and spur job creation in the United States:

It is time for the United States to seize new opportunities around the globe that will cement our role as the leader in global economic competitiveness and bolster our economic engine.²⁷

²⁶ Press Release, Senate Comm. on Fin., Baucus Statement on President’s International Tax Proposals (May 4, 2009), *available at* <http://finance.senate.gov/newsroom/chairman/release/?id=603c794b-61c7-41d8-ac62-33ae57ee1cfe>.

²⁷ Press Release, Senate Comm. on Fin., Baucus Comments on President’s FY 2011 Budget, *supra* note 5.

A. Understanding the Historical Policy Choices

As attention turns to this important debate, it is critical to avoid confusion regarding the historical policy underpinnings of the current U.S. international tax system. Some commentators view it as a failure or flaw of the operation of the current system that there is not complete neutrality in the U.S. tax treatment of a U.S.-headquartered global company regarding an investment in the United States and an investment outside the United States.²⁸

This argument assumes that the optimal U.S. international tax system would achieve capital export neutrality, which would be a pure worldwide tax system with an unlimited foreign tax credit. However, the United States has never had a pure worldwide tax system with an unlimited foreign tax credit. Moreover, none of the major U.S. trading partners use this approach to international taxation.

In 1962, when key components of the U.S. international tax system were established, lawmakers did not embrace all the elements of capital export neutrality as the exclusive guiding principle. Even then, when the United States was dominant in the global economy and foreign companies were relatively small players in the global marketplace, considerations of competitiveness and fairness led to the development of the current system. Although the Kennedy administration had advocated broad repeal of deferral, which has been part of the U.S. international tax system since the system's inception, Congress was unwilling to go that far for fear of putting U.S.-owned businesses at a disadvantage relative to foreign-owned businesses.²⁹

Instead of implementing a pure capital export neutrality approach, Congress developed the rules of subpart F, which ended deferral only for certain categories of income that were viewed as passive or as otherwise involving minimal activity. Therefore, referring to results of the existing system that depart from capital export neutrality as a "distortion" fails to recognize the mix of policy choices that are inherent in the system. The considerations and pressures that led policymakers in the 1960s to reflect a mix of policies are magnified for the United States today.

It is notable that a pure worldwide tax system was not chosen in 1962, even though the degree of interconnection between the U.S. economy and the global economy was much less than today. Even in 1962, the existing global business landscape was a factor that drove development of a system that departs in important ways from pure worldwide taxation. Those who advocate that the United States today move further toward a pure worldwide tax system make some key assumptions about global business in

²⁸ JCT REPORT, *supra* note 3, at 6–12.

²⁹ See OFFICE OF TAX POLICY, U.S. DEP'T OF THE TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS (2000).

the 21st century that must be critically examined in light of the current business landscape for U.S.-headquartered global companies and their foreign counterparts.

B. Considering the Global Business Landscape

As outlined earlier, global companies today are investing overseas to gain access to growing demand in emerging market economies. Given relatively flatter overall demand in their domestic markets, U.S.-headquartered global companies seeking to expand are likely to be faced with the choice of making an investment overseas or not making the investment at all. However, if a U.S.-headquartered company does not invest overseas, whether because of tax-related obstacles or for any other reason, a non-U.S. company likely will make the investment. The market share and other business advantages that will be gained by that company from being first to market will be difficult for U.S. companies to overcome with later investment. In essence, the issue is not whether investment is made, because it will be made where there is market demand. The issue is whether U.S.-headquartered global companies participate in these market opportunities. These dynamics should be a primary consideration for tax policymakers as they consider the U.S. international tax system.

Moreover, it should be remembered that the practical implications of choosing any particular policy approach are highly dependent on corporate tax rates—both the U.S. corporate tax rate and the corporate tax rates in the countries where business activity occurs. The effects of any move closer to a pure worldwide tax system would be even greater at the current combined U.S. federal and state statutory corporate tax rate than they would be if the U.S. rate were consistent with the corporate tax rates of U.S. trading partners.

Finally, as is discussed in the next section, recent economic research finds that increased global operations tend to increase employment of U.S.-headquartered global companies in the United States.³⁰ Therefore, U.S.-headquartered companies' success in global markets translates into additional U.S. jobs.

V. POTENTIAL CONSEQUENCES OF TAX POLICY DECISIONS

The potential consequences of placing additional tax burdens on foreign investment by U.S.-headquartered global companies must be considered.

