ECONOMIC DISTORTIONS ARISING FROM DEFERRAL

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One of the main policy issues in the Joint Committee on Taxation Report is how deferral of U.S. tax causes economic distortions. U.S. lawmakers are particularly concerned with how deferral influences the initial choice between foreign and domestic investment, the "lockout effect," and repatriating or reinvesting foreign earnings.

The tax system incentivizes U.S. corporations to invest abroad instead of domestically because corporations are able to defer U.S. tax on foreign earnings. The deferral of tax on foreign earnings enables taxpayers to reinvest higher amounts of income. When a U.S. taxpayer invests domestically, the income produced cannot be deferred and is subject to current taxation. Thus, a U.S. corporation will prefer to invest in a foreign country instead of the U.S. because the returns on the U.S. investment are immediately taxed, even if both investments generate the same pre-tax rate of return.

Here is an example. Suppose that a U.S. privately-held corporation that reports income subject to tax in the 35% tax bracket is considering whether to make an investment in an active enterprise in the United States or in an equivalent investment opportunity in a country in which the income tax rate is zero. Because the taxpayer is privately held, financial statement accounting rules that address deferred taxes have limited effect in management decisions except for any loan covenants. Assume the U.S. taxpayer chooses to make the investment in the foreign country through a C.F.C. that earns $100 of active income and the U.S. taxpayer defers tax on that income for five years by reinvesting the income in the C.F.C. Assume further that the C.F.C. can invest the money and earn a 10% return per year, and the income earned is not subject to foreign tax or current U.S. taxation under Subpart F. After five years, the taxpayer will have earned $161.05 of income and will pay tax of $56.37 on repatriation, for an after-tax income of $104.68.

If, instead, the U.S. entity pursues the equivalent investment opportunity in the United States, income from such an investment will not be eligible for deferral. When the taxpayer receives $100 in income today, it pays Federal tax of $35, and has only $65 to reinvest. The taxpayer invests that amount at an after-tax rate of 6.5%. At the end of five years, this taxpayer has an after-tax income of $89.06, in comparison to the foreign investment option which generates an after-tax income of $104.68. The result is that the foreign investment option to defer tax on the income for five years leaves the taxpayer with $15.62 more in profits than the domestic investment option, an increased return of 17.5%. Extrapolate this example to an active income of $10 million, and the difference in return over five years is $1,562,000. Is it any wonder that the owners and managers would be influenced by U.S. tax policy?

Deferral of U.S. tax may cause a "lockout effect." The lockout effect is of concern to publicly traded companies that must report deferred U.S. taxes as an expense in the current year. The lockout effect disappears if repatriation of overseas earnings

has no tax consequence, as would be the case if foreign earnings were permanently invested abroad. This means that the company has a policy of reinvesting the earnings abroad so that there is no realistic possibility that the deferred tax will be paid as business operations continue. The effect of this accounting policy is that dividends will not be paid. In recent times, the lockout effect was illustrated when Apple borrowed funds to pay dividends to shareholders rather than tap into the profits of its offshore subsidiaries. The need to borrow illustrated that Apple's foreign earnings were locked out of the U.S. For companies that are not at the level of Apple, the lockout effect means that U.S. corporations must increase their debt burden in order to invest in U.S. assets or pay dividends.

As the foregoing example illustrates, the lockout effect results in economic distortions. This impact could be diminished by reducing the tax rate on repatriatied foreign earnings. However, if, as the Administration proposes, the reduced rate remains above 15%, it is not likely that companies with publicly-traded debt will repatriate earnings if the effect is a provision for deferred tax at a rate of 15% or higher on unrepatriated earnings for financial statement purposes. Capital markets in the U.S. would likely lose significant value.