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March 22, 2004

CURRENT INTERNATIONAL TAX RULES PROVIDE INCENTIVES FOR MOVING JOBS OFFSHORE

Dear Democratic Colleague:

Since President Bush took office in January, 2001, we have experienced a net loss of 2.2 million jobs. We do not know how many of those jobs were lost due to companies moving operations offshore. On average, economists estimate that 690,000 jobs have been lost since 2001 because companies have moved operations overseas. Those estimates are conservative because they only take into account direct job losses. They do not take into account indirect losses sustained by small and medium sized businesses that were suppliers to the large companies that moved operations offshore. Also, they do not take into account the new jobs that were created offshore rather than in the United States.

Many Members have asked me whether our current overseas tax rules are contributing to the shift of jobs from the United States. Therefore, I asked the Democratic staff of the Committee on Ways and Means to prepare an analysis of that issue. Together we published the findings in today's "Bureau of National Affairs Daily Report for Executives."

I would encourage you to ready the study. If you do not have access to the BNA Daily Report, feel free to call the Democratic Staff of the Committee on Ways and Means who will email the article to you. I would like to take this opportunity to briefly summarize some of its findings. They highlight serious issues.

- Our current international tax rules provide benefits overseas greater than a total exemption of overseas business income. Our multinationals overseas enjoy the benefits of a negative tax, i.e., they receive substantial tax credits in addition to paying no tax on their foreign income – resulting in a subsidy for "offshoring."

over

- According to the Congressional Research Service (CRS), economic theory is relatively clear on the basic impact of our international tax system: "it encourages U.S. firms to invest more capital than they otherwise would in overseas locations where local taxes are low." More capital invested overseas means fewer jobs in the United States.

- The CRS is not alone in reaching that conclusion. An economist with the American Enterprise Institute stated "The U.S. tax code definitely provides a strong incentive for sending jobs overseas."

- <u>Even where our industries are competitive with low-wage economies overseas, companies have substantial incentives to move operations offshore because the tax benefits from doing so will increase earnings per share reported to shareholders</u>.

- U.S. multinationals utilizing tax havens abroad can substantially reduce the tax on their income from U.S. operations. Those tax benefits may mean that U.S. multinationals have competitive advantages over small and medium-size companies that have kept all of their jobs in the United States.

The Bush Administration and Ways and Means Committee Chairman Thomas for the last two years have been insisting that the United States should "reform" its international tax rules. Their idea of reform in this area is to increase the already robust incentives that U.S. companies enjoy for moving jobs offshore. In the next few weeks, we may have a Floor debate on chairman Thomas' bill increasing tax benefits overseas. I would urge you to join me and oppose that legislation.

Opposing Chairman Thomas' legislation should be just the first step. The report makes it clear that we should consider reform of our international tax rules with a view to decreasing the tax incentives from moving jobs offshore. American workers deserve a fair playing field, not a playing field tilted in favor of moving jobs offshore.

Sincerely,

Charlie

Charles B. Rangel
Ranking Democrat

Current International Tax Rules Provide Incentives for Moving Jobs Offshore

by Rep. Charles B. Rangel and John Buckley

Much has been made over the assertion, contained in President Bush's Economic Report, that the outsourcing of U.S. jobs overseas is positive for the U.S. economy. However, the press stories concerning the Bush praise of job outsourcing have missed a crucial point – this position is totally consistent with the Bush Administration's drive to provide more tax benefits for the offshore operations of U.S.- based multinational corporations.

As a result of an adverse ruling by the World Trade Organization, the United States is required to repeal its current export-related tax benefits or face escalating trade sanctions on some of our exports. Last year, the President's budget used the need to repeal those benefits as a pretext for requesting additional overseas tax benefits.[1] Essentially the Bush Administration was proposing to increase taxes on U.S. companies that export goods produced in the United States to fund tax benefits for companies that export jobs. It is an election year now, and the current Bush budget proposals are a bit more subtle. Nevertheless, the current Bush budget continues to advocate more overseas tax benefits.[2]

The Bush Administration seems willing to use any pretext as an excuse to push its agenda of providing more tax benefits for companies that move jobs offshore. In 2002, there was broad, bipartisan anger at companies that moved their headquarters overseas for tax avoidance. These expatriating companies were following the advice of a major accounting firm whose spokesperson suggested that "patriotism just has to take a back seat to profits." The Bush Administration refused to support bipartisan efforts to close this loophole and, instead, argued for more tax benefits overseas.[3]

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[1]See General Explanation of the Administration's Fiscal Year 2004 Revenue Proposals, U.S. Department of the Treasury, Feb. 2003, p. 147.