Much of the tax policy discussion regarding the U.S. international tax

³⁰ Mihir A. Desai, C. Fritz Foley & James R. Hines Jr., *Foreign Direct Investment and the Domestic Capital Stock*, THE AMERICAN ECONOMIC REVIEW, May 2005, at 33. Other studies regarding the interconnection between the global success of U.S.-based companies and their U.S. activity are referenced *infra* note 35.

rules casts the economic policy debate as a zero-sum game: employment and capital invested in the United States versus employment and capital invested overseas.

Clearly, there are specific cases of foreign employment substituting for U.S. employment because of lower wage and operating costs. In some industries and some functions in which U.S. productivity and skills are not a significant differentiator, the United States is seeing a decline in those activities because of advances in technology, rising productivity, and improved education in other countries.

However, in many other areas, successful foreign investment by U.S.-headquartered global companies in fast-growing markets results in more U.S. production, greater U.S. investment, and additional U.S. employment. This section includes a review of the empirical findings on the relationship between foreign direct investment and home-country activity.

The administration's fiscal 2011 international tax proposals have been estimated by Treasury as representing an increase in taxes on foreign investment by U.S.-headquartered companies of \$122 billion over the next 10 years. This would represent an average increase in U.S. income taxes paid by U.S.-headquartered global companies of more than 5.5 percent.³¹

Raising taxes on the foreign investments of U.S.-based businesses in this manner would make each investment more costly. Because these higher costs cannot easily be passed on to buyers because of tough global competition, U.S.-headquartered global companies likely would lose market share to foreign competitors. Investor capital, therefore, would shift toward foreign global companies with lower tax burdens on their foreign investments and better growth prospects.

It is also important to note that impeding the global growth of U.S.-headquartered global companies could impair economic growth within the United States as well. In a recent report, Robert Shapiro, former undersecretary of the U.S. Department of Commerce, wrote, "Those who believe that eroding or sharply limiting deferral would generate large tax revenues would be seriously disappointed. The job losses, wage cuts and lower investment would reduce tax revenues."³²

The empirical economic research regarding whether foreign investment is a substitute for or a complement to U.S. investment and employment is increasingly finding the latter. Theodore H. Moran, senior

³¹ Ernst & Young LLP, Quantitative Economics and Statistics practice calculations. See Estelle Dauchy & Tom Neubig, *President Obama's Business Tax Proposals: Industry Effects by Sector*, 125 TAX NOTES 314 (2009). U.S.-headquartered global companies pay a little more than half of the total U.S. corporate income taxes.

³² Robert J. Shapiro & Aparna Mathur, *The Economic Benefits of Provisions Allowing U.S. Multinational Companies to Defer U.S. Corporate Tax on their Foreign Earnings and the Costs to the U.S. Economy of Repealing Deferral* (June 2009) (unpublished paper available at http://www.techceocouncil.org/storage/documents/Shapiro-Mathur_June_8_2009_Report.pdf).

fellow at the Peter G. Peterson Institute for International Economics and the Marcus Wallenberg Chair at the Georgetown University School of Foreign Service, wrote, "The evidence consistently shows that the expansion of MNC operations abroad and the strengthening of MNC operations in the home country are complementary, and the answer to the counterfactual—would the home country be better off, or would workers in the home country be better off, if home-country MNCs were prevented from engaging in outward investment?—is indisputably negative."³³

A. Foreign Investment and Domestic Employment

Most recent empirical studies report that foreign investment by U.S.-headquartered global companies generally has positive economic effects within the United States, rather than being a substitute overall for U.S. investment. The recent JCT report on the administration's international tax proposals references the potential for substitution of foreign direct investment for home-country investment. However, the JCT report cites only one paper that reported empirical results finding net substitution of U.S. and foreign labor by global corporations.³⁴ The JCT report also cites, without discussion, two studies that report a complementary relationship between foreign direct investment and home-country investment and exports and two studies that found no adverse domestic effects.

There are several other recent empirical economic studies that have found positive relationships between foreign direct investment and home-country activities. These studies found a home-country positive effect from foreign direct investment not only in the case of U.S. companies, but also in studies of Australian, Canadian, and German companies.³⁵ For example, a 2009 study by Harvard Business School Profs. Mihir Desai and Fritz Foley and University of Michigan Prof. James Hines found that a 10 percent increase in U.S.-headquartered global companies' foreign direct investment was associated with a 2.6 percent increase in domestic investment. Also, 10 percent faster foreign sales growth for U.S.-headquartered companies was

³³ Theodore H. Moran, *American Multinationals and American Economic Interests: New Dimensions to an Old Debate* 1 (Peterson Inst. for Int'l Econ., Working Paper No. 09-3, 2009).

