



AMERICANS FOR TAX REFORM

**Americans for Tax Reform**

1920 L Street, NW, Suite 200

Washington, DC 20036

202.785.0266 • Fax 202.785.0261

## Time to Terminate the U.S. Repatriation Tax:

### Thomas & Puerto Rico Proposals: A Good First Step

- **The Window of Opportunity Has Been Created for International Tax Reform.**

In the next few weeks, Congress will start the debate to repeal the Foreign Sales Corporations (FSCs) and the extraterritorial income exclusion (ETI) export subsidies that were found to be in violation of World Trade Organization (WTO) agreements. Without changes, the United States is facing \$4 billion of sanctions. Congress should take advantage of this historic situation and reform the nation's abusive international tax law, which has placed American companies at a competitive disadvantage with other countries.

- **U.S. Firms Operate at a Competitive Disadvantage**

The U.S. corporate tax rate is the fourth highest in the industrialized world and, when state corporate rates are added, the nation may have the highest rates. Capital-intensive industries are subjected to the Alternative Minimum Tax. And the United States taxes repatriations of foreign-earned income. Most other nations use a better approach known as "territorial taxation," which only taxes corporate income earned inside the country's borders. Taken altogether, these factors have placed American companies at a competitive disadvantage with foreign companies.

- **Reforms Should Focus On Reducing the Highest Tax Rates and Double Taxation**

Legislation designed to bring the United States into compliance with the WTO rulings should work to reduce competitive disadvantages placed on American companies from high tax rates and double taxation. This includes corporate rate reductions, reducing the corporate alternative minimum tax, full business expensing, and territorial taxation.

- **Allow American Companies in Puerto Rico to Repatriate Earnings Back in America**

Moving from the current antiquated international tax code to a full territorial taxation system at this time may not be politically feasible. Therefore, as part of FSC/ETI legislation, Americans for Tax Reform proposes an incremental step, one which allows American companies based in Puerto Rico (and other American territories) to redistribute earnings back into the United States without being penalized with a 35 percent tax. This will work to boost economic growth in America, begin to reform U.S. international tax law, and significantly improve Puerto Rico's competitive disadvantage for global investment.

- **Begins the Process to a Level-Playing Field for American Companies**

For too long American companies have been disadvantaged by high rates of taxation, including the double taxation of foreign source income. Reforming U.S. international tax law with corporate rate reductions and tax simplification will begin the process of creating a level-playing field for American companies. Ultimately this will reduce the number of corporate inversions.

- **Proposal is a Win-Win for America and Puerto Rico**

Over the past seven years, Puerto Rico has experienced significant employment losses in manufacturing, while the U.S. economy continues to suffer from low business investment. Including the Puerto Rico proposal as part of FSC/ETI repeal will substantially boost new investment, employment, wages, and ultimately the standard of living in Puerto Rico. At the same time, this proposal allows America to capture new investment that would never make it back into America's economy.

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*Americans for Tax Reform (ATR) is a non-partisan coalition of taxpayers and taxpayer groups who oppose all federal, state and local tax increases. For more information or to arrange an interview, please contact Jonathan Collegio at (202) 785-0266.*