[2]See General Explanation of the Administration's Fiscal Year 2005 Revenue Proposals, U.S. Department of the Treasury, Feb. 2004, p. 187.

[3]Pamela F. Olson, Assistant Secretary for Tax Policy, U.S. Department of the Treasury, in testimony before the House Committee on Ways and Means, June 6, 2002. She suggested that the anti-inversion legislation was comparable to East Germany's construction of the Berlin Wall.

The additional overseas tax benefits proposed by the Bush Administration could further tilt the playing field against American workers. Already, our current tax rules, in combination with favorable accounting rules, provide powerful incentives for U.S. companies to shift capital and jobs overseas.

Taxation of Overseas Earnings of U.S.-Based Multinationals

A. General Description

The United States nominally taxes the worldwide income of U.S.-based multinational corporations. However, the impact of our worldwide system of taxation is dramatically reduced through two benefits, the foreign tax credit and deferral. The foreign tax credit prevents the potential double taxation of foreign earnings by reducing the U.S. tax on those earnings by the amount of foreign income taxes paid on those earnings. Deferral permits U.S. multinationals to postpone payment of the U.S. tax on most of their foreign earnings until the earnings are repatriated to the United States, either directly by distributions to the U.S. parent corporation or indirectly by investments in U.S. property. Essentially, deferral permits a multinational corporation to control when or whether it pays U.S. income tax on its foreign earnings.

For years, lobbyists for U.S. multinational corporations have argued that our worldwide system of taxation has placed those corporations at a competitive disadvantage overseas because our major trading partners tax their multinationals on a territorial basis, (i.e., they provide an exemption for the foreign business income of their multinationals). The Bush Administration essentially has echoed that argument:

> "Finally, we must continue our work to address the U.S. disadvantages for U.S.-based companies that do business abroad relative to their counterparts in our major trading partners. The U.S. international tax rules can operate to impose a burden on U.S.-based companies with foreign operations that is disproportionate to the tax burden imposed by our trading partners on the foreign operations of their companies."[4]

The argument made by the lobbyists, and echoed by the Bush Administration, has a dubious factual basis. First, the implication that all our

[4] Pamela F. Olson, Assistant Secretary for Tax Policy, U.S. Department of the Treasury, in testimony before the House Committee on Ways and Means, June 6, 2002.

major trading partners use a territorial system simply is not true. About one-half of developed countries in the world use a system for taxing foreign-source income of their multinationals that is similar to our worldwide system.[5]

More importantly, our system, with its combination of deferral and a foreign tax credit, is more generous in most circumstances than the partial territorial systems of other countries. When a U.S. multinational operates in a tax haven or other low-tax foreign country or succeeds in shifting income to a tax haven, it receives benefits from deferral equivalent to an exemption, because those earnings are rarely repatriated in a way that triggers U.S. tax.[6] When a U.S. multinational operates in a developed country that has corporate taxes comparable to or greater than ours, it receives benefits greater than an exemption because it typically can use a portion of those foreign taxes to offset the U.S. tax on other income, i.e., cross crediting.[7]

In 2001, the American Enterprise Institute published an article (the Grubert/Mutti territorial study) analyzing the impact of adopting a territorial system. The article concluded that the adoption of a territorial system would <u>increase</u>, not decrease, federal tax revenues by approximately $7 billion per year.[8] One of the authors of the study is a senior Bush Administration Treasury Department economist.

The conclusions of the Grubert/Mutti study are fairly surprising and worth emphasizing – <u>our current tax system results in a negative tax, or</u>

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[5]Michael J. Graetz and Paul W. Oosterhuis, "Structuring an Exemption System for Foreign Income of U.S. Companies", *National Tax Journal*, Vol. LIV, p. 771.

