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A Territorial Tax System Would Create Jobs and Raise Wages for U.S. Workers

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Abstract

There is widespread agreement that the current U.S. tax system for multinational businesses destroys jobs and suppresses wages for U.S. workers. However, there is a sharp division about how to fix it. One side argues for strengthening the current worldwide system. The other side argues for a territorial system. Strengthening the worldwide system would drive U.S. businesses and their jobs overseas. The U.S. needs to abandon the worldwide system because it is not neutral and therefore reduces investment by U.S. firms. A territorial system, in contrast, is neutral to investment and therefore does not discourage it. Congress should scrap the worldwide system and move to a territorial system like almost every other developed nation uses. More investment would be a boon to U.S. workers because it would increase job creation and raise wages.

An intense debate is raging over the proper way to repair the broken system the U.S. uses to tax its international businesses. There is widespread agreement that the current system destroys jobs and suppresses wages for U.S. workers. However, there is a sharp division about how to fix the system's shortcomings. One side argues for strengthening the current worldwide system that taxes U.S. businesses on the income they earn in foreign countries. The other side argues for a territorial system, which would mostly exclude foreign-earned income from U.S. taxation.

Strengthening the worldwide system would be disastrous for U.S. workers because it would drive U.S. businesses and their jobs overseas. The U.S. needs to abandon the worldwide tax system, not

Key Points

- The U.S. worldwide tax system is not neutral in that it raises the threshold for U.S. businesses to invest abroad.
- Less investment because of the worldwide system prevents improvements in business efficiency that would increase job creation and raise wages for U.S. workers.
- A territorial system, by contrast, is neutral to investment, creating neither an incentive nor a disincentive for businesses to invest.
- By moving to a territorial system the U.S. could unlock investment that the current worldwide system is restraining, improving business efficiency.
- More efficient businesses would create jobs and raise wages for U.S. workers.
- A territorial system would be a boon for U.S. workers by undoing the harm of the worldwide system.

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strengthen it, because it is not neutral and therefore reduces investment by U.S. firms at home and abroad. In stark contrast, a territorial system is neutral to investment, meaning that it neither discourages nor encourages the amount or location of investment.

Congress should scrap the worldwide system and move to a territorial system like almost every other developed nation has. Such a policy improvement would be a boon for U.S. workers by removing the worldwide system's disincentive to invest and its barriers to international competitiveness.

The U.S. Worldwide Tax System

The U.S. worldwide system taxes the domestic and foreign income of businesses with U.S. headquarters. Businesses can claim a "foreign tax credit" for taxes that their foreign subsidiaries (incorporated entities) or foreign branches (unincorporated entities) pay in other countries. This credit limits double taxation. Where the foreign tax rate exceeds the U.S. rate, no U.S. liability is generated. In the more common circumstances where the U.S. tax rate is greater, U.S. businesses owe a residual tax on their foreign earnings equal to the difference between the U.S. tax rate and the tax that their subsidiaries paid in the foreign country where they earned the income.

As a result of the worldwide tax system, U.S. businesses are expected to pay the same amount of tax on income that they earn abroad as they would if they earned that income in the U.S.

U.S. businesses owe tax on their foreign earnings in the current filing period when they earn that income through a foreign branch. However, when they earn "active" income (income they earn by selling a good or service)[1] through a foreign subsidiary, the income is generally subject to U.S. tax only when dividend income is remitted to the U.S. parent. Because of this, the foreign tax liability is said to be "deferred."

This treatment parallels the tax treatment when a U.S. parent corporation receives a dividend distribution from a domestic subsidiary. Deferral of foreign earnings is therefore proper and normal as a matter of tax policy design and has the additional benefit of lessening the damage to international competitiveness and domestic investment that the worldwide system causes.

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The Territorial Tax System

In contrast to worldwide taxation, a territorial system taxes businesses on only income earned within a country's borders. It applies to all businesses that operate within a country's boundaries, whether that business is headquartered in that country or another.

Instead of a pure territorial system, most countries use an exemption system under which foreign income is mostly exempt from taxation. The exemption is generally 95 percent of foreign earnings. Chairman Dave Camp (R–MI) of the House Ways and Means Committee released draft legislation for international tax reform that would set up a 95 percent exemption system for the U.S.[2]

The exemption system is a simpler way of denying businesses an extra tax benefit that would occur from allowing a deduction of expenses incurred earning foreign income. Since they are not paying tax on that income under a territorial system, they should not receive deductions for expenses incurred in earning it. Taxing a small portion of foreign earnings serves as a proxy for those expenses. Such a system is easier to apply than forcing businesses to somehow separate expenses incurred in earning exempt foreign income from expenses generated earning taxed domestic income.

