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Summary: Effects of the US Worldwide Tax Regime on Domestic Investment

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There are two basic systems for international corporate taxation. The US operates under a worldwide taxation system, in which the US government asserts its right to tax the global income of US resident corporations, whether that income is earned within the US or outside it. The US is the only G7 nation that maintains such a tax system. The majority of other nations in the world use a territorial taxation regime. A territorial regime embodies a source-based system where countries only tax business activity that happens within their borders. This summary of Professor Jennifer Blouin's B-School Seminar, focuses on differences in corporate tax regimes worldwide and the implications for corporate tax reform.

Keywords

corporate tax planning, worldwide vs. territorial regimes, tax rate, trade, worldwide tax system, foreign tax

Disciplines

Economic Policy | Finance | International Economics | Political Economy | Public Policy | Taxation

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Summary: Understanding the Effects of US Corporate Tax Policy on Multinational Firms' Investment

Seminar by Professor Jennifer Blouin

WORLDWIDE VS. TERRITORIAL REGIMES

There are two basic systems for international corporate taxation. The US operates under a **worldwide taxation** system, in which the US government asserts its right to tax the global income of US resident corporations, whether that income is earned within the US or outside it. The US is the only G7 nation that maintains such a tax system. The majority of other nations in the world use a **territorial taxation** regime. A territorial regime embodies a source-based system where countries only tax business activity that happens within their borders.

Historically, maintaining a worldwide tax system seemed advantageous for the US. Since the early 1990s, the top US corporate tax rate has been either 34% or 35%, and for a long time many of America's key trading partners had corporate tax rates higher than that. But today, the average tax rate among OECD nations outside the US is approximately 25%, and the US's major trading partners all have a tax rate below 35%.

The differential financial impact of the US worldwide tax system is illustrated in Figure 1 and Figure 2, showing after-tax cash flows for a US parent company and a Canadian parent company, each with a subsidiary in Ireland, and comparing scenarios where the Irish tax rate is 10%, versus a more historical scenario when the Irish tax rate might have been 40%.

As Figure 2 illustrates, the after-tax cash flows for the two parent companies are the same when the foreign tax is at the higher rate. But when operating under a territorial tax regime with a lower tax rate, the foreign competitor is able to yield a higher after-tax cash flow. This carries significant implications for business investment, making it harder for US companies to compete. Consequently, US companies often complain that they are mistreated from a US tax policy perspective.

DEFERRAL AND ITS CONSEQUENCES

To help address the competitiveness problem, the US offers the

Figure 1: Worldwide vs. Territorial Taxation - with 10% Foreign Tax

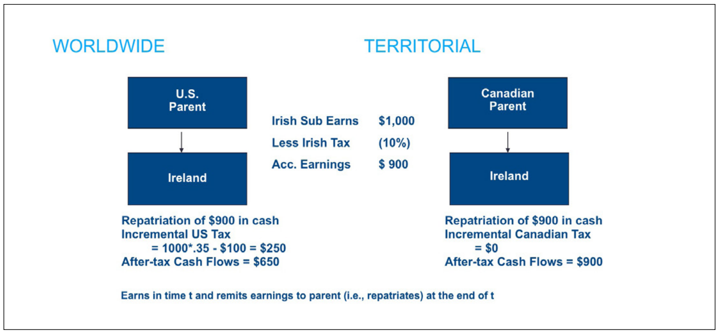
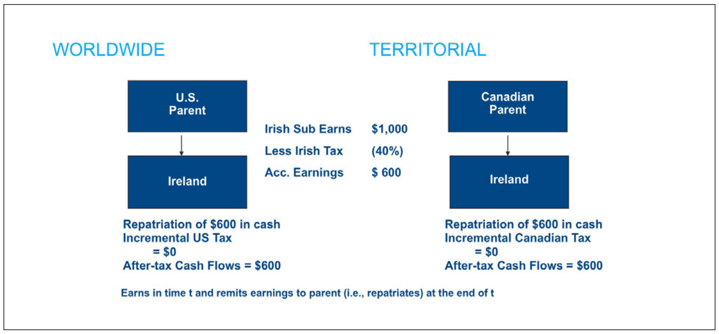


Figure 2: Worldwide vs. Territorial Taxation - with 40% Foreign Tax



concept of deferral: the tax is not imposed until the cash is remitted, or repatriated, back to the United States. But even with deferrals, the US worldwide system has become problematic. When a company puts money into a business investment in a low-tax jurisdiction overseas, it not only defers the US taxes, but the value of the investment continues to compound over time. This affects the calculation of the after-tax rate of return. In fact, it is possible that a US company can do better investing a foreign project with a lower pre-tax rate of return, as opposed to investing in a domestic project with a higher pre-tax rate of return, because deferral can lead to a higher after-tax rate of return for the foreign project. (See Figure 3 for an example.)