[6]Deferral provides an indefinite forgiveness of tax so long as the earnings are not repatriated to the United States. Not surprisingly, the repatriation rate (i.e., the percentage of foreign earnings repatriated to the United States) is extremely low for earnings in low-tax jurisdictions, less than 7%. The repatriation rate approaches zero for the first fifteen years that a company operates in a low-tax jurisdiction overseas. See Harry Grubert and John Mutti, Taxing International Business Income: Dividend Exemption vs. The Current System (AEI Press, 2000), p. 4, hereafter referred to as the "Grubert/Mutti territorial study."

[7]The "Territorial Tax Study Report," prepared for the National Foreign Trade Council, concluded that companies operating in high-tax jurisdictions overseas "could be worse off from a competitiveness viewpoint" if the U.S. were to adopt a territorial system. Being "worse off from a competitive standpoint" undoubtedly means that they would pay more tax under a territorial system. The study is available on the web page of the National Foreign Trade Council at www.nftc.org.

[8]Grubert/Mutti territorial study, p. 38.

subsidy, for the foreign business income of our multinationals in that it provides benefits greater than a complete tax exemption of the income overseas. According to the study, the size of the subsidy is at least $7 billion per year. There never has been any serious challenge to these conclusions.

B. Factors Contributing to the Tax Subsidy Overseas

i. Deferral

The ability to manipulate deferral is probably the largest reason for the subsidy that our multinationals enjoy overseas.

Our international tax rules developed at a time when most of the overseas operations and income of our multinationals were in developed countries. As recently as 1988, more than 75% of the overseas profits of our multinationals was earned in developed countries with significant income taxes.[9] Deferral provides little or no benefit in those circumstances. For example, excluding eleven low-tax foreign countries, our multinationals faced an average effective foreign tax rate of 38% in calendar year 2001.[10] As a result, even if deferral were repealed, there would be little or no additional U.S. tax collected on the non-tax haven income of our multinationals.

Now, however, almost 50% of the total overseas income of our multinationals is "earned" in low-tax jurisdictions overseas.[11] This phenomenon makes deferral far more valuable. U.S. companies are increasingly locating their operations in low-tax jurisdictions, and their advisors are increasingly adept at shifting income into those jurisdictions from operations in other countries. While almost 50% of the total overseas income of our multinationals was "earned" in low-tax jurisdictions, those countries accounted for approximately 9% of the overall overseas employment of our multinationals and 12.6% of the investments in plant and equipment overseas.[12]

U.S. multinationals may be exporting jobs overseas, but they are very

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[9]Martin Sullivan, "U.S. Multinationals Move More Profits to Tax Havens," *Tax Notes*, February 9, 2004, p. 691

[10]Id., at p. 693

[11]Id., at p. 691

[12]Id., at p. 690

careful to make sure that many of the expenses of creating those overseas jobs are retained in the United States and deducted in computing U.S. income tax. For example, a company closing a plant in the United States in order to move operations overseas can deduct the cost of the plant closing against U.S. tax liability. The company receives a tax benefit worth as much as 35% of the plant closing costs even though deferral may permit it to avoid tax on the income from the overseas operations. Similarly, a company can fund its foreign operations by borrowing money in the United States and making an equity investment in its foreign subsidiary. Interest on the loan gives rise to a U.S. tax deduction even though there is no U.S. tax on the income from the investment while the income remains overseas.

Countries that use a territorial system do not permit their multinationals to deduct expenses allocable to exempt foreign source income or they provide a partial exemption of the foreign source income instead of disallowing allocable expenses.[13] Otherwise there would be a negative tax due to the combination of an exemption for the income and a deduction for the expenses giving rise to the tax-exempt income. The logic is very similar to the reason why our tax system does not permit a deduction for interest on debt incurred to purchase tax-exempt bonds.

The United States has a complex system for the allocation of expenses to the overseas income of our multinationals. However, that allocation only affects the amount of the foreign tax credit. If a company operating in a low-tax jurisdiction does not repatriate its earnings from that jurisdiction (and few of them do in a way that creates tax consequences), it is permitted to deduct the expenses allocable to its foreign source income against its U.S. income without limit. The result is a classic subsidy, the combination of an effective exemption and a deduction for the expenses allocable to the exempt income. Therefore, it is not surprising that under a territorial system, "the effective rate on U.S. investments in low-tax jurisdictions would actually increase."[14]

The U.S. system attempts to address the negative tax potential through the overall foreign loss recapture rules. However, those rules affect only the amount of the foreign tax credit and can be avoided simply by not repatriating foreign earnings. Also, some types of income, such as royalties for the overseas use of U.S.-developed patents, trademarks, and other intangibles, are treated as foreign-source income under the tax rules even though economists view

[13]For discussion of territorial systems overseas, see "Territorial Tax Study Report" prepared by the National Foreign Trade Council, www.nftc.org.

