

# COMPETITIVENESS OF THE U.S. TAX SYSTEM

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## Tags

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## INTRODUCTION

U.S. policymakers are often concerned with promoting economic growth and the general economic wellbeing of the U.S. population, both of which are influenced significantly by the level of investment and employment in the United States. The meaning of “competitiveness” in U.S. tax policy discussions is broad but generally reflects these policy concerns. The competitiveness of the U.S. tax system refers in large part to how effectively it promotes domestic investment and employment, and U.S. economic growth in general.

Domestic investment and employment arises from a number of sources, including the activities of U.S. multinationals and other U.S. businesses as well as foreign multinationals. In turn, their investment decisions in the United States may be based on a number of factors, including:

- The quality of the U.S. workforce and the cost of labor;
- Expected sales growth both in the United States and abroad (*i.e.*, the demand for their goods and services);
- The location of both customers and input suppliers;
- Taxes; and
- The economic benefits of locating activities in particular areas, such as a geographic region (*e.g.*, Silicon Valley), because, for example, of existing research networks and proximity to universities.

In the cross-border context, concerns about the competitiveness of the U.S. tax system have centered on policy objectives that include: (i) fostering the growth of U.S. multinationals abroad, (ii) encouraging domestic investment by U.S. and foreign businesses, and (iii) promoting U.S. ownership, as opposed to foreign ownership, of U.S. and foreign assets. These particular policy objectives may be important to policymakers for a number of economic reasons, described below.

## FOSTERING THE GROWTH OF U.S. MULTINATIONALS ABROAD

When U.S. multinationals grow overseas, as measured by increased sales abroad, greater domestic investment and employment may result. For example, a company may increase employment at a manufacturing plant or build new facilities if sales of its U.S.-made goods increase abroad. Likewise, an opportunity to expand into a new foreign market may increase the resources that a company puts into its

*“Higher levels of domestic investment by U.S. and foreign businesses may contribute to U.S. economic growth and job creation.”*

U.S.-based marketing and management activities as it aims to gain a foothold in that market. To the extent that a U.S. company relies on its domestic operations to service foreign markets, increased sales overseas should increase domestic investment and employment. In addition, an increase in earnings may increase the value of the U.S. company, the benefits of which could accrue primarily to U.S. shareholders given the documented “home bias” in portfolio investments (*i.e.*, the disproportionate share of local equities that investors hold in their portfolio relative to what theories of the benefits of international diversification would predict).

However, if growth of U.S. sales abroad is accompanied by increased foreign investment and employment, that may in turn result in lower U.S. investment and employment. For example, a company may decide to move its U.S.-based manufacturing and marketing operations overseas, which reduces domestic investment and employment. However, it may also be the case that foreign investment and employment complements domestic investment and employment. For example, the successful expansion of a company’s overseas operations may provide the company with funds to make more domestic investments and increase its domestic workforce.

The evidence has been inconclusive on whether foreign investment and employment complements or substitutes for domestic investment and employment. One study has found that expansion of a company’s domestic economic activity is associated with expansion in the activity of its foreign affiliates. However, this can occur if a company develops a new product and expands its sales force both in the United States and overseas. In that case, domestic investment and employment growth coincides with, but is not caused by, foreign investment and employment growth. Another study finds that, on average, increases in domestic employment by U.S. multinationals are associated with increases in employment of their foreign affiliates.

However, this result holds only for affiliates in high-income countries. For affiliates in low-income countries, where labor costs may be significantly lower than in the United States, the authors found that foreign employment growth is associated with reductions in U.S. employment.

## **ENCOURAGING DOMESTIC INVESTMENT BY U.S. FOREIGN BUSINESSES**

Higher levels of domestic investment by U.S. and foreign businesses may contribute to U.S. economic growth and job creation. For example, when a U.S. business makes a new investment, such as constructing a new factory or research facility, it may need to hire workers as part of the investment. These investments may also increase the productivity of the operations of the U.S. business, which may promote overall economic growth in the United States and potentially raise wages (to the extent that workers’ wages rise as their productivity rises). These same economic effects are not restricted to domestic investments by U.S. businesses and could be brought about by domestic investments made by foreign businesses.

