No. 878

May 12, 2003

# International Provisions of Senate Tax Bill Undermine U.S. Competitiveness

*Daniel J. Mitchell, Ph.D.*

The Senate Finance Committee tax bill contains a number of provisions that would undermine American competitiveness and restrict fundamental rights of labor and capital to cross national borders. If approved, these provisions will undermine the parts of the tax bill—such as the acceleration of marginal tax rate reductions and small-business expensing—that promote economic growth. Three provisions are particularly damaging.

**Americans Working Abroad.** Under the Senate Finance Committee bill, Americans who work and live in other nations will have to pay tax to the IRS on all their income, even though that income is earned—and subject to tax—overseas.

The United States is one of the few nations to tax its citizens when they live and work in other nations—the misguided practice of "worldwide" taxation. This policy hurts U.S. companies trying to compete in global markets and reduces American exports. It also is a form of double taxation since U.S. citizens employed in other nations are subject to all applicable taxes in those nations (much as foreigners working in the United States pay tax to the IRS). Current law tries to limit the damage of America's worldwide tax regime by taxing workers only on annual income above $80,000—a policy known as the Section 911 exclusion. The Finance Committee proposal eliminates this $80,000 exclusion.

Repealing Section 911 would significantly increase the cost of employing American citizens and make it more likely that foreigners would get these jobs instead. This would result in fewer exports since U.S. workers working abroad—particularly executives—are likely to purchase U.S. products. According to PricewaterhouseCoopers and Johns Hopkins University economists, eliminating Section 911 would reduce U.S. exports by $8.7 billion and result in a loss of nearly 150,000 U.S.-based jobs.

Produced by the
Thomas A. Roe Institute for
Economic Policy Studies

Published by
The Heritage Foundation
214 Massachusetts Ave., NE
Washington, D.C.
20002–4999
(202) 546-4400
http://www.heritage.org

This paper, in its entirety, can be found at: *www.heritage.org/research/taxes/em878.cfm*

The United States is the only developed nation to tax its citizens working in other nations. Indeed, only a tiny handful of nations—places like Jamaica and the Philippines—make the same mistake.

**Corporate Expatriation.** If the Senate Finance Committee bill is enacted, companies that re-charter in low-tax jurisdictions will be treated as if they were still chartered in the United States. This means they will be taxed on income earned in other nations, undermining their competitiveness and harming U.S. workers and shareholders.

The proposal is designed to punish corporate "inversions," which occur when U.S.-chartered companies decide to re-charter in jurisdictions like Bermuda and the Cayman Islands. However, this is akin to blaming the victim. Companies invert

because the Internal Revenue Code taxes companies on income earned in other nations, and this "worldwide" tax system undermines competitiveness. American companies trying to compete in global markets can (a) passively allow their market share to decline, (b) become takeover targets for foreign-based competitors, or (c) have their charter in a filing cabinet in a low-tax jurisdiction instead of in a filing cabinet in Delaware.

Option (c) is the only choice that helps America. An "inverted" company still keeps its headquarters and factories in the United States. All that changes is that the company no longer has to pay tax to the IRS on income earned in other nations, but this is exactly what should happen. Every tax reform plan—including the flat tax—is based on "territorial" taxation, the commonsense notion of taxing only income earned inside national borders.

The Senate tax bill would preclude option (c) since an "inverted" company would continue to be taxed as if it were chartered in the United States. In effect, the bill would empower the IRS to chase down companies seeking to protect the interests of their workers and shareholders. Hence, this provision is known as the "Dred Scott Tax Act"—a reference to the infamous Supreme Court decision that said slaves were still property even if they escaped to a free state.

**Individual Expatriation.** The Senate Finance Committee bill imposes heavy exit taxes on American residents who emigrate. Émigrés would be forced to surrender a significant share of their assets as a penalty for exercising their rights.

Like every other free nation, the United States allows people to emigrate. Unlike most other civilized nations, however, the United States sometimes imposes a tax penalty on people for choosing another nation—and the Finance Committee proposal would make the law even worse. Émigrés currently must pay tax to the IRS on their U.S.-source income, but because of discriminatory rules, they pay significantly more tax than do other foreigners with U.S.-source income. The Senate proposal would compound this bias by forcing émigrés to pay tax on unrealized capital gains—a form of double taxation on imaginary income.

This proposal will discourage investors and entrepreneurs from other nations from becoming U.S. residents. Moreover, U.S. taxpayers thinking about emigrating would have an incentive to place their investments in other nations. The correct approach is to fix the problems with U.S. tax law—punitive tax rates and pervasive double taxation of savings and investment—that motivate taxpayers to emigrate.

The Senate bill is to the left of even the United Nations. The 1948 Universal Declaration of Human Rights states that "Everyone has the right to leave any country, including his own" and that "No one shall be...denied the right to change his nationality." Yet the Senate bill makes the right to emigrate contingent on paying a ransom on the way out the door. The taxation of emigrants is almost unprecedented, at least among democratic governments.

**Conclusion.** The three provisions of the Senate Finance Committee tax bill outlined above undermine good tax policy and harm U.S. competitiveness. Why, then, are politicians taking these steps? In two cases, the actions are motivated by spite, not revenue. The anti-inversion provision raises only $2.6 billion over 10 years, and the anti-expatriation provision raises only $700 million. The tax on Americans working abroad, by contrast, is driven by greed. According to static revenue estimates, this provision will increase tax collections by more than $32 billion over the 2004–2013 period.

If enacted, these provisions will substantially offset the pro-growth impact of other provisions of the tax bill. Combined with the decision to emasculate the President's dividend proposal, the Senate Finance Committee has produced a tax bill that will provide only modest benefits for the U.S. economy.

*—Daniel J. Mitchell, Ph.D., is McKenna Senior Fellow in Political Economy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.*

*NOTE: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.*