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Win Some, Lose Some

New tax act takes billions and returns billions more to American business.

BY RICHARD SCHAUL-YODER

Last Friday, President George W. Bush signed into law the American Jobs Creation Act of 2004. The centerpiece of the legislation is the repeal of the extraterritorial income exclusion tax incentive for U.S. exporters. The extraterritorial income exclusion was the most recent U.S. tax incentive to be declared an illegal export subsidy by the World Trade Organization at the urging of the Western European governments.

After a two-year wind-down that has angered the Europeans, the extraterritorial income exclusion now will go the way of other export subsidies—such as the domestic international sales corporation, first enacted in 1971, and the foreign sales corporation, first enacted in 1984.

The Joint Committee on Taxation estimates that repeal of the extraterritorial income exclusion will produce a $50 billion tax windfall for the Treasury. Congress was encouraged, and agreed, to use the windfall to provide other tax benefits to business rather than to reduce the deficit. Thus, the legislation adds $88 billion in additional tax breaks, with the extra $38 billion to be paid for by a broad variety of anti-abuse provisions, loophole closers, user fees, and excise tax increases.

Before the act's passage, the debate centered on how to spend the tax savings from extraterritorial income exclusion repeal. The exporters, of course, wanted recompense for their $50 billion loss. U.S. manufacturers wanted a tax benefit for domestic production activities, and they argued that such a benefit would also compensate exporters for their loss of the extraterritorial income exclusion.

U.S.-based multinationals, on the other hand, wanted to use the $50 billion in their long-fought effort to expand deferral of U.S. tax on their foreign income and simplify (and thereby increase) the availability of the foreign tax credit.

The legislation gives something to both groups. The U.S. manufacturers get an estimated $77 billion for domestic production activities (although it remains to be seen how many exporters can take advantage of this benefit). U.S.-based multinationals get an estimated $43 billion in changes to the anti-deferral and foreign tax credit regimes, as well as a one-time tax amnesty for repatriation of foreign earnings.

IMMEDIATE WINNERS AND LOSERS

In terms of the immediate costs and benefits resulting from this particular legislation, the American Jobs Creation Act will be bad principally for U.S. exporters.

The exception will be exporters who are also engaged in U.S. production activities or who have significant foreign income that has not been taxed in the United States and that they want to repatriate to the United States. It is not clear how much of the $77 billion production benefit will go to exporting as opposed to non-exporting manufacturers. To avoid being labeled as another illegal export subsidy, the legislation does not link this benefit to the production of export goods.

In addition, many large U.S. exporters do not have significant foreign operations of the sort that would allow them to benefit from the relaxation of the anti-deferral and foreign tax rules and the new temporary tax holiday for repatriation of foreign earnings. On balance, the exporters appear to be net losers.

The act will be good for at least two types of U.S. companies: profitable U.S. manufacturers engaged in "qualified production activities" and profitable U.S.-based multinationals. Companies that are not profitable, unfortunately, will derive no benefit other than possible additions to their loss carry-forwards.

The legislation gives U.S. manufacturers about $77 billion in benefits for "qualified production activities." Eligible manufacturers may deduct a percentage of their "qualified production activities income." The deduction is limited to 50 percent of wages paid by the manufacturer. The percentage of qualified production activities income that will be deductible is phased in at 3 percent for 2005 and 2006, 6 percent from 2007 through 2009, and 9 percent thereafter.

The new legislation gives U.S.-based multinationals an estimated $30 billion in new benefits, including the following:

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• ***Fewer foreign tax credit "baskets."*** U.S. taxpayers get a credit against their U.S. taxes for foreign taxes they pay. The foreign tax credit, however, is subject to various limitations. One of these limitations is imposed by categorizing different types of foreign income in different baskets. The purpose of the baskets is to prevent the crediting of foreign taxes paid on high-taxed foreign income of one sort against the U.S. tax on low-taxed foreign income of a different sort. The new legislation reduces the number of baskets from nine to two, thus substantially increasing the ability to achieve such cross-crediting. The Joint Committee on Taxation expects the benefit to cost the Treasury approximately $7.8 billion.

• ***Substantial one-time only rate relief for repatriation.*** The new legislation provides a one-year tax holiday during which U.S. multinationals can repatriate foreign earnings to the United States at tax rates reduced by 85 percent. The effective tax rate on such repatriating dividends will thus be 5.25 percent instead of the usual 35 percent. The reduced rate is available only for extraordinary dividends in excess of a five-year average, up to a maximum amount of $500 million. The U.S. multinational must reinvest the dividends in the United States. U.S. multinationals are expected to benefit in the amount of approximately $3.5 billion.

• ***More favorable rules for interest-expense allocation.*** The foreign tax credit allows a U.S. taxpayer a credit for foreign taxes paid on foreign-source taxable income. Taxpayers must allocate income and deductions, including interest expense, between U.S. and foreign sources. The new legislation allows U.S. multinationals to change the method by which they compute their interest allocation. This change is expected to cost the Treasury approximately $14 billion.

Long-Term Winners and Losers

The more interesting question is who won this round of the long-standing debate about U.S. taxation of our multinationals' foreign income. The basic dialogue has centered on whether the U.S. system is too generous to U.S. companies with foreign profits, such that they are actually encouraged not to repatriate foreign income to the United States.

According to Martin Sullivan, a former Treasury Department economist who specializes in international tax, the hard data suggest that the answer is yes. In a study published in *Tax Notes* on Sept. 14, Sullivan says that U.S. companies keep an extraordinary percentage of their foreign earnings—$149 billion out of $255 billion in 2002, or 58 percent—in pure tax havens, that is, low-tax countries where the companies conduct no significant business activities. According to Sullivan's data, this is a 68 percent increase since just 1999.

This shift of foreign earnings from higher-tax to tax-haven jurisdictions allows these U.S. companies legally to escape not only foreign tax on the earnings, but also, with proper planning, to escape U.S. tax until the earnings are repatriated. While not definitive, Sullivan's data strongly suggest that U.S. multinationals are doing precisely that to an ever-increasing degree. Many tax policy experts and economists have long argued forcefully that considerations of fairness, economic efficiency, simplicity, and revenue protection mandate broad reform to eliminate the privilege of deferring U.S. tax on foreign earnings.

The business community, however, insists that the answer to whether the United States is too generous in forgoing immediate taxation of foreign income is no—that the United States cannot be an island when making tax policy. U.S.-based multinationals have long urged simplification and relaxation of the anti-deferral regime embodied in the tax code's Subpart F rules, initially enacted in 1962. The U.S.-based multinationals claim that these rules place them at a competitive disadvantage vis-à-vis multinationals based outside the United States. They also claim that the Subpart F rules are antiquated, unduly complex, and often internally inconsistent.

> The act will be good for at least two types of U.S. companies: profitable U.S. manufacturers engaged in 'qualified' production and profitable U.S.-based multinationals.

For now, it appears that the U.S.-based multinationals may have won round one in the debate over the proper U.S. taxation of their foreign income. This debate has been gathering steam for several years, however, and will continue long past the temporary fix embodied in this particular legislation.

In the future, look for continued heated discussion of fundamental reform of our system of taxing foreign earnings. The multinationals will press their case for expansion of the tax code's deferral of U.S. tax on their foreign earnings, while many economists and policy experts will argue that deferral should be eliminated.

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