[14]Grubert/Mutti territorial study, p. 4.

such income as earned in the United States. Tax on those types of "foreign" income can be eliminated without triggering the overall foreign loss recapture rules.

ii. Cross Crediting

As noted above, most developed foreign countries have corporate income taxes with effective rates equal to or greater than ours. The average corporate tax burden (outside eleven low-tax jurisdictions) faced by our multinationals overseas was 38% in 2001. Companies operating in those high-tax jurisdictions often have excess foreign tax credits, i.e., the foreign tax on their income exceeds the U.S. tax on such income. Companies can use those excess foreign tax credits (cross-crediting) to offset U.S. tax on other types of income, including income essentially earned in the United States, such as royalties arising from U.S.-developed intangibles. Companies also can use excess foreign tax credits to reduce or eliminate the tax on profits "earned" in low-tax jurisdictions.

Countries that use a territorial system do not allow a credit for foreign taxes imposed on exempt overseas income. The foreign tax credit is designed to eliminate double taxation. Since there is no tax on the overseas income under a territorial system, there is no potential double taxation and no need for a foreign tax credit. Our system provides benefits greater than a total exemption because the foreign tax credit eliminates any U.S. tax on income from many developed countries, and permits cross-crediting to reduce tax on income effectively earned in the United States or in low-tax foreign countries.

C. Favorable Tax Rules Contribute to U.S. Job Losses

Few people dispute the fact that our tax rules provide benefits that favor overseas expansion. However, apologists for our beneficial international tax rules argue that cost savings, not tax savings, are the impetus for moving jobs offshore. The top tax lawyer of a multinational that moved major operations to a low-tax jurisdiction overseas contended that wage rates, not taxes, were the motivation for the move. "Taxes were just the icing on the cake," he claimed.[15]

More objective analyses support the common sense proposition that tax rates do matter when a company decides where to locate its operations.

> "Host country average effective tax rates appear to have a highly significant effect on the location and investment decisions of U.S. manufacturing companies. This conclusion is based on country-level

[15]Jonathan Weisman, "Democrats Can't Get Firm Grip on Jobs Issue," *Washington Post*, February 19, 2004.

analysis of the international operations of more than 500 U.S. companies in 60 potential locations. The results appear to be quite robust."[16]

This conclusion is significant because it is part of a study that acknowledges that wage rates, market access, and other "quality of life" factors play a role. The study adjusted for those differences between countries and still concluded that taxes are a large factor in determining whether a U.S. multinational invests in the United States or abroad.

The Congressional Research Service reached a similar conclusion in a recent report to the Congress:

> "We begin by looking at the incentive effects of the current U.S.-international system, with the deferral system and indirect foreign tax credit described above. Economic theory is relatively clear on the basic incentive impact of the system: it encourages U.S. firms to invest more capital than they otherwise would in overseas locations where local taxes are low...Deferral poses an incentive for U.S. firms to invest abroad in countries with low tax rates over investment in the United States."[17]

Even conservative economists reach similar conclusions. "The U.S. Tax Code definitely provides a strong incentive for sending jobs overseas," says Kevin Hassett, an economist at the conservative American Enterprise Institute.[18]

The favorable tax treatment outside the United States may not be the determining factor in circumstances where there are large cost savings to be derived from outsourcing U.S. jobs. However there are many segments of our economy that are competitive with low-wage economies overseas. Those who believe that outsourcing is good for our economy argue that jobs in areas where the U.S. has a competitive advantage will replace the jobs being lost from outsourcing. It is in those circumstances – where U.S. industries are competitive with low-wage economies – that the tax incentives could easily tip the balance toward locating overseas. Even if our workers are more than competitive, the tax incentives may nevertheless encourage companies to move offshore.

