REPATRIATION, INVERSIONS AND TAX POLICY

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ABSTRACT

In the ongoing debate over how to reform our tax system, one important question involves how to treat income U.S. corporations earn from their activities overseas. This paper examines the two major ways countries answer this question: territorial and worldwide tax systems, and how these two different systems impact corporate behavior. This paper will also discuss how we can change our tax system in order to promote economic growth.

The Worldwide Tax System

The United States has a worldwide tax system. A corporation headquartered in the U.S. must pay U.S. corporate income tax on all its income, regardless of whether it is earned in the U.S. or overseas. The corporation pays this tax when the foreign earnings are 'repatriated' by bringing the income back to the U.S. This is known as 'deferral' because the income tax owed can be deferred until a later date when the income is repatriated.

The Territorial Tax System

Under a territorial tax system, nations tax only the income earned in the country; accordingly, if the U.S. had such a system, most or all income earned by foreign subsidiaries of a U.S. corporation would be exempt from tax in the U.S. Most countries have territorial systems.

The United States of America

By having a worldwide tax system, the U.S. is subjecting its companies to the highest tax rate in the world, not only on income earned in the U.S., but on all income earned worldwide and repatriated back to the U.S. This encourages many companies to keep income overseas. According to one study, U.S. multinational firms have almost $2 trillion in foreign earnings kept overseas. Even if an American company plans to repatriate their income eventually, it is advantageous to delay repatriation of the income as long as possible, since the company can invest and earn income on that foreign cash until the time comes for repatriation.

The Foreign Tax Credit and the Lock-Out Effect

When American corporations repatriate income from subsidiaries operating abroad, that income may have already been taxed by a foreign country. If it has, corporations are generally allowed to claim a dollar for dollar tax credit (up to a limit) for foreign taxes paid. The credit, formerly known as the foreign tax credit, is intended to alleviate the double taxation of corporate income.

Cross-Crediting

Cross-crediting refers to American corporations applying excess foreign tax credits generated in a high-tax country to U.S. tax owed on income generated in a low-tax country. This is possible because deferral allows corporations to selectively decide when to repatriate income and, therefore, when to use excess credits. By choosing to repatriate income from low-tax countries when excess foreign tax credits exist, corporations can lower the amount of U.S. tax they would otherwise have to pay.

Response by Corporations

The use of a worldwide system, coupled with a high corporate tax rate results in lower net earnings for American corporations and less cash available to be invested in the U.S. This, in turn, can mean a lower growth rate for those companies. This has led U.S. corporations to use different approaches to reduce their overall tax payments, ranging from keeping retaining their foreign income abroad as discussed before to tax inversion and profit-shifting.

Tax Inversions

Inversions have recently become a major issue. A corporate inversion is a process by which an existing U.S. corporation changes its country of residence. Post-inversion, the original U.S. corporation becomes a subsidiary of a foreign parent corporation. Corporate inversions occur through three different paths: the substantial activity test, merger with a larger foreign firm, and merger with a small foreign firm. Regardless of the form of the inversion, the typical result is that the new foreign parent company faces a lower home country tax rate and no tax on the company's foreign source income.

Profit Shifting

Profit shifting generally refers to corporations which artificially move taxable income from high-tax countries to low-tax countries as part of a tax reduction strategy. A popular method used to accomplish this is debt shifting.

In summary, the United States has to deal with these important issues:

a. Lock out (deferral) of taxes on earnings retained overseas;
b. Tax inversions which are an growing way for multinational companies headquartered in the U.S. to reduce their tax bill;
c. Profit-shifting techniques used by these multinationals; and
d. The potential for movement of research and development activities away from the United States to jurisdictions with more favorable treatment of intellectual property.