Figure 3: Comparison of Project *After-Tax Returns*: U.S. versus Foreign

	Holding Period			
	1	5	10	20
U.S. project, 12% return, 35% tax rate	7.8%	7.8%	7.8%	7.8%
Foreign project, 12% return, 10% tax rate	7.8%	8.2%	8.7%	9.3%
Foreign project, 11% return, 10% tax rate	7.2%	7.5%	7.9%	8.4%

US companies like the ability to defer their tax obligation. But to the extent that it can incentivize firms to invest in projects overseas with lower pre-tax rates of return, it is distortionary and thus bad economic policy. There is in fact evidence that US multinationals with a lot of cash "trapped" outside the US wind up over-investing in foreign mergers and acquisitions.

Other mechanisms that might allow for more domestic investment—i.e., having a foreign affiliate lend earnings to the US parent, or guarantee a bank loan to the US parent, or invest directly in the US—are considered acts of repatriation that would trigger the very taxes that US multinationals are trying to defer. Funds from the foreign affiliate can even be sitting in a US bank, but they cannot be used by the US parent company for productive purposes without incurring the repatriation tax.

Consequently, we also see a lot of domestic borrowing among US multinationals. Borrowing to fund domestic activites is ultimately less expensive than repatriating foreign earnings. For example, consider Apple, Inc. Three-quarters of Apple's balance sheet is in cash and marketable securities, but they have been borrowing domestically to pay dividends. It is cheaper to pay the interest rate for borrowing than to pay the repatriation tax.

CORPORATE TAX PLANNING

For all intents and purposes, US companies have "tax planned themselves" into a territorial system in order to avoid triggering the imposition of the US worldwide tax rate. Such tax planning has led several major US firms to pursue strategies such as the so-called "Dutch Sandwich" or "Double Irish" corporate structures. Take Google, for example. The intellectual property rights that drives Google are held in Google Ireland Holdings (Bermuda). Google Ireland LTD, which collects the income from data and ad revenue generated by everyone Google-ing outside the United States. It then has a licensing agreement with Google Netherlands Holdings BV, a Dutch entity; Google Ireland LTD pays most of its income as a royalty payment to Google Netherlands Holdings. Google Netherlands Holdings, in turn, has a licensing agreement with Google Ireland Holdings (Bermuda) to pay 99.8% of royalty payment proceeds.

The intermediary Dutch entity is key. Ireland's tax rate is around 15%. Withholding tax rates are imposed on royalties as flows of cash move between intermediaries. Transfers directly from Ireland to Bermuda, for instance, would be taxed at 20%. But with the Dutch intermediary, transfers from Ireland to the Netherlands are taxed at 0% because of EU trading agreements, and then transfers from the Netherlands to Bermuda are also 0%, as they are historically close trading partners. And Ireland, for its part, is satisfied with the income generated from taxing the personal income, assets, and economic activity indirectly derived from Google's operations located in Ireland. Such arrangements are facilitated by the "check-the-box" rule, which allows a US corporation to elect, by checking a box on their tax return, to have certain foreign subsidiaries treated as if they do not exist (or are disregarded) for purposes of US corporate income tax reporting. The US government recognizes only legal entities deemed to be corporations. This means there is no backstop to prevent the creation of such convoluted organizational structures to mitigate withholding taxes. Check-the-box also enables the practice of earnings stripping, a practice by which a firm makes a loan to a subsidiary for operational expenses, allowing the subsidiary to deduct interest payments related to this loan from its earnings, avoid US anti-abuse provisions and thus reduce the firm's overall tax liability.

Figure 4: Firms with the Largest 2015/2016 Indefinitely Reinvested Earnings — In $ Billions

10.	Exxon Mobil	$51.0
9.	Johnson & Johnson	58.0
8.	Google	58.3
7.	Merck	59.2
6.	Cisco	65.6
5.	IBM	68.1
4.	Pfizer	80.0
3.	GE	104.0
2.	Apple	109.8
1.	Microsoft	124.0

LOCKOUTS

Looking beyond issues of deferrals and the artificiality of moving and holding assets overseas, the US tax system also fosters a state of "earnings lockout." The US has an **accrual basis of accounting** for financial reporting, so firms accrue the expense for estimated taxes that they owe on earnings. But if these earnings are indefinitely (or permanently) invested overseas, firms don't have to make the accrual for the incremental US taxes that would be due upon their repatriation. Consequently, firms with indefinitely reinvested earnings not only get the cash flow benefits of deferring the US tax on income earned overseas, but they also get the capital markets benefits. It is estimated that US companies have upwards of $2.5 trillion in indefinitely reinvested earnings, equating to billions in unrecognized tax liabilities.

Cash is also getting locked out, along with earnings. Looking at major companies, only 20% of their cash is held in the US—and sometimes much less. At the start of 2016, Johnson & Johnson reported having $38.3 billion in total cash, but only $0.1 billion of that was in the US.

When thinking about policy, though, the focus should be on the earnings, not cash. Cash and earnings are not the same thing, and it is the unremitted earnings that get taxed. The current, widespread practice of permanently reinvesting earnings is itself a response to federal policy—specifically, the American Jobs Creation Act of 2004, which offered the first pure tax holiday ever in the US. At the time, Congress had promised that it would be a one-time deal. But it set a precedent that has altered the expectations and behavior of US firms. They are waiting for another tax holiday in light of the one in 2004. Or, barring that, they are waiting for tax reform that will transition the US to a territorial regime. But as current tax planning practices make clear, what US multinationals are not going to do is pay the 35%.