1. The tax code makes an important distinction between active income and passive income, the details of which are complex and generally not relevant to the present discussion except that tax on active income is subject to deferral, while tax owed on most passive foreign income might not be deferrable.
2. U.S. House of Representatives, Committee on Ways and Means, "Technical Explanations of the Ways and Means Discussion Draft Provisions to Establish a Participation Exemption System for the Taxation of Foreign Income," October 26, 2011, http://waysandmeans.house.gov/uploadedfiles/final_te_--_ways_and_means_participation_exemption_discussion_draft.pdf (accessed March 27, 2013).

A Neutral Tax Policy

Neutrality is the guiding principle of sound tax policy. It holds that taxes should influence the economic decisions of individuals and businesses as little as possible. If neutrality is defined from the standpoint of where a business earns its income, taxing businesses the same regardless of where they locate their operations could make sense. Such an analysis supports a worldwide tax system.

However, neutrality is not concerned with *where* businesses earn their income. Market demand and the nature of a business's functional operations rightfully determine location. Rather, neutrality is about minimizing the influence of taxes on the returns to business activity. That way taxes do not influence businesses' decisions.

> In the case of business investment, true tax neutrality is defined with respect to a business's investment decisions, not the business itself.

Therefore, true tax neutrality is defined with respect to a particular business activity, such as an investment's timing, location, and amount. In the case of business investment, true tax neutrality is defined with respect to a business's investment decisions, not the business itself. A tax system violates neutrality to the extent it raises the minimum required pre-tax return on an investment and thus influences the business's decision-making process regarding an investment.

Worldwide Tax System Reduces Investment

The U.S. worldwide tax system is the wrong policy because it is not neutral. By seeking to tax the location where businesses earn income equally, it reduces the extent to which U.S. businesses invest in foreign markets.

Before deciding whether to invest abroad, a U.S. business looks at all of the costs it would incur and the potential income it would earn by moving into a new market. All of the different variables go into determining whether the return from expanding into the new market would generate the return that the business requires for taking that risk. The business will make the investment if the estimated return matches or exceeds the rate it requires.

The worldwide tax system in the U.S. makes it less likely that the new investment's estimated rate of return will match or exceed the business's required rate of return because the U.S. tax on its foreign income raises the return required to justify the new investment. This applies whether the business is deciding to expand in a specific new country or determining the location of a new investment that it could place in several possible countries.

Even though a higher required rate of return under the worldwide system makes fewer investments viable, supporters of the worldwide system argue that the foreign tax credit and deferral mitigate the tax system's disincentives for U.S. businesses to invest abroad. While this is true, mitigation is not elimination. A tax-based disincentive persists.

Even with deferral, the extra tax under the worldwide system does not change the investment calculations of a business seeking to meet new demand abroad. The extra U.S. tax imposed on its foreign income from the worldwide system remains a cost to the U.S. business even though it does not owe the U.S. tax right away because it must report the accrued liability on its financial statements. It therefore still reduces the investment's estimated profitability.

U.S. businesses can mostly remove that accrued tax liability from their financials by establishing their intent to invest foreign-source income abroad permanently, but doing so makes it extremely difficult for them to ever bring that income back to the U.S. Rather, businesses generally decide to permanently reinvest their foreign earnings after they earn them. It is unlikely that they would ever decide not to bring their foreign earnings back to the U.S. before making an investment.

Because the worldwide system causes some potential investments to fall short of meeting the required rate of return, it causes U.S. businesses not to make investments that they would otherwise have made if the extra tax had not interfered. While the worldwide tax system does not prevent all foreign investment, the extra tax it applies stops the marginal investments that do not meet the higher rate of return.

Taxes matter at the margin, and the worldwide tax system is dissuading a multitude of U.S. businesses from making potential investments that they would otherwise make. Because it reduces

investment, the worldwide system destroys jobs and suppresses wages for U.S. workers.

The Superior Territorial System

In contrast, under a territorial tax system, U.S. businesses would mostly factor in only the taxes they would pay to foreign countries before making a decision on whether to invest abroad. U.S. taxes would be a minor and insignificant factor in the decision, assuming a partial exemption system. Almost totally eliminating U.S. taxes from the business investment decision would increase investment because marginal opportunities that currently fall short of the required return under the worldwide system would become viable because the extra U.S. tax would no longer factor into businesses' investment decisions.