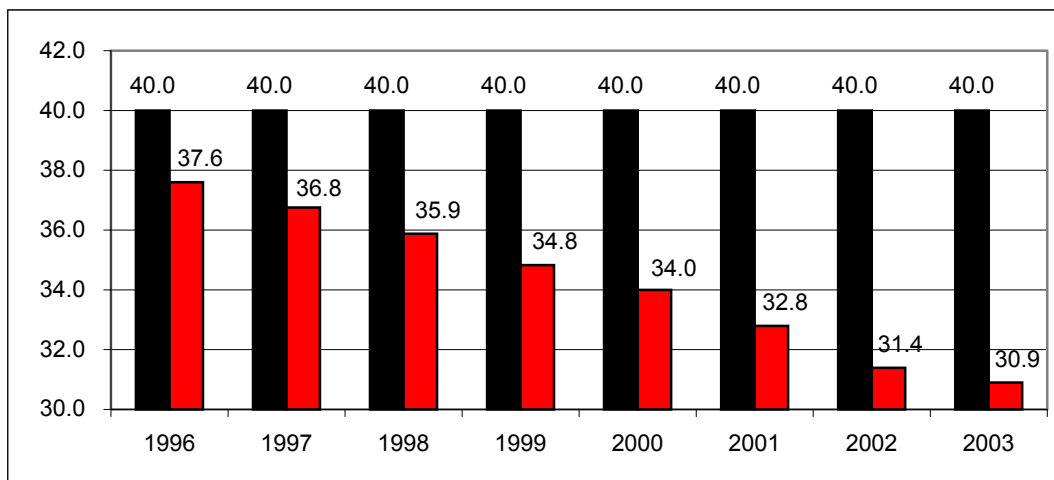
## Overview

In the coming months, Congress will debate the repeal of the Foreign Sales Corporations (FSCs) and the extraterritorial income exclusion (ETI) export subsidies that were found to be in violation of World Trade Organization (WTO) agreements. Without changes, the United States is facing \$4 billion of sanctions effective Jan. 1, 2004. Congress needs to act immediately and should take advantage of this historic situation to reform the nation's international tax law.

The current tax laws for American companies selling products abroad is nothing short of abusive. As a starting point, American companies are subject to the second highest corporate tax rate in the world. When state corporate tax rates are added to the federal rates America may in fact have the highest corporate rate in the world.

As the chart below demonstrates, a worldwide shift has taken place to lower corporate rates since 1996. The red bar is the world average top corporate tax rate (including sub-national governments). This largely reflects an understanding by governments around the globe that capital is mobile and taxing that capital leads to an outward migration of new investment, employment and population. The United States, however, has not lowered its top rate as other countries were, thus leaving U.S. firms with an incentive to move their capital out of the country.

**Chart 1: Average Top Corporate Income Tax Rate: OCED v. U.S.**



Source: Cato Institute based on KPMG

A second related disadvantage stems from the Alternative Minimum Tax (AMT). Congress replaced the old add-on minimum tax with the corporate AMT in 1986 to ensure that corporations could not use many deductions, exclusions and credits to avoid paying taxes. Yet those very same deductions, exclusions and credits were created by Congress to spur the sorts of new investment that provide jobs. As a result, the corporate AMT converts incentives into liabilities by means of a contradictory tax code that can punish corporations for investing in capital equipment.

Although corporations that pay the AMT pay a lower tax rate of 20 percent (as compared to 35 percent under the regular corporate income tax) the base of income subjected to the AMT is much broader and typically leads to higher tax bills for such firms. Corporations paying the AMT therefore face one of the highest tax rates on new investment in the industrialized world.<sup>1</sup> The corporate AMT has significantly

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<sup>1</sup> <http://www.accf.org/corpamtfacts.htm>

restricted economic growth in the United States by discouraging capital investment, which diminishes labor productivity and undermines overall Gross Domestic Product (GDP) growth.

U.S. firms that plan for long-term expansion, invest their earnings in capital, and reduce their taxable income under the regular corporate income tax feel the AMT's pinch most acutely. This dampens future investment by significantly increasing the real cost of capital for these firms. For example, corporate spending on capital such as structures and equipment would have increased by an additional \$8 to \$10 billion per year from 1996 to 2005 had the corporate AMT been repealed, according to a DRI/McGraw Hill study conducted for the American Center for Capital Formation.<sup>2</sup>

Adding insult to injury, corporations are often subjected to the AMT at times when they (and the economy) can least afford it: in times of economic downturn, which decreases taxable income, which in turn pulls the AMT trigger. In short, under the AMT, corporations are taxed at a higher rate when they can least afford it.

Most importantly, however, U.S. firms are subject to a repatriation tax when they distribute income earned abroad in foreign subsidiaries back to the United States. Most other nations use a better approach known as "territorial taxation," which only taxes corporate income earned inside the country's borders.

To illustrate this competitive disadvantage, Heritage Foundation scholar Daniel Mitchell used the following example:

An American-based company operating in Ireland is at a competitive disadvantage since its profits are subject to the 35 percent U.S. corporate income tax, as well as Ireland's 12.5 percent corporate tax. A Dutch firm, by contrast, only pays Ireland's low corporate tax rate of 12.5 percent. The U.S.-based company supposedly gets a credit for taxes paid to Ireland, so the tax rates aren't cumulative. But even if the tax credit operates perfectly, the U.S. company's tax burden is about three times larger than the one the Dutch company faces.<sup>3</sup>

Taken altogether, these variables have placed American companies at a competitive disadvantage with foreign companies. To better compete in worldwide markets many U.S. firms have reorganized their companies overseas to avoid this onerous taxation and regulatory burden. Politicians have railed against these companies by seeking to punish these companies with higher taxes and even more regulation. Adding new taxes and regulations, however, will make everyone worst off by leveling down American companies. The goal of the Congress should be to make everyone better off. Reforming the United States tax code to make corporations more competitive with foreign competition and lowering the corporate tax rates will prevent inversions from taking place, protect American jobs, and increase the standard of living for working American families.