³⁴ JCT REPORT, *supra* note 3, at 15.

³⁵ Desai, Foley, & Hines, *supra* note 30. See also Mihir A. Desai, C. Fritz Foley & James R. Hines Jr., *Domestic Effects of the Foreign Activities of US Multinationals*, AM. ECON. J. ECON. POL'Y., Feb. 2009 at 181; Isabel Faeth, *Consequences of FDI in Australia — Causal Links Between FDI, Domestic Investment, Economic Growth and Trade* (Univ. of Melbourne Dep't of Econ., Research Paper No. 977, 2006); Jörn Kleinert & Farid Toubal, *The Impact of Locating Production Abroad on Activities at Home: Evidence From German Firm-Level Data*, REV. WORLD ECON. (forthcoming); Christian Arndt, Claudia M. Buch & Monika Schnitzer, *FDI and Domestic Investment: An Industry-Level View* (Governance and the Efficiency of Econ. Systems, Discussion Paper No. 212, 2007); Walid Hejazi & P. Pauly, *Motivations for FDI and Domestic Capital Formation*, 34 J. OF INT'L BUS. STUDIES 282 (2003).

associated with a 6.6 percent increase in U.S. exports and a 3.2 percent more rapid growth in the U.S. parents' R&D activity.³⁶

The results of these more recent empirical studies may reflect their capture of the rapid growth of consumer markets in developing countries since 2000, where global companies are competing for market share that previously did not exist. Because of their use of data that capture these current trends, these more recent empirical studies likely are better indicators of economic conditions and companies' responses currently and in the future.

It should be noted that some observers have recommended a cautious approach in evaluating the conclusiveness of empirical research on this subject. For example, Martin A. Sullivan, contributing editor to *Tax Notes*, recently discussed the question whether foreign job creation is a substitute for, or a complement to, U.S. job creation, commenting that "both tendencies exist" and sometimes "even occur simultaneously inside a single multinational."³⁷ While many empirical analyses are not definitive, several recent analyses do show evidence of complementarity. Perhaps more importantly, empirical analyses cannot take into account the expected future growth of markets in developing countries that will be the locus of future investment opportunities for global companies.

The implication of the arguments in support of the administration's international tax proposals, which would increase the tax burden on U.S.-headquartered global companies' foreign investments, is that if U.S.-headquartered companies reduce their foreign investments, they would invest more in the United States. However, based on both the recent empirical research just discussed and the projections for the location of future economic growth, that is unlikely to occur in most cases. The greatest growth opportunities for many businesses are concentrated outside the United States, so adding barriers to those opportunities would be harmful to the businesses' growth. Indeed, if an attractive foreign investment opportunity is not seized by a U.S.-headquartered company, mobile capital will be redirected to foreign-based companies that can make the investment. If capital is redirected from investment in a U.S.-headquartered company to investment in a foreign-based company, the consequence is that the U.S. company will be unable to grow and could well contract.

B. Global Success Driving Domestic Success

Many of the policy arguments about globalization ignore the importance of scale economies in modern business. For many industries,

³⁶ Desai, Foley, & Hines, *Domestic Effects of the Foreign Activities of US Multinationals*, *supra* note 35.

³⁷ Martin A. Sullivan, *Jobs and International Tax Rules*, 126 TAX NOTES 710 (2010).

scale is critical to success in the global marketplace. Reduced growth in foreign markets would undermine the scale of U.S.-based businesses.

If U.S.-headquartered global companies are less competitive in the global markets, foreign companies will seize those markets and grow larger. Increased strength and presence in foreign markets will make those foreign companies a greater competitive threat not only in foreign markets but also in the U.S. domestic markets.

As noted earlier, most foreign direct investment occurs through acquisitions of existing foreign companies rather than through new greenfield investments. Tax disparities may mean that a foreign-headquartered company would have an advantage over its U.S. counterparts both in making the acquisition and in operating the foreign company once it is acquired. If U.S.-headquartered global companies operate abroad at a tax disadvantage, their ability to succeed in bidding to acquire new foreign affiliates will be reduced.

U.S.-headquartered global companies could also be more attractive acquisition targets for foreign acquirers to the extent that U.S. companies only can capitalize on their global synergies at higher costs because of higher U.S. taxes on foreign investments. Foreign acquirers might undertake a post-acquisition restructuring to avoid those higher U.S. taxes on non-U.S. operations and therefore might bid more for attractive U.S.-headquartered companies. These future tax savings available to a foreign acquirer could help it fund an acquisition of a U.S.-headquartered global business.