That investment would allow U.S. businesses to meet their global demand more efficiently and allow U.S. businesses to form stronger corporate synergies that would further enhance efficiency. As explained below, these efficiency increases would greatly benefit U.S. workers.[3]

Compared with the current worldwide system, a territorial system would also increase the competitiveness of U.S. businesses. Foreign businesses unencumbered by the worldwide U.S. tax system are free to make investments that the U.S. worldwide tax system makes unprofitable for U.S. businesses. In these situations, U.S. businesses decline in standing compared with their foreign competitors because foreign businesses enjoy increased earnings and enhanced global efficiency from making investments that the U.S. worldwide system forces U.S. businesses to forgo. A territorial system would free U.S. businesses to make those investments so they can match the increased earnings and efficiency of their foreign competition.

Territorial Taxation in OECD Countries

Only six other countries in the Organization for Economic Cooperation and Development (OECD), a group of the 34 most highly developed nations in the world, employ a worldwide system for taxing their multinational businesses: Chile, Greece, Ireland, Israel, South Korea, and Mexico.[4] The other 27 have mostly territorial systems achieved through the exemption method.

Each of these six countries has a top corporate income tax rate that is lower than in the U.S., which is unsurprising since the U.S. has the highest rate in the OECD.[5] The U.S. rate exceeds 39 percent when the federal tax rate of 35 percent and the average rate of the states are combined. Most states do not tax foreign income, so the 35 percent federal rate is what matters in international tax issues. However, the 35 percent federal rate is still the highest for central governments in the OECD and well above the rates in the other countries with worldwide systems.

The U.S. rate far exceeds the 25 percent average rate of the other 33 countries in the OECD. The top rates in all the countries with worldwide systems match or are lower than the average rate in the OECD, except for Mexico (30 percent). The rates in Chile (20 percent) and Ireland (12.5 percent) are considerably lower than the OECD average.

Like the U.S., the six other countries with worldwide tax systems provide their businesses with a credit on the tax that they pay in foreign locations. The comparatively lower rates in these countries, combined with their foreign tax credits, means that their worldwide systems are a minor issue because their businesses pay little, if any, additional tax to their home countries on their foreign income. They effectively have territorial systems because their rates are consistent with OECD norms.

The U.S. worldwide system is more damaging to U.S. businesses than to businesses with headquarters in other worldwide taxation countries because of the high U.S. corporate tax. The high rate and worldwide system require U.S. businesses to pay an additional

3. A territorial system would also aid in fixing a defect in the current worldwide system. The tax code now considers royalties that U.S. businesses earn from licensing intangibles to their foreign subsidiaries as foreign-source income even though those intangibles are often developed, funded, and maintained in the United States. Royalty income is usually included in Subpart F income, but businesses can shield that income from U.S. tax with their excess foreign tax credits. A territorial system would fix this discrepancy because businesses would no longer have the credits to avoid paying tax on their royalty income.

4. Diana Furchtgott-Roth and Yevgeniy Feyman, "The Merits of a Territorial Tax System," Manhattan Institute for Policy Research *Issues* No. 29, October 2012, p. 2, http://www.manhattan-institute.org/pdf/ir_29.pdf (accessed March 7, 2013).

5. Curtis S. Dubay, "No Fooling: U.S. Now Has Highest Corporate Tax Rate in the World," The Heritage Foundation, The Foundry, March 30, 2012, http://blog.heritage.org/2012/03/30/no-fooling-u-s-now-has-highest-corporate-tax-rate-in-the-world/.

tax to the U.S. on their foreign earnings in every other developed country in which they earn income. Although the ability to cross-credit excess foreign tax credits offsets some of the extra tax,[6] cross-crediting does not lessen the worldwide system's negative impact on business investment because its mitigating impact occurs long after businesses decide whether a new investment matches its required return.

The developed world has mostly abandoned worldwide taxation in favor of territorial taxation because of the worldwide system's harmful economic effects on investment. Those in favor of strengthening the worldwide system usually fail to acknowledge this important fact that gives real world credence to the superiority of territorial over worldwide.

Creating Jobs and Raising Wages in the U.S.

In addition to allowing their businesses to maintain their global competitive edge, a chief benefit that other developed nations realized from switching to a territorial tax system is more jobs and higher wages for their workers that arise from their businesses increasing investment.