## PROMOTING U.S. OWNERSHIP OF U.S. AND FOREIGN ASSETS

Some policymakers may prefer that ownership of U.S. and foreign assets should be held by U.S. persons instead of foreign persons. With regard to foreign assets, U.S. ownership may confer a number of benefits on the U.S. economy. Foreign assets may serve as a platform for overseas expansion and growth, potentially increasing domestic employment and investment. In addition, when a U.S. company acquires a foreign company, it may also be acquiring intangible property, such as intellectual property and managerial know-how. The intangible property may complement existing U.S. operations and enhance effectiveness. Moreover, income generated from the asset will be part of the U.S. income tax base rather than the income tax base of another country.

Relative to situations involving U.S. ownership of a foreign asset, it is less clear how, as a general matter, U.S. ownership of a U.S. asset benefits the U.S. economy more than foreign ownership of a U.S. asset. For example, when a foreign company acquires a U.S. company, the headquarters operations of the U.S. company may move outside the United States. This may result in the direct loss of employment in the United States as well as some of the local economic benefits that accompany headquarters operations, including involvement in philanthropic activities. Not mentioned in the J.C.T. Report is the effect of cash flows from dividends to domestic shareholders. Although U.S. persons can own American Depository Receipts relating to a foreign publicly traded entity, the cash flow to U.S. investors and U.S. tax exempt entities may be more pronounced when the owner of the U.S. assets is a U.S.-based multinational group rather than a foreign counterpart. This factor is curiously missing in the J.C.T. Report.

When a foreign company starts a new venture in the United States by making new investments (“greenfield investments”) instead of acquiring an existing company, the U.S. economy may benefit through increased employment and investment. This positive economic impact may come at the expense of U.S. businesses, though. For example, the foreign company’s U.S. venture may be competing directly with a U.S. company for control of a market for a particular product. If the foreign company’s U.S. venture succeeds in controlling the market at the expense of its U.S.-based competitor, net investment and employment in the United States may still increase, but dividend tax, net investment income tax, and future taxable pension payments funded by dividends may be reduced. No mention of these reductions is made in the J.C.T. Report. In addition, no inquiry was made regarding the carry-on effect for the U.S. economy when a business is sold by U.S. investors. In principle, this includes additional investments in new direct and portfolio investments in the U.S.

In both of the foregoing examples, a foreign-headquartered company owns a U.S. asset that could have been owned by a U.S.-headquartered company. However, while new foreign investment has a positive impact on the U.S. economy, the economic impact of a foreign company acquiring an existing U.S. company and moving its headquarters overseas is negative. These examples, and the U.S. economic impact described, are hypothetical, but they illustrate that the distinction between foreign ownership of an existing versus a new U.S. asset is important for economic analysis. However, there is little empirical evidence on the extent to which these

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hypothetical examples reflect existing investment patterns, and if so, whether, on balance, U.S. ownership of U.S. assets provides greater economic benefits than foreign ownership of U.S. assets.

General consideration should be given to whether a U.S. asset is more productive under foreign ownership than U.S. ownership for purely economic reasons. A foreign company, for example, may have a stronger overseas presence (in the relevant markets) than prospective U.S. acquirers of a U.S. company, and may facilitate the global expansion of the U.S. company more effectively. However, that would seem to be more likely if the foreign markets are not already served with a product that is comparable to the product manufactured in the U.S. The economic case for promoting U.S. ownership of the U.S. company in this situation is unclear. However, if the U.S. company is more productive under U.S. ownership, but for tax reasons is more valuable in the hands of a foreign owner, there may be a stronger case for designing tax rules to promote U.S. ownership of these assets. Whether the latter case exists is open for debate.