It would be unwise to believe that raising taxes on foreign investment by U.S.-based businesses would help or at worst would not adversely affect the U.S. economy and American workers. This premise and the economic effects of a potential move in that direction should be closely scrutinized.

There is a great deal at stake, given the growing importance of the global economy to the U.S. economy. Historically, the international sector has been a much smaller segment of the U.S. economy, and changes in U.S. international tax rules therefore had less significant effect. Today an imprudent choice regarding U.S. international tax policy could have far-reaching and long-lasting effects. Once policymakers begin to implement a particular policy choice, if the consequences prove detrimental to U.S. businesses, American workers and the U.S. economy, the effects could be difficult to reverse.

VI. THE ROLE OF GLOBAL TRANSFER PRICING RULES

Any unilateral change to the U.S. transfer pricing rules must consider their integration with the rules of U.S. trading partners.

The U.S. transfer pricing rules, and the coordination of those rules with the transfer pricing rules of developed and developing countries around the world, are a crucial element of the overall U.S. international tax

system. Developments in the global economy affect the transfer pricing system in important ways. Increasing global integration and technological innovation can mean more numerous and more complex transfer pricing determinations.

In recent years, some commentators have asserted that our transfer pricing system is broken. The recent JCT report raises questions about the efficacy of the current U.S. transfer pricing rules, particularly in the area of intangible property.³⁸ The administration's fiscal 2011 budget includes a new conceptual proposal that would seem to have the potential to override the transfer pricing rules in some cases involving transfers of intangible property. In contrast, other commentators have suggested that the increasing sophistication of transfer pricing rules around the world could reduce pressures on other aspects of the U.S. international tax system. These divergent perspectives underscore the need to consider transfer pricing when examining the U.S. international tax system.

A. The Arm's-Length Principle

Although the U.S. and global transfer pricing system may not be perfect, it is the means to effect the fundamental arm's-length principle and, thus, to reflect the underlying economics of complex cross-border transactions and relationships.

The establishment of appropriate transfer prices in a modern global enterprise is an effort that is taken seriously by taxpayers and tax administrators alike. Taxpayers conduct thorough economic analyses and develop comprehensive documentation. The IRS closely scrutinizes these analyses and documentation and does its own corroborating analyses. Also, in most cases the tax authority of the country on the other side of the transaction does the same.

One alternative to the current global transfer pricing system that attracts attention periodically is some type of formulary apportionment approach. However, formulary apportionment has serious drawbacks. Unlike the arm's-length principle for establishing prices for transactions among and between affiliated entities, formulary apportionment uses an arbitrary weighting of different factors, such as payroll, property, and sales. A recent paper by Hines shows that the standard apportionment factors are not accurate predictors of corporate profitability and thus would be unlikely to be accurate in allocating company profits across operations in different countries.³⁹

³⁸ JCT REPORT, *supra* note 3, at 26.

³⁹ James R. Hines, *Income Misattribution Under Formula Apportionment* (Nat'l Bureau of Econ. Research, Working Paper 15185, July 2009). Hines found that the apportionment factors explain less than 22 percent of the variation in firm profitability and that for 64 percent of the firms analyzed, the apportionment formula predicted profits that were less than 50 percent or more than 150 percent of their reported firm profits.

Formulary apportionment, used by the 44 U.S. states that have corporate income taxes, in practice results in double taxation, undertaxation, and significant distortions and complexity. States use different factors, different factor definitions, and different weighting of the factors. Distortions and complexity would result from a unilateral move to formulary apportionment by the United States. In this regard, the JCT report acknowledges that commentators frequently note the need for international consensus regarding any move to formulary apportionment, including consensus regarding the composition of the formula to be employed.⁴⁰

The global transfer pricing system is where it is today because the United States spent years advocating the arm's-length principle as the appropriate guiding principle to be embraced by all countries. Importantly, the arm's-length principle that the United States successfully advocated is grounded in fundamental economic principles and thus provides a neutral basis for dividing economic income among taxing jurisdictions. The combination of the embodiment of the arm's-length principle in the tax laws of the United States and other countries and its reiteration in bilateral tax treaties is a cornerstone of the global international tax system. Dispute resolution mechanisms under tax treaties provide an avenue for addressing any differences between countries that otherwise would result in double taxation. Any move away from the arm's-length principle and the international consensus by the United States or any other country would lead to clashes between inconsistent approaches, with the result being the economic double taxation that today's system is designed to prevent. Jeffrey Owens, director of the OECD's Centre for Tax Policy and Administration, recently cautioned against abandoning this international consensus standard, stating, "My message today is: Let's get on with the job of making the arm's-length principle work."⁴¹

