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November 4, 2003

Oppose Additional Tax Incentives for Moving Jobs Offshore

Dear Colleague:

Last week, the Committee on Ways and Means reported legislation, H.R. 2896, that would provide substantial new tax benefits for the offshore operations of U.S. multinationals. Justifying additional offshore tax benefits would be difficult under any circumstance. It is particularly difficult now given the fact that the manufacturing sector of our economy is in a crisis of historic proportions. 2.5 million manufacturing jobs have been lost during the Bush Administration. We have seen the longest period during which there has been a contraction in manufacturing employment since the Great Depression.

I would ask you to carefully examine some of the arguments being made to justify the large offshore tax benefits contained in the Thomas bill. If you do so, I am confident that you will agree with me that those tax benefits simply provide additional incentives for moving jobs offshore. Following are some facts to keep in mind as you make your decision on this issue.

I. U.S. foreign tax system is more generous than systems in most other countries.

For years, supporters of the foreign tax benefits contained in the Thomas bill have asserted that the U.S. has a worldwide system of taxation that is fundamentally different from the systems used in other countries. The facts are not so clear.

About half of other developed countries use a worldwide system of taxation similar to that used by the United States. Other developed

countries tax their multinationals on a predominately territorial basis by exempting from tax all or a portion of the foreign active business income of their multinationals. No developed country uses a pure territorial system that exempts all foreign source income from tax.

At first blush, our worldwide system of tax would seem to be less generous than the partial territorial systems of other countries. The facts are otherwise.

The impact of our worldwide system is dramatically reduced through deferral, which (in most cases) permits U.S. multinationals to defer the tax on their foreign business earnings until repatriated (brought back) to the United States. Our system permits virtually unlimited deferral of tax on active business income overseas – an unlimited deferral that provides benefits substantially equivalent to an exemption. In addition, U.S. companies are permitted to reduce the U.S. tax on their foreign earnings by the amount of income taxes paid to other countries, i.e. the foreign tax credit.

The U.S. 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 jurisdiction, it receives benefits from deferral equivalent to an exemption. When a U.S. multinational operates in a developed country with corporate taxes comparable or greater than ours, it receives benefits equal to or greater than an exemption because quite often it can use a portion of those foreign taxes to offset the U.S. tax on other income, i.e. cross-crediting.

Not surprisingly, most large U.S. multinationals oppose adoption of a partial territorial system similar to that used abroad.

II. Effective rate on foreign earnings is already very low or negative.

As a result of deferral and the foreign tax credit, the U.S. tax on foreign business income is extremely low. Studies published by two Treasury economists estimate that the effective U.S. tax rate on overseas earnings is only 1.9 percent. It is extremely difficult to contend that our system places large burdens on our multinationals when the effective rate is that low.

In fact, the low effective rate described above may overstate the real effective rate offshore. There have been recent studies that indicate that adopting an exemption for the offshore business earnings of our multinationals would be a tax increase. The classic definition of a negative income tax is a system that is more generous than a total exemption. Using that definition, there may be an overall negative tax on the offshore operations of our multinationals. Again, it is not surprising that our multinationals prefer our current system to an outright exemption.

III. Thomas bill will provide new tax incentives for moving jobs offshore.

The Thomas bill does not significantly simplify the current rules. It merely provides further liberalization of a system that is already very generous. It provides new tax incentives for moving jobs offshore in three important ways.

A. Repeal of limitations on deferral.

Under current law, there are some limitations on the ability of U.S. multinationals to defer tax on their income from their offshore operations. Those limitations, contained in subpart F of the Internal Revenue Code, limit deferral when companies use tax havens to avoid both U.S. and foreign tax. The Thomas bill would repeal many of those limitations. As a result, U.S. companies will find that they can realize large tax savings when they shift income or operations to low tax jurisdictions abroad. In contrast, they would pay U.S. corporate tax if they keep their operations in the United States. Clearly, this would provide incentives to move offshore.

B. Expanded cross-crediting.

When a U.S. company operates in many developed countries overseas, it will have excess foreign tax credits, i.e. taxes paid to the foreign country in excess of the U.S. rate. In some circumstances, it can use those excess foreign tax credits to offset tax on income from low-tax countries. This benefit is call cross-crediting.

For example, a company operating in many European countries will have excess foreign tax credits. It can use those excess credits to offset the U.S. tax on income that it realizes from moving production from the United States to countries like China. It cannot use those excess foreign tax credits to reduce the U.S. tax on its income from operations in the United States.

The Thomas bill repeals most of the current law limitations on the cross-crediting of excess foreign tax credits. In effect, the bill would provide additional tax credits that could be used against the U.S. tax on income from operations moved out of the United States.

C. Liberalized rules for reinvesting earnings overseas.

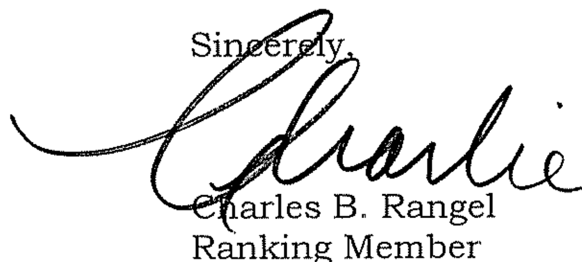
The current subpart F rules place some limitations on the ability of U.S. multinationals to reinvest earnings from one foreign country in another foreign country.

For example, a distribution of earnings from one foreign subsidiary to another foreign subsidiary for reinvestment overseas results in U.S. tax under current law. Similarly, a distribution of those earnings to the United States parent for reinvestment in the United States also results in U.S. tax.

Under the Thomas bill, a distribution for reinvestment overseas would be exempt from U.S. tax. But, the bill would retain U.S. tax when the distribution is for reinvestment in the United States. The bill changes the rules in a way that dramatically increases the incentive to invest offshore, not in operations producing jobs in the United States.

I would implore you to examine the facts and not to be intimated by the complexity of some of the rules, a complexity not reduced by the Thomas bill. If you do so, I am confident that you will agree with me and Small Business Committee Chairman Don Manzullo that the Thomas bill will make "it easier or more attractive for American companies to invest, source, and move operations overseas, especially to China."

Sincerely,



Charles B. Rangel
Ranking Member