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[16]Harry Grubert and John Mutti, 2002, "Do Taxes Influence Where U.S. Corporations Invest?", *National Tax Journal*, Vol. LIII, No. 4, Part 1.

[17]CRS Report for Congress, Tax Exemption for Repatriated Foreign Earnings: Proposals and Analysis, October 22, 2003, pp. 5-6.

[18]Steven Liesman, "U.S. Tax Code Provisions Encourage Offshore Jobs," *Wall Street Journal Online*, March 12, 2004.

Following are some specific examples of how our tax rules can encourage outsourcing of jobs overseas.

i. Outsourcing Services Overseas

There has been a fair bit of publicity given to the outsourcing of service jobs overseas. The press reports give the impression that companies outsource services simply by hiring a group of employees overseas. Some outsourcing transactions are that simple although the simple transactions normally involve contracting with an unrelated service provider that does the actual hiring. The simple outsourcing transactions generally involve "non-core" services that have low profit margins and do not require the sharing of sensitive technology with an unrelated foreign company.[19]

However, as companies outsource more complex technical services or services that are part of their "core business," the outsourcing transactions become more complicated and have large tax benefits. These services may have high profit margins, and companies are unwilling to share technology with unrelated foreign companies. Therefore, a U.S. parent company often will create a foreign subsidiary that hires the workers to perform the services. The foreign subsidiary will then sell those services directly or indirectly to the U.S. parent.

The key to the tax benefit from this type of outsourcing is the transfer price charged by the foreign subsidiary for the service. The higher the transfer price, the greater the tax benefits. Theoretically, the transfer price is the price that would be charged if the transaction were between unrelated corporations conducting business at "arms length."

In practice, companies have flexibility in determining transfer prices particularly where the product or services have value due to technology or know-how. It would not be difficult to establish a defensible transfer price that would result in the foreign subsidiary being attributed the portion of the profit due to lower wages overseas.

As a result, this type of outsourcing can provide significant tax advantages to the U.S. parent company. The cost saving from the outsourcing is reflected in the earnings of the foreign subsidiary that will not be taxed because of deferral. The U.S. parent deducts an amount that can approach the U.S. value of those services when computing its U.S. tax liability. Quite often, the company may not wish to retain the profits in the country where the

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[19]The simple arrangements do not have any significant tax benefits. They reduced the company's ordinary business expenses that are deductible in computing U.S. tax liability. In effect, the cost savings give rise to greater U.S. taxable income.

computer programmers are hired. Therefore, the company might use a hybrid entity to move the profits to Bermuda, from where the profits can be invested in other operations overseas.

Even if U.S. employees were willing to take a wage cut equal to the cost saving of hiring the foreign workers, the company would still have a large incentive to outsource the jobs overseas. For example, if the cost savings were $100, the company would have after-tax profits of $65 if the work were retained in the United States. The company would have after-tax profits of $100 if the work was outsourced. Because of the favorable tax rules, there is a "robust" incentive to outsource overseas even when U.S. workers are competitive with the overseas labor.

ii. Cost-sharing Arrangements

Cost-sharing arrangements can be used to "facilitate a disguised transfer of intangibles outside the United States in a manner inconsistent with the arms length standard."[20] Under a cost-sharing arrangement, a U.S. company grants the right to exploit a U.S.-developed patent or other intangible asset to one of its foreign subsidiaries. The foreign subsidiary bears a portion of the cost of developing the intangible. Even if the cost-sharing payment were accurate, much of the income from the U.S. development work would be shifted overseas. In practice, the payments are low, and can result in a disproportionate shift of income overseas (principally to low-tax jurisdictions).

The cost-sharing arrangements are more than just tax avoidance devices; they play an important role in the decision of where U.S. companies produce the patented products. The tax savings are realized only if the patented products are produced overseas. There are no similar savings if the products are produced in the United States.

Many people argue that new U.S. inventions and new industries will create jobs that will replace the jobs lost by outsourcing. We undoubtedly will develop new inventions, but abuses of cost sharing arrangements may result in many of the new jobs being located overseas.

iii. Hybrid Entities

Hybrid entities are an invention of creative tax lawyers. These entities take advantage of the fact that the U.S. definition of what is a taxable corporation often differs from definitions utilized in other countries, and the fact that U.S. law is completely elective in many circumstances. Sometimes

[20] Pamela F. Olson, Assistant Secretary for Tax Policy, U.S. Department of the Treasury, in testimony before the House Committee on Ways and Means, June 6, 2002.

these entities are treated as a taxable corporation for U.S. tax purposes and as a partnership or other flow-through entity for foreign tax purposes. Other times, these entities are treated as a partnership or flow-through entity for U.S. tax purposes, but as a taxable corporation for foreign tax purposes.