The best way to illustrate how a territorial system in the U.S. would create jobs and raise wages is through an example.

If a hypothetical Ohio manufacturer of automotive tires wants to invest in Germany because its market researchers have perceived growing demand for their tires there, the business can best meet that demand by having a domestic presence in Germany. Any time the product of a U.S. business experiences higher demand that justifies new investment, it is good for the business and its domestic workers because it means growth that benefits them both.

The U.S. business would likely open two subsidiaries to serve the German market better: a distributor to sell tires in the German market—and perhaps in the rest of Europe and beyond—and a manufacturer to make the tires to sell to the distributor. For the German distributor and manufacturer to function, they would need services and intangible intellectual property ("intangibles") provided by the U.S. parent company.

Some specific examples of intangibles that the U.S. parent tire business would license or sell to its German manufacturing subsidiary would include:

- The design of its entire line of tires,
- The manufacturing process for the tires, and
- Business practices used to ensure the quality and consistency of its tires.

The German distributor would also license or buy intangibles from the U.S. parent. Some of these items would include:

- The tire company's brand name,
- Branding practices,
- Customer relationships, and
- Business relationships, such as with car companies.

The German distributor and manufacturer would also need a host of services that the U.S. parent would provide. These are services that the German subsidiaries would need to provide on their own or pay other companies to provide if their U.S. parent did not provide them, such as:

- Procurement,
- Management,
- Executive functions,
- Human resources,
- Employee training,
- Treasury,
- Finance,
- Accounting,
- Legal,
- Government affairs,
- Public relations,

6. Edward D. Kleinbard, "Stateless Income's Challenge to Tax Policy," *Tax Notes Special Report*, September 5, 2011, p. 1028.

- Communications,
- Logistics, and
- Information technology.

In addition, the U.S. parent would provide the German manufacturer with additional services such as engineering and quality control. To the German distributor, it would provide marketing, advertising, sales support, and customer support.

The U.S. parent's provision of intangibles and services to its German subsidiaries would create jobs in the U.S. and raise wages for the U.S. parent's current employees. First, the parent's existing workforce would provide the services listed above. They would also work with the German subsidiaries to use the intangibles properly, whether the U.S. parent licensed it or sold it to its German subsidiaries.

The wages of employees of the parent business would rise because their productivity would increase. Their productivity would necessarily rise because of the increased efficiency that would result from new investment and from the corporate synergies that would result from the business more seamlessly meeting its customers' demands. Higher productivity is the key driver of higher wages.

The U.S. parent's expansion into the German market would create new jobs as its German subsidiaries grow more quickly. At some point, its existing workforce would run out of the capacity to meet the growing demands of the German subsidiaries. At that point, the parent would need to add new workers so as not to slow the growth of its German businesses.

From the sample of services and intangibles provided by the U.S. parent, expansion into the German market would clearly create highly skilled, high-paying jobs in the U.S. For instance, it would need more scientists and researchers to maintain and improve its intangibles; engineers to help the German manufacturer with the machinery needed to make the tires; more marketing experts, sales personnel, and business services professionals to help the distributor sell the tires; and more managers, executives, human resource professionals, finance experts, accountants, lawyers, communications experts, technology experts, and government affairs experts to help both subsidiaries with these respective business functions. These are just a sampling of the good jobs that the U.S. parent would create because it invested in a foreign country.

The increased wages and creation of new jobs resulting from a U.S. business expanding abroad are powerful examples of how globalization and integrated worldwide production generate benefits for U.S. workers by allowing U.S. businesses to increase both foreign and domestic investment.

These jobs are from a hypothetical anecdote. Academic research confirms that these beneficial effects accrue domestically in the real world when U.S. businesses expand abroad. In fact, the research finds that for every 10 percent U.S. businesses increase investment abroad, their domestic investment increases 2.6 percent.[7] That investment is necessary to support the new investment abroad with the provision of services and intangibles. More domestic investment results in more domestic jobs.

More investment also means higher wages for domestic workers. The same research also shows when businesses increase what they pay workers at their foreign subsidiaries by 10 percent, the wages of their domestic workers rise 3.7 percent.[8] The wage increases result from both increased domestic investment and the increased productivity of workers as described above, both of which occur because the U.S. business invested abroad.