## COMPETITIVENESS OF THE U.S. TAX SYSTEM IN A GLOBAL ECONOMY

The United States is part of a global economy in which many governments adopt policies to attract investment and promote the overseas growth of their multinationals. Over the past decade, there have been declines in statutory corporate income tax rates and adoption of tax rules that exempt active foreign-source income from home-country taxation. To illustrate, the corporate tax rate in the U.K. is 21% and is scheduled to be reduced to 20%. Dividends from foreign subsidiaries are promoted through a 100% dividends received deduction or exemption. Compare this to the situation of a corporation based in the U.S., where the topline corporate tax rate is 35% at the Federal level with State and local taxes added on top (although deductible in computing Federal taxable income). In addition, dividends from foreign subsidiaries are fully taxed but subject to a foreign tax credit. This policy encourages publicly traded corporations to permanently invest profits outside the U.S. and, therefore, to use funds to acquire additional property, plants, and equipment abroad. This permanent investment enhances financial statement performance because deferred U.S. tax is viewed to be nil. In addition, preferential tax regimes for income derived from intellectual property have been widely adopted, causing the O.E.C.D. to focus on patent box companies as a form of base erosion and profit shifting.

### **Decline in Statutory Corporate Income Tax Rates and the Adoption of Exemption Systems**

#### *Decline in Statutory Corporate Income Tax Rates*

The gradual decline in statutory corporate income tax rates around the world and the emergence of the U.S. as the most highly taxed country is illustrated by the following table:

**“In 2014, the United States had the highest combined statutory corporate income tax rate (39.1%) among O.E.C.D. countries.”**

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Australia	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0
Austria	34.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0
Belgium	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0
Canada	34.4	34.2	33.9	34.0	31.4	31.0	29.4	27.6	26.1	26.3	26.3
Chile	17.0	17.0	17.0	17.0	17.0	17.0	17.0	20.0	20.0	20.0	20.0
Czech Republic	28.0	26.0	24.0	24.0	21.0	20.0	19.0	19.0	19.0	19.0	19.0
Denmark	30.0	28.0	28.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	24.5
Estonia	26.0	24.0	23.0	22.0	21.0	21.0	21.0	21.0	21.0	21.0	21.0
Finland	29.0	26.0	26.0	26.0	26.0	26.0	26.0	26.0	24.5	24.5	20.0
France	35.4	35.0	34.4	34.4	34.4	34.4	34.4	34.4	34.4	34.4	34.4
Germany	38.9	38.9	38.9	38.9	30.2	30.2	30.2	30.2	30.2	30.2	30.2
Greece	35.0	32.0	29.0	25.0	25.0	25.0	24.0	20.0	20.0	26.0	26.0
Hungary	16.0	16.0	17.3	20.0	20.0	20.0	19.0	19.0	19.0	19.0	19.0
Iceland	18.0	18.0	18.0	18.0	15.0	15.0	18.0	20.0	20.0	20.0	20.0
Ireland	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5
Israel	35.0	34.0	31.0	29.0	27.0	26.0	25.0	24.0	25.0	25.0	26.5
Italy	33.0	33.0	33.0	33.0	27.5	27.5	27.5	27.5	27.5	27.5	27.5
Japan	39.5	39.5	39.5	39.5	39.5	39.5	39.5	39.5	39.5	37.0	37.0
Korea	29.7	27.5	27.5	27.5	27.5	24.2	24.2	24.2	24.2	24.2	24.2
Luxembourg	30.4	30.4	29.6	29.6	29.6	28.6	28.6	28.8	28.8	29.2	29.2
Mexico	33.0	30.0	29.0	28.0	28.0	28.0	30.0	30.0	30.0	30.0	30.0
Netherlands	34.5	31.5	29.6	25.5	25.5	25.5	25.5	25.0	25.0	25.0	25.0
New Zealand	33.0	33.0	33.0	33.0	30.0	30.0	30.0	28.0	28.0	28.0	28.0
Norway	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	27.0
Poland	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0
Portugal	27.5	27.5	27.5	26.5	26.5	26.5	26.5	28.5	31.5	31.5	31.5
Slovak Republic	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	23.0	22.0
Slovenia	25.0	25.0	25.0	23.0	22.0	21.0	20.0	20.0	20.0	17.0	17.0
Spain	35.0	35.0	35.0	32.5	30.0	30.0	30.0	30.0	30.0	30.0	30.0
Sweden	28.0	28.0	28.0	28.0	28.0	26.3	26.3	26.3	26.3	22.0	22.0
Switzerland	24.1	21.3	21.3	21.3	21.2	21.2	21.2	21.2	21.2	21.2	21.1
Turkey	33.0	30.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
United Kingdom	30.0	30.0	30.0	30.0	28.0	28.0	28.0	26.0	24.0	23.0	21.0
United States	39.3	39.3	39.3	39.3	39.3	39.1	39.2	29.2	39.1	39.1	39.1
O.E.C.D. Median	30.0	29.0	28.0	27.0	26.8	26.0	25.8	25.5	25.0	25.0	25.0

