

10 Minutes on International Tax Increases*

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Will new international tax proposals hinder US competitiveness?

Highlights

- President Obama's new budget proposes \$210 billion in revenue increases over 10 years generated through international tax measures.
- The president proposes to severely restrict or indirectly limit the current "deferral" rules under which foreign earnings of US companies are not subject to US tax until repatriated to the United States.
- With nearly half of the income of US multinationals earned by their foreign affiliates, these proposed changes would increase tax burdens and create challenges for US companies competing in global markets.

President Barack Obama's 2010 budget proposes fundamental changes to the taxation of US multinational corporations.

The president has stated, "The budget also begins to restore a basic sense of fairness to the tax code, eliminating incentives for companies that ship jobs overseas and giving a generous package of tax cuts to 95% of working families."

The budget calls for a 10-year tax increase of \$210 billion generated through international tax measures. The president's budget director described these measures as laying "the groundwork for reforming our tax code so multinational corporations pay taxes more like domestic companies rather than being able to defer taxation of profits earned by their subsidiaries."

What is at stake for US companies?

- 1. Tax burden on foreign operations.** Severe restrictions or indirect limits on deferral could significantly increase current taxes on US companies that reinvest foreign earnings abroad.
- 2. Competitiveness.** Large tax increases on US-owned foreign subsidiaries would make it more difficult to compete against foreign-owned companies in foreign markets, where 95% of the world's consumers live.
- 3. Jobs.** Many US jobs depend on successful US operations in foreign markets. Increased taxation of foreign operations could put these jobs at risk, contrary to policy makers' desire to maintain and increase jobs at home.
- 4. Corporate tax rates.** Unlike some tax reform proposals, the budget would not use corporate tax increases to reduce the statutory corporate tax rate, which is now second highest among the 30 countries in the Organisation for Economic Cooperation and Development.

At a glance

“Large US-based multinationals almost uniformly report their growth now relies on penetrating new foreign markets. With annual revenue growth of 2–3% a year in the United States and 10–15% a year abroad, they know they have to adapt to a post-American world—or else lose out on it.”

—Fareed Zakaria,
The Post-American World

“Pro” and “con” of changing the taxation of foreign earnings:

- Advocates for restricting deferral believe that foreign operations of US companies are tax favored over domestic operations. Increasing taxes on foreign operations, they believe, would redirect jobs and investment to the United States.
- Proponents for maintaining the current deferral rules believe that foreign operations provide growth opportunities for US companies that also expand their domestic operations. Investment abroad, they believe, leads to more investment at home and better-paying jobs for Americans.

What actions you should consider:

- The budget proposal deserves top-level attention. How would changes to deferral affect the company’s bottom line and ability to compete in foreign markets?
- Evaluate the company’s best course of action if the proposal were to become law. How would the company adapt?
- Review past approaches to limiting deferral. Would some proposed approaches be less adverse to the company than others?
- Be prepared to engage in the debate and help Congress understand the consequences of this proposal to the company and its employees.

What international tax changes are being proposed?

The Administration's budget blueprint calls for \$210 billion in increased taxes on foreign operations, including changes in the ability of US corporations to defer US tax on foreign earnings. Details of the proposal have not yet been released.

What is deferral?

The United States follows the general principle that the worldwide income of a US corporation is subject to US tax. Foreign subsidiary income generally is not taxed until distributed to the parent company, typically as a cash dividend. This is referred to as "deferral" of tax on foreign earnings. Foreign taxes are paid on current earnings under the laws of the country in which they are earned.

What is the impact of deferral?

Most OECD countries exempt foreign subsidiary earnings from tax in the home country, while the other OECD countries provide deferral. Accordingly, US limits on deferral would advantage the foreign-based competitors of US companies.

What changes to deferral can be expected?

Although the proposal is still under development, the \$210 billion budget estimate suggests that proposed changes to deferral are likely to be severe.

Why are these changes being considered?

President Obama campaigned on a pledge to "repeal tax breaks and loopholes that reward corporations that retain their earnings overseas." Additional revenue is also desired to restrain the growth in the national debt.

How would these changes affect the United States?

A change in US tax law to significantly limit deferral would be unparalleled among developed nations—subjecting US multinationals to tax burdens not borne by foreign-based competitors and diminishing economic activity in the United States.

What form will changes to deferral take?