Hybrid entities can be used to shift income from a high-tax foreign country to a low-tax foreign country.[21] In doing so, the U.S. multinational avoids both foreign tax and U.S. tax on the shifted income. The widespread use of hybrid entities may be one reason why nearly half of the income of U.S. multinationals overseas now is earned in tax havens. Some argue that the U.S. should not be concerned about these transactions because the transactions avoid foreign, not U.S., tax. However, the long term consequences of these transactions could be negative to our economy. "If U.S. companies can get the benefit of low tax rates for investment located in high-tax countries, the United States is more likely to lose capital and jobs as well as all the taxable profits associated with them."[22]

Hybrid entities also can be used to shift capital out of low-tax countries so that it can be invested in other foreign countries. That means that companies operating in low-tax jurisdictions can use their earnings for investment in all other countries overseas without any U.S. tax consequences. Only if they invest their earnings in the United States would there be an additional U.S. income tax. Again, in the long term, the consequences of these entities could be negative, resulting in greater investment overseas and less investment in the United States.

Hybrid entities are but one example of transactions that exploit the differences between our tax laws and the tax laws of other countries. These transactions all have the same goal — avoidance of both U.S. tax and foreign tax, i.e., double non-taxation. The tax avoidance is possible only if the company moves operations offshore.

iv. Cross-crediting

Under current law, foreign tax credits from high-tax jurisdictions overseas can be used to reduce U.S. tax on royalty income from U.S. patents and other intangibles. "This practice can create perverse incentives, causing a

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[21]For example, the operating company makes a deductible payment (interest or royalties are examples) to the hybrid that reduces its foreign tax. The payment is disregarded for U.S. purposes since the hybrid is treated as a branch and, therefore, there is no subpart F inclusion taxable to the U.S. parent corporation.

[22]Martin Sullivan, "U.S. Multinationals Move More Profits to Tax Havens," *Tax Notes*, February 9, 2004, pp. 691-692

company to exploit a patent overseas rather than in the United States."[23] Exploiting a patent overseas means producing the patented good overseas, not in the United States. Again, our tax laws provide incentives that may mean that many of the new jobs that the apologists of outsourcing promise may actually be created outside the United States.

D. Favorable International Rules Disadvantage Small and Medium-Sized Domestic Firms

The favorable tax treatment enjoyed by our multinational companies overseas creates two problems for small- and medium-size companies.

First, these small- and medium-size companies often rely on sales of goods or services to larger companies for much of their business. That important market will erode as those larger companies move operations offshore because of the tax incentives.

Second, the large multinational companies with subsidiaries in low-tax jurisdictions enjoy lower U.S. tax burdens than their purely domestic competitors. "We find that U.S. manufacturing firms with subsidiaries in low-tax countries have relatively low U.S. tax payments per dollar of assets or sales."[24]

Favorable Book Accounting Rules

Our corporate tax rules admittedly are complex, but the financial accounting treatment of taxes is even more difficult to understand. The amount shown as tax expense by corporations when reporting to shareholders quite often bears little resemblance to the amount of corporate taxes actually paid. The difference between the amount reported to shareholders and the amount actually paid gives rise to a confusing mix of deferred tax assets and deferred tax liabilities included on corporate balance sheets.

Many of our domestic business tax benefits essentially result in a deferral, not forgiveness of tax. The deferral often arises because of provisions in the tax law that permit an acceleration of a deduction or the deferral of an income item. For example, the largest domestic tax benefit for business is accelerated depreciation, a provision that accelerates deductions that otherwise would have been allowed in a future year. Generally, the financial accounting

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[23]Grubert/Mutti territorial study, p. 3.

[24]David Harris, Randall Marck, Joel Slemrod, and Bernard Yenna, "Income Shifting in U.S. Multinational Corporations, Studies in International Taxation, University of Chicago Press, 1993, page 277.

rules disregard those tax benefits for purposes of determining earnings per share reported to shareholders. The earnings per share are computed as if the company actually paid currently the deferred taxes.