House Ways and Means Chairman Bill Thomas (R-Calif.) has a proposal to repeal FSC/ETI and institute reforms that will make American companies more competitive. His legislation, H.R. 2896, reduces the corporate tax rate from 35 percent to 32 percent for firms with taxable incomes less than \$10 million, increase depreciation allowances, provide AMT relief, and encourages U.S. companies to temporarily reinvest repatriated earnings in the United States. ATR proposes to take this one step further.

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<sup>2</sup> <http://www.accf.org/caseamtrepeal.htm>

<sup>3</sup> <http://www.heritage.org/Press/Commentary/ed082003a.cfm>

## **Changing the Tax Treatment of Investments in Puerto Rico**

Moving from the current antiquated international tax code to a full territorial taxation system at this time may not be politically feasible. Therefore, as part of FSC/ETI legislation, Americans for Tax Reform proposes an incremental step, one which allows American companies based in Puerto Rico (and other American territories), to redistribute earnings back into the United States without being penalized with a 35 percent tax. This will work to boost economic growth in America, begin to reform U.S. international tax law, and significantly improve Puerto Rico's competitive disadvantage for global investment.

Currently, the Thomas proposal seeks to encourage American businesses to reinvest foreign earnings back in the United States by significantly reducing the double tax on foreign source income for a six-month window. The Thomas proposal would allow a U.S. corporate shareholder to deduct 80 percent of the amount of dividends received from controlled foreign corporations. Companies can then use this reinvestment back into America to increase dividends to shareholders, bolster domestic R&D, reduce domestic debt loads, and raise equity market valuations by increasing funds available for share repurchase.

Currently, American companies would have to pay a 35 percent tax rate on the dollars repatriated from foreign subsidiaries. Under current U.S. law that money may never enter America's economy. This proposal will significantly reduce this hurdle to new American investment. A recent Bank of America study estimated more than \$400 billion will be reinvested in America in 2004.

This proposal is a great first step toward reforming international tax law. However, ATR's proposal will take this initiative one step further by allowing a subsidiary located in Puerto Rico (and other U.S. territories) to reinvest their earnings back into America at a 0 percent rate on a permanent basis. By implementing this initiative, U.S. international tax law will move one step closer to true tax reform while bolstering investment in America. At the same time, Puerto Rico will secure long-term economic growth by becoming more competitive in the global marketplace.

### ***Why Puerto Rico?***

As a starting point, strong economic growth in Puerto Rico is good for the American economy and will create jobs in America. The Island is one of the world's greatest consumers (per capita) of American products. In fact, U.S.-Puerto Rico trade is responsible for more than 270,000 American jobs (see table).<sup>4</sup>

Puerto Rico must also compete with foreign countries for new investment and production but is still bound by U.S. regulations. Foreign countries now hold a competitive advantage over Puerto Rico. As such, implementation of this proposal will not only provide a concrete example of the benefits of reforming US international tax law, the legislation will boost growth for the Island's struggling economy.

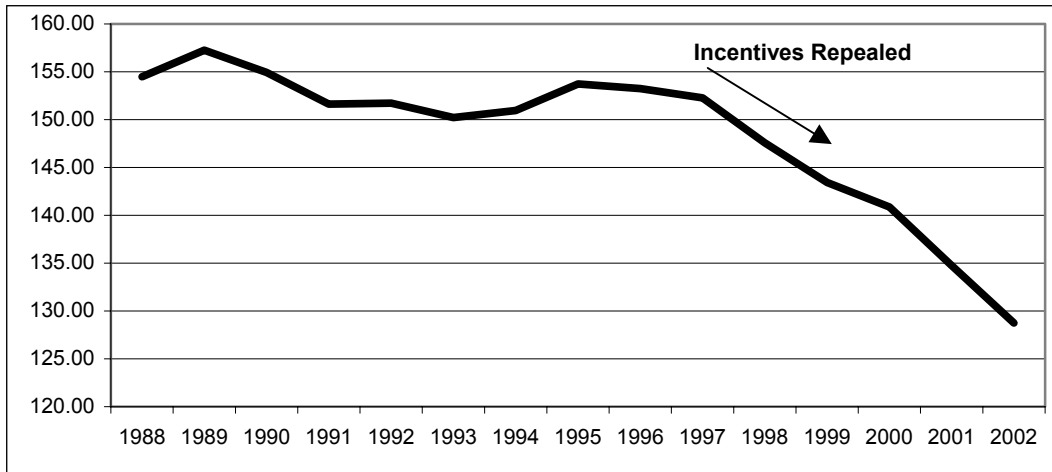
For years Congress provided economic development incentives to the Island as a way to offset the competitive disadvantages with lower cost jurisdictions stemming from U.S. regulatory obligations (OSHA, EPA, minimum wage, etc.). Since 1996, the Island has been hit with a confluence of negative economic factors, which has undermined economic growth. In 1996, economic development incentives were repealed and while the economy remained strong during the boom years, the absence of the economic development initiatives undermined the ability to attract new investment. Now that the economy has slowed, the effects have become much more visible and pronounced.