Source: O.E.C.D. Tax Database.

For each year, the cell corresponding to the country with the highest tax rate is shaded pink, while the cell associated with the country with the lowest tax rate is shaded blue. There has been a steady, downward trend in statutory corporate tax rates in O.E.C.D. countries other than the United States. From 2004 to 2014, the median combined statutory corporate income tax rate fell from 30% to 25%. Moreover, in 2014, the United States had the highest combined statutory corporate income tax rate (39.1%) among O.E.C.D. countries, while Ireland had the lowest (12.5%) for active business operations.

### Adoption of Exemption Systems

Since 2000, many O.E.C.D. countries have adopted some form of exemption system for the taxation of foreign-source income. According to one report, of the 34 countries that make up the O.E.C.D., 28 have some form of an exemption system compared to 13 at the start of 2000.

### Implications for the Competitiveness of the U.S. Tax System

#### Growth of U.S. Multinationals Abroad

In foreign markets, U.S. corporations may have more limited options for growth than foreign competitors. Consider a U.S. corporation and a foreign corporation that both require an after-tax rate of return of 10% on investments in a given market outside their home country. The market jurisdiction has a tax rate of 20%. If the earnings of the foreign corporation are exempt from home-country tax, this means that it will pursue investments that yield a required pre-tax rate of return of 12.5%. In contrast, the U.S. corporation's required pre-tax rate of return may be greater than 12.5%, even though it can defer paying residual U.S. tax on its earnings, because it cannot reduce the present value of its U.S. residual tax liability below zero in the absence of cross crediting the income, meaning a blending of tax rates among various foreign investments in several countries. Therefore, the U.S. corporation may forego investments – such as expansion of manufacturing facilities or acquisitions of local companies – that it would have pursued if its returns were not subject to U.S. taxation. This may make it more difficult for the U.S. corporation to gain market share relative to the foreign corporation, and also may have an indirectly negative effect on employment and economic growth in the United States, at least to the extent that a U.S. company's success overseas translates into increased domestic investment and employment. However, if the U.S. corporation is able to fully offset the residual U.S. tax liability on its earnings with credits allowed for income taxes paid in another jurisdiction, it would not be at a competitive tax disadvantage relative to the foreign corporation. Moreover, the ability of a U.S. corporation to defer paying residual U.S. tax on its earnings may limit its competitive tax disadvantage because its cash flow would not be immediately reduced by its U.S. tax liability. However, the profits must remain abroad – outside the U.S. economy – for this benefit to be realized, leading one to question whether that is prudent economic policy.



#### Domestic Investment by U.S. and Foreign Businesses

Economics literature has found that the location of foreign direct investment is sensitive to both statutory tax rates and effective marginal tax rates, which is the effective rate of tax on the income generated by the investment, accounting for all features of the tax system such as tax incentives and methods of cost recovery, including depreciation, amortization, depletion, credit, advantageous loan terms, and grants. In a competitive global market for investment, the United States is at a competitive disadvantage even in the presence of certain incentives such as the Code §199 domestic production activities deduction (which yields a tax benefit of three percent for a profitable taxpayer) and accelerated cost recovery methods.