International tax changes could take different forms, from current taxation of retained foreign earnings to new limitations on deductions and foreign tax credits. Higher taxes, in any form, would reduce a company's bottom-line profits from foreign operations and cash flow.

Current taxation. A direct limit on deferral would make some earnings of a US company's foreign subsidiaries taxable to the US parent at the current 35% corporate rate even if reinvested to expand abroad. This could represent a substantial increase in tax burden. For example, assuming a 20% tax rate in the host country, this would result in additional US taxes of 15% of the included foreign earnings (35% US tax less a foreign tax credit of 20%)—a 75% increase in current taxes.

Potential new limitations on domestic expenses and foreign tax credits. Alternatives to direct limitations on deferral could be indirect methods such as limits on deductions for domestic expenses and additional foreign tax credit limits tied

to deferred foreign income, as proposed in a bill introduced by House Ways and Means Chairman Charles Rangel in 2007.

That bill would delay deductions for US expenses "allocable" to deferred foreign income until the deferred foreign income is repatriated. As a result, unless all foreign income was distributed to the US company, a portion of the company's expenses incurred in the United States would not be currently deductible.

That bill also would impose a new limitation on the foreign tax credit. The credit would be limited to the average foreign tax rate on all foreign income, whether distributed or not. Relative to present law, this could significantly increase taxes on income repatriated from high-tax jurisdictions.

Higher taxes on foreign operations would reduce the return on foreign investments and make it more challenging for US multinational corporations to compete with their foreign-incorporated counterparts.

What issues should policy makers consider?

Advocates for restricting deferral believe that current law unfairly subsidizes foreign production at the expense of US investment and US jobs. These advocates believe that foreign production by US companies substitutes for production at home.

Advocates for maintaining deferral believe foreign production is complementary to US economic activity, helping companies penetrate foreign markets and create new markets for US goods and services.

Some studies find that expansion abroad leads to greater exports of goods and services from the United States. A prominent study by economists found that for every 10% increase in sales by foreign subsidiaries of US companies, exports by US parents to their foreign subsidiaries increase by 6.6%.

Facts on US multinationals.

US multinational companies are predominantly US centric, with 70% or more of their worldwide employment, investment, and production in the United States. US multinational companies perform 87% of their worldwide R&D in the United States, and they account for 76% of total R&D performed in the United States.

Trade by US multinationals accounts for more than half of all US exports, and sales by their foreign subsidiaries generate \$4.1 trillion in revenues. Foreign markets are important sources of growth for US multinationals.

Policy questions. The argument for limiting deferral assumes that if the tax cost of foreign operations increased, US companies would locate these operations in the United States. But if instead this production was replaced by operations of a foreign-owned company, then changes to deferral could have adverse effects for the US economy.

How can you prepare for the coming debate?

The stakes are high in this debate over the future of our international tax system. A significant increase in taxes on the foreign operations of US companies would have adverse economic effects abroad and at home.

Analyze the effects of potential changes to deferral. Examine the effects on your company's ability to compete internationally if deferral were significantly cut back or if new limitations were imposed on deductions and foreign tax credits. What would be the direct effects of changes to deferral on the profitability of the company's foreign operations? What would these changes imply for parent company operations?

After making this analysis, inform Treasury and Congress. President Obama has stated that he does not wish to place US companies at a competitive disadvantage with foreign multinational companies. Explain the nature of your foreign operations and how these would be affected. Explain the impacts on your US workforce. US multinationals directly

employ over 20 million workers in the United States and generate jobs for another 30 million workers through their suppliers and the communities dependent on purchases by their employees.

Be prepared. President John F. Kennedy proposed repeal of deferral in 1961. Explanations by business of the importance of deferral for competitiveness reasons led Congress to maintain deferral for most active business income. Congress did, however, limit deferral for passive and certain other forms of mobile income.

The historical lesson may be twofold:

First, Congress can respond favorably to well-founded analysis and data from businesses regarding how changes to deferral can endanger the competitiveness of US companies.

Second, companies should be prepared for the possibility of adverse legislation being enacted and should consider steps that would minimize those impacts.

Upcoming 10Minutes topics

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Traditional, compliance-focused approaches to risk management have created dangerous blind spots for businesses—financially and operationally—threatening not only growth, but basic survival. This 10Minutes discusses how an integrated approach to managing risk and business performance may help companies systematically link risk and reward to avoid the pitfalls of operating in a volatile global economy.

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How PwC can help

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