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<sup>4</sup> U.S Exports to Puerto Rico and Export-Related Jobs in 2001. National Economic Consulting. 11/26/02

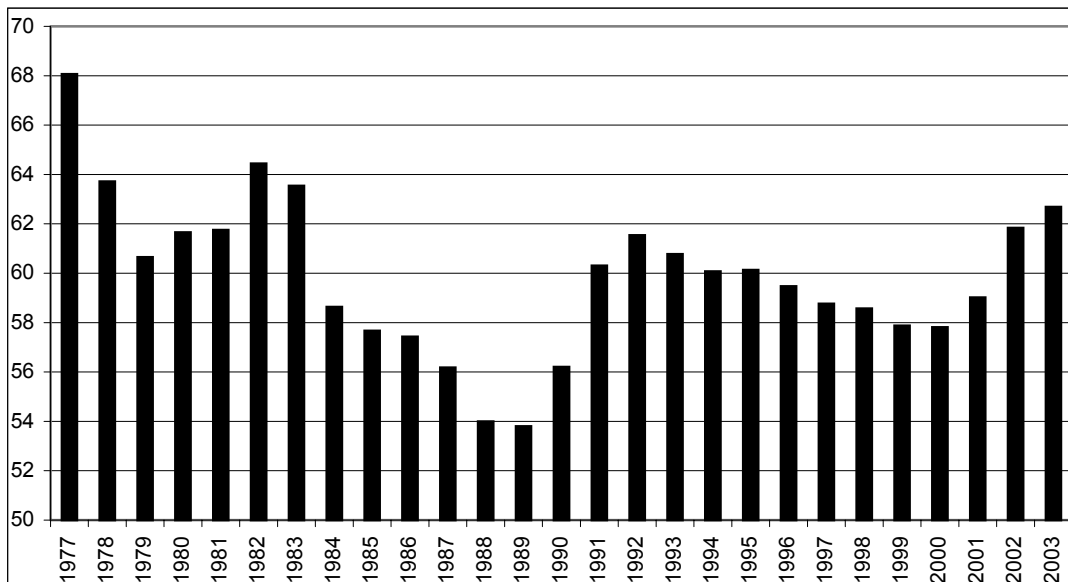
During this time, manufacturing employment significantly declined throughout the late 1990's despite the Island's economy expanding by as much as 7 percent. However, once the economy slowed, the loss of manufacturing employment continued to slide even faster, thus resulting in an 18.5 percent decline since the incentives were removed. By contrast, for the same time period, U.S. manufacturing declined by just 10.5 percent.

**Chart 2: Puerto Rico Manufacturing Employment**



At the same time, regulations governing Puerto Rico's businesses continued to increase and the regulatory burden is now at its highest level since 1983. Regulatory burden as a percent of national income increased for the third straight year. In the states, ATR estimates federal regulations to cost \$994 billion in 2003 and growing.

**Chart 3: Regulatory Burden as a % of National Income**



Given these constraints, policymakers in Puerto Rico have sought new initiatives to attract growth and remain competitive with foreign competition. As such, this provides an ample opportunity for the United

States to move one step closer to international tax reform by providing Puerto Rico with a new tool to attract global investment. It is from this incremental step that the country could move one step closer to tax reform, which conveys enormous benefits to American businesses, workers and shareholders.

However, it should be noted that reforms in Puerto Rico are also needed to fully maximize the benefits of this proposal. Regulatory and further tax reform is needed along with spending restraint and the governor of Puerto Rico is headed in the right direction with her 12-point economic plan to make the Island more competitive.