B. The Importance of Intangibles

Criticism of the current transfer pricing system often focuses on the application of the rules to transfers of intangible property. Those transactions often involve sophisticated and unique assets and complex arrangements between the parties, with significant potential income to be divided and substantial potential tax revenue to be shared. However, the principle of grounding the transfer pricing in the underlying economics of the transaction is the same, and the international consensus on the arm's-length principle is as important there as in more routine transactions.

While the administration's proposal on the tax treatment of intangible property transferred outside the United States has not yet been fleshed out

⁴⁰ JCT REPORT, *supra* note 3, at 53.

⁴¹ Kevin A. Bell, OECD's Owens Rejects Unitary Tax Proposal, Focuses on Arm's-Length Principle Success, BNA DAILY TAX REPORT, Sept. 22, 2009.

in any detail, the broad conceptual approach causes concern because it seems to have the potential to abandon the international consensus on the arm's-length principle. The proposal appears to deem some foreign earnings on a transferred intangible as "excess returns" subject to immediate U.S. taxation even though the foreign earnings reflect a return determined under the applicable transfer pricing rules. Also, the suggestions for revisions to the U.S. transfer pricing rules described in the JCT report would similarly represent unilateral U.S. actions that could have implications for the international consensus on the arm's-length principle as applied in the context of intangible property.⁴²

In considering these concepts for unilateral changes in transfer pricing for intangible property, policymakers should recognize the importance of intangible assets in modern business and the global economy. As discussed in an earlier section, the source of new ideas today is global. A company's R&D activities are not isolated in a single laboratory but frequently are conducted at locations around the world. Similarly, the application of the results of successful R&D is global. Businesses are able to invest more in R&D and thereby achieve greater innovations because they can leverage that investment by delivering those innovations to markets around the world. Certainty and consistency in the U.S. transfer pricing treatment of intangible assets are critically important. To remain on the cutting edge of technological advances, U.S.-based businesses must be able to involve multiple affiliates in different countries in the development and deployment of intangible assets. The U.S. transfer pricing rules for intangible property should operate in a manner that both recognizes modern business models and appropriately coordinates with the transfer pricing rules of U.S. trading partners.

C. Transfer Pricing and the Overall Tax System

In evaluating the U.S. transfer pricing experience, just as in evaluating other aspects of the U.S. international tax system as discussed earlier, the U.S. corporate tax rate should be considered. There is a natural relationship between corporate tax rates and the potential for pressure on transfer pricing determinations. The high U.S. statutory corporate tax rate, relative to the rates in other countries around the world, creates an environment in which there is more pressure on transfer pricing. In contrast, lower corporate tax rates would ease these pressures.

In the transfer pricing area, as with all other aspects of the tax system, the United States should be vigilant in eliminating any opportunities for noncompliance. Increased information reporting and enhanced coordination with other tax administrations should be used to increase compliance and eliminate potential for abuse. These tools also should be

⁴² JCT REPORT, *supra* note 3, at 53–55.

used to increase certainty and reduce multiple taxation. U.S. policymakers can and should continue to work to improve the operation of the U.S. and global transfer pricing system, but that work should start from the existing framework of the arm's-length economic principle embraced by the United States and countries around the world.

VII. CHOOSING THE RIGHT PATH

During comments at the G-20 summit in Pittsburgh last fall, President Obama underscored the importance of new ways of thinking and an increased focus on international cooperation, particularly with emerging-market countries, in today's globally integrated economy. He said, "We can no longer meet the challenges of the 21st-century economy with 20th-century approaches."

From an international tax perspective, the United States stands at a crossroads. The international tax system, and the business tax system as a whole, cannot remain tethered to the approaches of the last century.

International activity is, and will continue to be, critical to the success of U.S.-headquartered global companies. The future growth of the world's population and commerce will occur primarily outside the United States. For U.S.-headquartered companies to thrive, they must operate and succeed in markets all around the world. Global engagement is not a choice, it is an imperative.

U.S. policymakers should ensure that the tax laws contribute to the success of U.S. businesses operating in the global economy, which will contribute to the diversity and growth of the U.S. economy and the well-being of the American people.