#### Ownership of Assets

Policymakers may be concerned that the U.S. system of worldwide taxation may put U.S. multinationals at a competitive disadvantage in acquiring operating assets

and businesses. It is not difficult to conclude that foreign multinationals have more opportunities to fund growth when dividends from operating companies and profits of foreign branches are exempt from home country tax, all other things being equal.

### **Intellectual Property or “Patent Box” Regimes**

A number of countries make it a priority to promote domestic investment in research and development (“R&D”) that generates innovation. Efficiencies attributable to innovation can be an important offset to a low tax rate on the income from an investment in operating assets. The typical path involves the establishment of intellectual property (“I.P.”) regimes for companies that engage in innovation activities. These companies are often referred to as “box companies” because innovation technology is ring fenced within the box. These regimes offer preferential tax treatment on income attributable to I.P. Belgium, Cyprus, France, Hungary, Luxembourg, Malta, the Netherlands, Portugal, Spain, and the United Kingdom all have box company legislation in place at this time. Italy and Ireland have announced adoption of similar regimes as part of their annual budgets. The following table illustrates the various regimes.

<b>Country</b>	<b>Qualified I.P.</b>	<b>Nexus Requirement</b>	<b>Benefits</b>
<b>Belgium</b>	Qualifying patents (excludes trademarks, designs, models, or secret recipes or processes)	Requires patent to be developed by Belgian company or acquired patent to be further improved by Belgian company	80% deduction of qualifying gross patent income
<b>Cyprus</b>	Patents, copyrights (including literary works, scientific works, artistic works, films, etc.), trademarks, designs and models	Property must be owned by the Cyprus resident company	80% of royalty income and profit generated from the disposal of qualified property is exempt
<b>France</b>	Patent granted in France, United Kingdom, or European Patent Office or specified European countries or if invention would have been patentable in France (excludes trademarks, design rights and copyrights)	Intellectual property rights must be owned by the French company, must own acquired rights for at least two years	Revenue or gain derived from the qualified property (does not include embedded royalties) taxed at 15%
<b>Hungary</b>	Patents, know-how, trademarks, business names, business secrets and copy	Applies to developed and acquired intellectual property	50% deduction for royalties received from related or third parties for the use of property
<b>Ireland</b>	Patents and property functionally equivalent to patents	Intent to follow O.E.C.D. and E.U. modified nexus approach	
<b>Italy</b>	Patents and property functionally equivalent to patents	Intent to follow O.E.C.D. and E.U. modified nexus approach, must perform research and development activity either directly or in cooperation with universities, must enter into an advanced pricing agreement	Exemption for income sourced from intangible assets, 30% exemption in 2015, 40% exemption in 2016, 50% exemption after 2016

Country	Qualified I.P.	Nexus Requirement	Benefits
<b>Luxembourg</b>	Patents, trademarks, designs, domain names, models and software copyrights	Luxembourg company must be the economic owner of the rights (does not include rights acquired from a related party)	80% tax exemption for net income derived from the use or right to use qualified property
<b>Malta</b>	Patented intellectual property and qualifying copyrights	Must own the rights to the patented intellectual property and receive royalties or similar income	Full tax exemption for qualifying patented inventions and qualifying copyrights
<b>The Netherlands</b>	Worldwide patents and intellectual property arising from research and development activities for which the taxpayer has obtained a declaration from the Dutch government (trademarks, non-technical design rights and literary copyrights are not included)	Dutch company must be the economic owner and bear the risks associated with ownership, development activities must be conducted at the risk of the Dutch company, but research and development is not required to be performed in the Netherlands	5% rate on income from a qualifying intangible, includes embedded royalties if more than 30% of the derived income is attributable to the patent
<b>Spain</b>	Patents, drawings or models, plans, secret formulas or procedures, and rights on information related to industrial, commercial, or scientific experiments	Intellectual property must be created by the resident company and includes other requirements related to the use of the property	Exempts 60% of the net income derived from the qualified property
<b>United Kingdom</b>	Patents granted by the United Kingdom or European Patent Office (excludes trademarks and registered designs) and certain associated intellectual property	Requires legal ownership of the patent, must be developed by a company in the worldwide corporate group, U.K. company must make a significant contribution to developing the patent	10% tax rate on income from patented inventions and certain other innovations