### **A Win-Win For America and Puerto Rico**

For too long American companies have been disadvantaged by high rates of taxation, including the double taxing of foreign source income. Reforming U.S. international tax law with corporate rate reductions and tax simplification will start the process to creating a level-playing field for American companies.

This also brings the country one step closer to fundamental tax reform. And with tax reform comes tax simplification, which leads to a better allocation of resources over time. The complexity of international tax law imposes a significant cost to the economy relative to the actual revenue generated. Simplification will reallocate resources away from unproductive uses to increasing employment, raising wages, and improving the value businesses. Simplification will boost economic growth in of itself.

Puerto Rico is on the verge of modernizing their economy for the 21<sup>st</sup> century. And the proposal put forward in this report conveys to the Island a powerful tool to lure new investment and job creation for Puerto Rico. With manufacturing in decline and unemployment stubbornly high, allowing earnings to be repatriated back to America will reduce the cost of capital for American companies and enhance the competitive advantage for Puerto Rico. At the same time, new investment and job creation will occur in America that never would have occurred. Including this proposal as part of FSC/ETI repeal will substantially boost new investment, employment, wages and ultimately the standard of living in Puerto Rico, while allowing America to capture new investment that would never make it back into America's economy.

<b>U.S. EXPORTS TO PUERTO RICO AND EMPLOYMENT BY STATE, 2001</b>				
<b>State</b>	<b>Exports</b>	<b>Export Employment</b>		
	<b>(\$ millions)</b>	<b>Direct</b>	<b>Indirect</b>	<b>Total</b>
<b>Total US</b>	<b>15,586.1</b>	<b>72,562</b>	<b>201,243</b>	<b>273,805</b>
Alabama	0.3	2	3,029	3,031
Alaska	224.5	732	450	1,182
Arizona	143.3	645	3,437	4,082
Arkansas	14.9	76	1,734	1,810
California	691.2	3,295	24,486	27,781
Colorado	58.9	255	3,293	3,548
Connecticut	246.7	1,326	2,475	3,801
Delaware	59.2	182	602	784
District of Columbia	1.5	13	387	400
Florida	3,876.3	21,671	10,890	32,561
Georgia	1,104.0	4,733	5,909	10,642
Hawaii	0.0	0	860	860
Idaho	4.1	16	965	981
Illinois	851.2	3,776	8,948	12,724
Indiana	118.7	522	4,425	4,947
Iowa	48.1	182	2,287	2,469
Kansas	83.6	350	1,970	2,320
Kentucky	120.0	400	2,771	3,171
Louisiana	351.2	724	2,872	3,596
Maine	21.5	125	979	1,104
Maryland	224.4	1,008	4,055	5,063
Massachusetts	341.1	1,827	4,713	6,540
Michigan	1,058.0	4,103	7,302	11,405
Minnesota	275.0	1,380	4,038	5,418
Mississippi	82.6	474	1,825	2,299
Missouri	114.9	458	4,216	4,674
Montana	0.0	0	662	662
Nebraska	120.3	461	1,339	1,800
Nevada	0.3	2	1,444	1,446
New Hampshire	26.6	133	989	1,122
New Jersey	1,675.7	7,075	5,965	13,040
New Mexico	0.1	0	1,189	1,189
New York	395.9	2,120	12,518	14,638
North Carolina	470.2	2,247	5,621	7,868
North Dakota	3.3	14	490	504
Ohio	288.1	1,172	8,352	9,524
Oklahoma	19.8	87	2,387	2,474
Oregon	17.4	78	2,503	2,581
Pennsylvania	555.2	2,665	8,620	11,285
Rhode Island	35.8	258	715	973
South Carolina	372.6	1,822	2,746	4,568
South Dakota	0.5	2	584	586
Tennessee	384.2	1,887	4,011	5,898
Texas	602.4	1,942	14,832	16,774
Utah	20.2	100	1,590	1,690

Time To Terminate U.S. Repatriation Tax

Vermont	4.4	24	481	505
Virginia	201.8	892	5,286	6,178
Washington	20.6	86	4,178	4,264
West Virginia	3.4	14	1,180	1,194
Wisconsin	252.0	1,207	4,252	5,459
Wyoming	0.0	0	389	389

Source: U.S. Exports to Puerto Rico and Export-Related Jobs in 2001, National Economic Consulting