A territorial tax system makes it more likely that the hypothetical U.S. tire business would invest in Germany and that U.S. workers would experience the higher wages and increased job creation because of that investment. In contrast, the worldwide tax system forces businesses to forgo many similar investments, precluding U.S. workers from enjoying those benefits.

Net Job Creation

Some argue that a territorial system would create an extra incentive for U.S. businesses to invest overseas, but this is incorrect. Instead, a territorial system would remove a disincentive created

7. Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Domestic Effects of the Foreign Activities of U.S. Multinationals," *American Economic Journal: Economic Policy*, Vol. 1, No. 1 (February 2009), pp. 181–203.
8. Ibid.

Foreign vs. Domestic Income

Before the German subsidiaries start making and selling tires, their U.S. parent company would capitalize both to get them up and running. The U.S. parent would earn its share of the businesses' net income as dividends in proportion with its share of the subsidiaries' equity that it owns. Since the subsidiaries would earn that income on the sale and manufacture of tires in Germany, it would be active "foreign-source income." Thus, any residual U.S. tax owed by the U.S. parent would be deferrable until it brings the income into the U.S. The U.S. parent would then receive a foreign tax credit for the taxes the subsidiaries paid on the income in Germany.

The German subsidiaries would pay their parent company for the services and the intangibles. The prices that the U.S. parent charges the German subsidiaries would reflect the price of an "arm's-length" transaction (the price of a similar market transaction between two unrelated businesses as dictated under the transfer pricing rules). The income that the U.S. parent earns from the provision of services—and the intangibles (in the cases where the parent sells the intangibles to its foreign subsidiaries)—would be domestic U.S. income because the U.S. parent would provide them from the U.S. It would be taxable to the U.S. parent the same as income earned from selling tires in the U.S, and it would not be deferrable.

The distinction between the foreign-source and domestic income is important because it exemplifies another reason why worldwide taxation is the wrong policy. The income earned by the two German subsidiaries (the foreign-source income) results from activity in Germany. Under the worldwide system, the U.S. exercises its claim to this income because they are subsidiaries of a business with a U.S. headquarters. Yet taxes should be levied only in and by the jurisdiction in which an economic event occurs, meaning sales, production, the assumption of risk, or the development, funding, and maintenance of intangibles. Otherwise, taxes influence the economic decisions of businesses just as in the worldwide system in the U.S.

Since the two German businesses earned that income from sales and production that occurred solely in Germany, it violates the sound application of neutrality for the U.S. to tax that income—assuming the intangibles of the tire company are properly allocated among the parent and subsidiary. The U.S. taxation of the domestic service and intangible income is in line with sound policy because the economic activity that generated that income occurred within the U.S.

Determining Intangibles. The proper allocation of intangibles is difficult to determine. Without proper policies in place, U.S. businesses could artificially move intangible income abroad. However, the traditional argument for worldwide taxation is that a business headquartered in the U.S. should pay the U.S. tax rate on all of its income, not because U.S. businesses are moving intangibles abroad that should remain in the U.S. A worldwide system is not necessary to ensure that a U.S. business's intangibles are properly taxed. A territorial system can do so.

by the current worldwide system. A territorial system is neutral to investment decisions because, by taking U.S. taxes mostly out of the equation, it provides neither incentives nor disincentives for businesses to determine where to locate their resources. Eliminating a disincentive is not the same thing as creating a new incentive.

A territorial system certainly creates jobs overseas, but that is only half the story. During the 2012 presidential campaign, Vice President Joseph Biden, reflecting the Obama Administration's preference for harmful worldwide taxation,[9] famously quoted a misleading academic study that found that moving to a territorial system would create 800,000 jobs

9. ABC News, "Transcript: Vice President Joe Biden's DNC Speech," September 6, 2012, p. 4, http://abcnews.go.com/Politics/OTUS/transcript-vice-president-bidens-democratic-convention-speech/story?id=17178040 (accessed June 19, 2013).

in foreign countries.[10] The implication was that U.S. businesses would create those jobs in foreign countries instead of in the United States. Whatever the true figure,[11] the analysis ignores that these jobs would be created to meet new demand in foreign countries—an improvement in efficiency that the worldwide system largely prevents today.

Of course, as more authoritative academic research cited previously shows and the example above makes clear, increased foreign investment would result in more investment in the U.S. That investment would lead to more jobs and higher wages in the U.S. The study that Vice President Biden cited fails to mention that, while investment by U.S. business creates jobs overseas, it also results in jobs at home.