As previously discussed, the major benefit that multinationals enjoy overseas is the ability to defer tax on their foreign operating income. The financial accounting rules treat that deferral far more favorably than the income tax deferrals available for U.S. operations. If the company contends that its foreign earnings will be invested overseas indefinitely, the company can treat the deferral as if it were a permanent forgiveness of tax. The tax savings from moving jobs overseas immediately flows to the bottom line and increases earnings per share.

The ability to increase reported earnings by moving operations overseas is a powerful incentive to move jobs out of the United States, perhaps even more important than the cash flow savings from the tax benefits themselves.[25]

Bar to Reinvestment in the United States

The tax and financial accounting rules have created a large and growing pool of untaxed corporate earnings overseas. At the end of 1999, the pool of unrepatriated foreign earnings of U.S. multinationals was $403 billion. By the end of 2002, the pool was estimated to be $639 billion, an increase of over 50% in 3 years.[26]

The major tax benefit for overseas operations is deferral, which ends when the earnings are either distributed back to the U.S. parent or invested in U.S. property. The tax that a company would pay if the earnings are reinvested in the United States can have a dramatic impact on where the company chooses to reinvest those earnings. Typically, a company will reinvest overseas unless it anticipates substantially higher returns from an investment in the U.S. to compensate for the tax liability that would result from the U.S. investment. The financial accounting consequences perhaps are even more important than the additional tax liability. Assuming the company took advantage of the favorable book accounting rules discussed above, the company would have to show a loss to shareholders by reason of the investment in the United States, and the loss could be as much as 35% of the U.S. investment.

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[25]For an article discussing how multinationals have increased earnings per share by shifting capital overseas, see "Multinationals Find Tax Relief Overseas," *Financial Times*, February 1, 2004.

[26]CRS Report for Congress, Tax Exemption for Repatriated Foreign Earnings: Proposals and Analysis, p. 8.

There are indications that companies have succeeded in repatriating their earnings without tax consequences through a variety of devices. One example is borrowing money in the United States, indirectly secured by the overseas assets of the company. That may be one reason why there are major corporations that both have large cash balances and fairly significant borrowings. Another strategy involves a multinational with subsidiaries in both high-tax and low-tax foreign countries. If the low-tax subsidiary has excess funds, but the high-tax subsidiary does not, the low-tax subsidiary can make an investment in the high-tax subsidiary. Then the funds can be repatriated without tax because of the foreign tax credit.[27] However, the fact that many companies are seeking a temporary holiday during which the tax on repatriated earnings would be as little as 5.25% indicates that some of the informal ways of reducing the repatriation tax may have reached their limit.[28]

There is no question that current law imposes barriers to the reinvestment of foreign earnings in the U.S., the only question is the strength of those barriers. Also, there is no question that the pool of unrepatriated earnings is growing rapidly. Both of those facts have negative, long-term implications for our economy.[29]

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[27]Grubert/Mutti territorial study, p. 17 and following.

[28]Some have suggested that the new emphasis on corporate disclosure makes it more difficult to borrow money using untaxed foreign earnings as security since the use of those foreign earnings to repay the loan would create large tax liabilities and book losses.

[29]The proposals for a temporary holiday taxing repatriations at a low rate does not address those negative long-term implications. At best, it would create a temporary bulge in repatriations, many of which may be used to repay debt incurred in connection with past indirect repatriations. If not viewed as only a one-time proposal, it actually could increase incentives to move offshore by creating hope for substantially tax-free repatriations in the future.

Conclusion

There is a broad consensus among economists that our current international tax rules provide strong incentives for companies to move capital and jobs overseas. The Bush Administration and their congressional Republican allies have chosen to ignore that consensus and have continued to support more tax benefits for the offshore operations of U.S.-based multinational organizations.

Since President Bush took office in January 2001, this nation has experienced a net loss of 2.2 million jobs. President Bush's term in office may be the first time that this nation has experienced a net job loss during a President's term since Herbert Hoover. Those job losses require a reform of our international tax rules with the goal of reducing the current law incentives to move jobs offshore. Those job losses also make the Bush Administration's support for more offshore tax benefits indefensible.

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