Key Implications of International Tax Rules

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Eakinomics: Key Implications of International Tax Rules

Tax reform negotiations continue, with the “Big Six” (Treasury Secretary Mnuchin, National Economic Council Director Gary Cohn, Speaker Paul Ryan, Ways & Means Chairman Kevin Brady, Senate Majority Leader Mitch McConnell and Senate Finance Chairman Orrin Hatch — FWIW, they need a better nickname) indicating they will reveal details of the proposed tax bill during the week of September 25. Among the most eagerly anticipated features of the plan are the rules for taxing overseas income.

Recall that at present the United States has a 35-percent corporate tax rate and subjects the global earnings of U.S. headquartered firms to tax. In contrast, all of our developed competitors tax only the domestically earned income of their corporations. This puts our corporations at a tax-based competitive disadvantage because, for example, a German firm selling in the Czech Republic pays only the Czech rate of 19 percent, while the U.S. firm pays 19 percent to the Czech government and other 16 percent (for a total of 35 percent) to the United States. This disadvantage is ameliorated somewhat by the fact that U.S. firms can defer their additional tax (the 16 percent) for as long as the funds remain overseas. Unfortunately, this has simply produced a “lockout effect” — funds are locked-out of the United States by the potential additional tax, remain unavailable for investment in the U.S. economy, and are ultimately invested abroad. In this way, the tax system tilts the playing field toward foreign production.

The final defect of the current system is that it favors having headquarters in other countries. If, during a merger or acquisition, the firm can move the headquarters to another country, it will shed the U.S.-based tax disadvantages. Unsurprisingly, this has become an ongoing issue in the United States.

The negotiators are expected to produce a more “territorial” system, with firms taxed on the basis of their U.S. earnings. (There will be a one-time tax on the accumulated past overseas earnings.) This is an improvement, but not a panacea. By itself, it will still leave in place an advantage to having earnings taxed at lower rates prevailing around the world. This is true for legitimate transactions, but it is also true for so-called profit-shifting using transfer prices.

In these schemes, a U.S.-based firm will buy products from its foreign subsidiary in, e.g., Ireland. But it will do so at an inflated “transfer price” that serves to generate profits in Ireland and costs in the United States. The latter reduces profits (taxable at 35 percent), while the former raises profits in Ireland (taxable at 12.5 percent). This kind of tax avoidance must be controlled, and the way the Big Six proposes to do so will be of intense interest.

Notice that the lower is the U.S. corporate rate, the lower is the incentive for transfer-pricing to shift profits. This is directly good for preserving the U.S. tax base. But it will have two other ancillary effects as well. Notice that when transfer prices inflate the cost of Irish-made intermediates, the value of U.S. imports rises and (other things the same) the trade deficit widens. Recent research suggests that this is more than a theoretical matter — such transfer pricing may be responsible for as much as one-half of the trade deficit in 2012. Since 2010, the trade deficit has averaged 3.2 percent of Gross Domestic Product (GDP). This suggests that a complete elimination of the incentives would raise GDP by as much as 1.2 percent and the adjustment to this higher level would yield growth faster by 0.1 to 0.2 percentage points over the 10-year budget window.

Finally, the lower is the U.S. tax rate, the more equal will be the tax treatment of capital raised in the United States and that capital attracted from abroad (known as foreign direct investment). Capital from both sources employs U.S. workers, raises their productivity and wages, and improves the performance of the U.S. economy. Avoiding discrimination against either source should be a benchmark for evaluating tax policy.

The international tax reforms are central to the objectives of investing, innovating and hiring in the United States as a direct route to a more robust middle class.