References to lost U.S. jobs also fail to note that U.S. businesses would rarely create those jobs in the U.S. regardless of the tax regime in place because they will seldom make the same investments in the U.S. as in foreign markets. U.S. businesses would create new jobs abroad and at home to take advantage of new opportunities in growing foreign markets. The jobs that the U.S. economy gains from increased investment because U.S. businesses expand abroad are all a net gain.

Driving U.S. Businesses Abroad

Despite the ample benefits that would accrue to U.S. workers from moving to a territorial system, a strengthened worldwide system remains the policy preference of many policymakers, and President Barack Obama is the chief proponent of this harmful approach. Those who favor this approach usually propose strengthening the worldwide system by reducing or denying businesses the foreign tax credit and deferral. They also often support instituting a minimum tax rate on all the foreign income of U.S. businesses, either in place of limiting deferral and the foreign tax credit or in addition to those harmful measures.

During the 2012 campaign the President often said that he wants to close loopholes in the tax system that encourage U.S. businesses to ship jobs overseas. Since no such explicit policies exist, President Obama was likely referring to the foreign tax credit and deferral. In fact, his latest budget, like his previous budgets, proposes limiting both.[12] President Obama also supports applying a worldwide minimum tax on all foreign-source income.[13] Of course, arguing that the foreign tax credit and deferral encourage businesses to move jobs overseas gets the economics exactly wrong. They exist to lessen the damaging impact of worldwide taxation.

Applying these policies would be devastating for U.S. workers. Rather than miss out on even more opportunities to increase their competitiveness and profitability, many businesses would seek ways to avoid the even higher residual U.S. worldwide tax that would result.

The worldwide system only applies to businesses headquartered in the U.S. If a U.S. business moves its headquarters abroad, it would still owe tax on income earned in the U.S., but moving its headquarters to another country would avoid the extra tax on foreign income. The U.S. has strong anti-inversion rules that make it difficult for a business headquartered in the U.S. to move its headquarters to another country, but little prevents U.S. businesses from selling themselves to foreign-owned businesses.

When a business moves its headquarters to another country, it takes high-quality jobs with it and leaves a palpable absence in the communities it once inhabited. Businesses often become synonymous with the cities in which they are founded and grow, such as Microsoft and Seattle; Nike and Beaverton, Oregon; Apple and Cupertino, California; FedEx and Memphis; Coca-Cola and Atlanta; and GM, Ford, and Chrysler and the city of Detroit.

10. Kimberly Clausing, "A Challenging Time for International Tax Policy," *Tax Notes*, July 16, 2012, http://services.taxanalysts.com/taxbase/magdailypdfs.nsf/PDFs/136TN0281.pdf/$file/136TN0281.pdf (accessed March 28, 2013; subscription required).

11. Gary Clyde Hufbauer, "800,000 Jobs Shipped Overseas? Check the Math!" *Tax Notes*, August 6, 2012, http://services.taxanalysts.com/taxbase/magdailypdfs.nsf/PDFs/136TN0717.pdf/$file/136TN0717.pdf (accessed March 27, 2013; subscription required).

12. U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2014* (Washington, DC: U.S. Government Printing Office, 2013), pp. 215–215, Table S-9, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/budget.pdf (accessed June 19, 2013).

13. The White House and U.S. Department of the Treasury, "The President's Framework for Business Tax Reform," February 2012, http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf (accessed July 1, 2013).

Until recently, Anheuser-Bush and St. Louis would have been on that list. However, in 2008, Anheuser-Bush merged with InBev, a Belgium beverage company. In part because of the high corporate tax rate in the U.S. and the worldwide tax system, the newly merged business placed its headquarters in Belgium. Consequently, St. Louis lost executive and other quality jobs that left for the new Belgium headquarters. It also lost the community involvement of Anheuser-Busch and its employees working in the headquarters.

A stronger worldwide tax system could similarly drive more U.S. businesses to put themselves up for sale to foreign businesses and move their headquarters abroad with the same damaging impact on and destruction of quality jobs in the communities that they leave behind.

A stronger worldwide tax system could similarly drive more U.S. businesses to put themselves up for sale to foreign businesses and move their headquarters abroad.

Misunderstanding Outsourcing

Those who favor a stronger worldwide system often claim—albeit wrongly—that it would prevent U.S. businesses from outsourcing production and thereby shipping U.S. jobs overseas. U.S. businesses outsource by moving certain business functions, often manufacturing, to foreign countries where they pay lower costs for those activities.