Source: J.C.T. Report

While patents qualify for the benefits of the regime in all of the above countries, some countries offer benefits to non-patented property, including trademarks, copyrights, and business secrets. Some countries only require that the I.P. be owned by the resident company, while others may require that the I.P. be developed or improved by the resident company. The regimes have been an area of focus and scrutiny under the O.E.C.D.'s B.E.P.S. Action Plan. A view exists that I.P. regimes promote unfair tax competition if countries do not require some physical nexus between the location of I.P. ownership and the economic activities that helped produce that property. Of course, abuse is in the eye of the beholder, and the O.E.C.D. view is that the income of a box company is easily placed in a company based in a country with a low tax regime, and for that reason, it may be viewed as abusive unless developmental activities also occurred in that country.

### Modified Nexus Approach

Recently, the European Commission and O.E.C.D.'s Forum on Harmful Tax Practices conducted reviews of certain regimes, including I.P. tax regimes. In the case of the O.E.C.D., the review was part of B.E.P.S. Action Plan item 5. The O.E.C.D. report identified that countries shared the goal of aligning the taxation of preferential regime profits with the location of a company's substantial activities in order for it



to be eligible for preferential tax treatment. At that time, no consensus existed regarding the approach that would be used to evaluate the substantial activity requirement. One approach was the nexus approach, which evaluates a regime based on whether benefits are conditioned on a link between the performance of R&D activities and the entitlement to benefits. In this approach, the R&D expenses act as a proxy for the amount of activities conducted. The test is based on the proportion of expenditures that demonstrate real value added by the taxpayer. Under this approach, the provision of capital used by another entity would not be a qualifying activity. This should be compared with U.S. domestic R&D credit rules, where R&D performed by a research institute can give rise to a credit claimed by a taxpayer.

In order to reach consensus within the O.E.C.D., the U.K. and Germany proposed a modified nexus approach. This approach has been endorsed by all of the O.E.C.D. and the G20 countries. Existing regimes would be allowed to continue for five years with no new entries into the regime after June 2016. The agreement calls for general acceptance of the modified nexus approach with an addition for an “uplift.” The up-lift would allow an additional 30% of qualifying expenses for outsourcing, and I.P. acquisition costs would be included as qualifying expenditures. I.P. assets that could qualify for the preferential regime include patents and functionally equivalent I.P. assets that are legally protected and subject to approval and registration processes, where such processes are relevant. Marketing-related I.P. assets such as trademarks are explicitly excluded.

#### *Economic Analysis of I.P. Regimes and Implications for the United States*

Promoting domestic investment in R&D is important to U.S. policymakers. While the U.S. tax system subsidizes research activities by offering a credit for certain qualified research expenditures, and allowing such expenditures to be expensed instead of amortized, concern has been expressed that the I.P. regimes mentioned above will attract research activity away from the United States. Some commentators have argued that the United States should adopt a patent box regime to promote investment in R&D through lower tax burdens. The J.C.T. Report challenges this view, commenting that it is not clear that an I.P. regime is more effective than a research credit, which is more targeted in identifying qualified activity. The J.C.T. Report posits that a more generous U.S. research credit may better address the concern that many U.S. policymakers have with patent box regimes. Stated differently, an untargeted regime that broadly lowers taxes does not necessarily result in the creation of I.P. that increases efficiencies in operations. However, there is little empirical research on this particular claim.

Policymakers have also pursued I.P. regimes based on the premise that the location of legal entitlements to I.P. influences where companies make investments related to that I.P. Although there are a number of studies showing that innovation activity often is concentrated in particular locations near universities, there are few studies that examine whether investments related to a particular piece of I.P. are also concentrated in the geographic location where ownership rights are held.

***“The nexus approach, which evaluates a regime based on whether benefits are conditioned on a link between the performance of R&D activities and the entitlement to benefits.”***