Their concern is misguided because the tax system does not cause U.S. businesses to outsource. The lower costs, mostly lower labor prices, are the motivating factor. Advances in information technology and reductions in transportation costs have enabled some U.S. businesses to further reduce the costs by producing their products overseas. Businesses that use other nations' comparative advantages become more competitive.

These developments are part of a long-term change in the global economy that benefits U.S. consumers through lower prices, but they cause short-term and medium-term pain for workers in industries that outsource. This phenomenon is not new. The economy frequently experiences structural changes that cause short-term unrest by uprooting previous ways of doing things, but ultimately help to fuel expansion. U.S. economic policy—tax policy included— can do little to change the powerful force of globalization, even if it were beneficial to do so. Strengthening the worldwide tax system will not stop most businesses from outsourcing because the gains in competitiveness from outsourcing will usually far exceed the extra tax cost.

Anti-Base Erosion and Earnings Stripping

Although a territorial system would not create an incentive for U.S. businesses to move jobs overseas, it does need certain policy safeguards to protect the U.S. tax base from erosion.

Examples abound in the press of U.S. businesses engaging in elaborate schemes to shift money between foreign affiliates. Ultimately, this movement of income results in it arriving in countries where they face little or no tax. The arrangements have eye-catching names such as the "double Irish with a Dutch sandwich."[14] The unstated implication of such reports is that U.S. businesses set up these complicated systems to duck U.S. taxes.

Supporters of worldwide taxation use the public outrage about these little understood arrangements to argue for strengthening the worldwide system. For example, the Senate Permanent Subcommittee on Investigations recently called on Apple CEO Tim Cook to explain how Apple pays such a low amount of tax on its foreign income. That committee took advantage of the hearing to make it seem like Apple, by virtue of its tax arrangement in Ireland and other foreign countries, is dodging U.S. taxes. For instance, Senator Carl Levin (D–MI) claimed that Apple's foreign tax strategy was reducing tax collections in the U.S.[15]

14. Charles Duhigg and David Kocieniewski, "How Apple Sidesteps Billions in Taxes," *The New York Times,* April 28, 2012, http://www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html (accessed June 19, 2013).
15. Teresa Welsh, "Are Apple's Tax Shelters an Outrage?" *U.S. News & World Report*, May 21, 2013, http://www.usnews.com/opinion/articles/2013/05/21/is-carl-levin-or-rand-paul-right-on-apples-tax-shelters (accessed June 19, 2013).

The indignation from such news reports and the Senate hearings is generally misplaced. The money U.S. businesses shift between foreign affiliates is not income that they earned in the U.S. It is income that they earn in foreign countries and then shift between those countries to minimize their *foreign* tax liability. A U.S. business, such as Apple, for the most part cannot earn income from the sale of tablet computers in the U.S. and shift it to a foreign country without paying U.S. tax on the income. To do so would be illegal tax evasion.

Eventually, the foreign income often ends up in jurisdictions that levy little or no tax on the income because businesses use the differences in foreign tax laws to minimize their tax bills—U.S. tax law included. U.S. "check-the-box" rules allow businesses to shift foreign income to low-tax jurisdictions more easily. The businesses leave their foreign income there indefinitely and do not pay U.S. tax on it because of deferral the same as if they earned the income in a country with higher taxes. The income that accumulates in these low-tax countries is usually generated by intangibles that the businesses sell to subsidiaries there. Those businesses usually have no functional operations other than as entities that own, assume the risk, and possibly fund the upkeep and development of intangibles.

While the indignation in the U.S. is for the most part misplaced under the current worldwide system, the issue could become a more pressing problem under a territorial system because U.S. businesses would have a larger incentive to move more of their intangibles abroad to subsidiaries in countries with lower tax rates. Under a territorial system, businesses that can move more of their intangibles overseas, instead of gaining an indefinite reprieve from U.S. taxes as under the current worldwide system, would receive a permanent reprieve. If U.S. businesses can sell their intangibles to their foreign affiliates at prices that are too low and thereby create an incentive to sell them more intangibles than a neutral tax system would suggest, they would erode the U.S. tax base, reducing U.S. tax collections for a given set of tax rates. This would push tax rates higher to collect a targeted amount of revenue, such as the historical average of 18 percent of GDP. Higher rates are the antithesis of pro-growth tax policy. Policies that curb such abuses are vital for a properly functioning territorial system and for maximizing potential growth under a reformed tax code.

However, there are no widely accepted methods for determining the value of many intangibles that businesses sell between their various entities, especially newly developed intangibles. Intangible property typically is unique in nature and generates income that is difficult to isolate and highly speculative at the time of the sale or license. Thus, unlike tangible property, intangible property is generally not sold in open markets that would help to establish market-based prices.

These factors make it difficult to establish a fair market price between two unrelated businesses. The amount of intangibles owned by foreign subsidiaries varies by industry and function of the various subsidiaries. There is no way to create an overarching rule to dictate where and in what quantities intangibles should reside. Despite these difficulties, properly accounting for intangibles is essential in both territorial and worldwide tax systems, and it will likely become even more important because intangibles will likely become a bigger part of business profitability as technology expands its share of the economy.

Stricter transfer pricing policies governing the sale of intangibles would likely not address this problem because of the inherent difficulties in valuing and determining the proper location of intangibles. The sensible way around this dilemma is to set broad policies that allow the U.S. to tax income businesses earn from intangibles if the business pays little or no tax on that income. In other words, the U.S. would tax intangible income if a business moves its intangibles to a low or no-tax country where they generate little or no economic activity. This assumes that U.S. tax authorities can properly identify such income. Such policies would greatly reduce the incentive for U.S. businesses to improperly move intangibles abroad and erode the tax base under a territorial system.

The House Ways and Means Committee draft bill for international tax reform has three policy options that seek to serve this purpose.[16] Option A would tax income generated by intangibles as current domestic income if that income exceeds 150 percent of the costs associated with it and was not subject to a minimum foreign effective tax rate of 10 percent. Option B would tax income generated from intangibles that subsidiaries do not earn while engaged in active

16. Committee on Ways and Means, "Technical Explanations," October 26, 2011, pp. 32–35.

trade or business in their home country as current U.S. income if the effective tax rate in the subsidiary's home country is less than 10 percent. Option C would tax all income generated by intangibles in foreign countries as current U.S. income at a reduced rate. Each of these could be a viable way around the difficult problem of accurately pricing intangibles that would curtail the incentive for U.S. businesses to sell too much of their intangibles abroad to escape U.S. tax under a territorial system.

Whether the U.S. wisely adopts a territorial system or tweaks the existing worldwide system, anti-base erosion policies will continue to need the backing of policies that prevent earnings stripping. Earnings stripping occurs when U.S. businesses take on large amounts of domestic debt to finance income produced in foreign countries with lower tax rates than the U.S. The U.S. business can deduct the interest on the debt which lowers its U.S. tax. Meanwhile, foreign subsidiaries can use the borrowed capital to invest and increase their earnings. Such an arrangement artificially shifts income to lower-taxed countries. The Ways and Means draft proposal handles this issue by denying U.S. businesses interest deductions if its indebtedness exceeds that of all of their combined foreign subsidiaries or if its debt exceeds a certain portion of its income.[17] Neither option is a perfect solution, but perfection may be too much to ask in this arena.

Conclusion

Supporters of territorial taxation routinely argue that the U.S. needs such a reform to allow businesses to repatriate their foreign earnings to invest domestically. They use the same justification to support a repatriation holiday that would absolve U.S. businesses of paying tax that they previously accrued on foreign-source income. While there is certainly nothing wrong with businesses bringing more income back to the U.S., eliminating the lock-out effect in which businesses keep foreign earning abroad to avoid U.S. tax alone will not spur job creation and wage growth because it is backward-looking.[18] However, changing to a territorial system on future profits will unlock investment at home and abroad that the current worldwide system is holding back. That new investment will improve the efficiency and competitiveness of U.S. firms and spur U.S. job creation and wage growth.

The U.S. is far behind the rest of the world in territorial taxation. Sticking with the antiquated and harmful worldwide system is hurting job creation and suppressing wages for U.S. workers. The sooner the U.S. catches up, the sooner American workers and savers will reap the benefits of updating to a 21st-century system of taxing businesses.

To move the tax system into the modern world, Congress should institute a territorial tax system on future profits with anti-base erosion and profit-shifting polices as a replacement for the damaging worldwide system.

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17. Ibid., pp. 35–36.
18. J. D. Foster and Curtis S. Dubay, "Would Another Repatriation Tax Holiday Create Jobs?" Heritage Foundation *Backgrounder* No. 2610, October 4, 2011, http://www.heritage.org/research/reports/2011/10/would-another-repatriation-tax-holiday-create-jobs.