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CONGRESSIONAL TESTIMONY

Congress Should Only Make Changes to Repatriation Policy When Establishing a Territorial System

Testimony before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means United States House of Representatives

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Confusion Over Repatriation and Highway Trust Fund Needs Clearing

Changes to repatriation policy have been spoken about often as a way to fill the hole in the Highway Trust Fund (HTF). Although the conversations have been frequent, details about what such a policy would entail have been scant. By holding this hearing, the Committee is taking an important step to clear up any confusion that may exist.

There are usually two options discussed when it comes to using changes to repatriation policy as a way to fill the gap in the HTF.

The first would be Congress either granting a repatriation tax holiday on the untaxed overseas earnings of U.S. businesses at a lower rate than current law, or deeming those earnings repatriated and taxing them at a rate lower than under current law. In this option, repatriation would be a stand-alone policy to fund the HTF.

The second option would be to establish a territorial system (or dividend-exemption system) in place of our current worldwide one, and deem the foreign earnings repatriated to help pay for the transition to that better system.

The first option would not be sound policy; the second one would strongly boost economic growth.

Changes to Repatriation Should Be Done Exclusively in Tax Reform

The country needs tax reform because the current tax code is holding the economy back from growing as strongly as it should. The biggest factor holding back growth is the antiquated way the tax code treats businesses. In addition to having the highest corporate tax rate in the developed world, as defined by the Organization for Economic Co-operation and Development (OECD), the worldwide system that taxes U.S. businesses on their foreign earnings is the biggest reason the business tax system is so outdated.

It would be best if Congress passed fundamental tax reform, where it would reform both individual and business taxes. However, since the need for business reform is so pressing, it makes sense to focus on business-only first if that is what is achievable.[1]

Business tax reform contains many pieces, such as lowering tax rates, moving to expensing of capital purchases, and establishing a territorial system. It would be better to pass those policies

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[1] Curtis S. Dubay and David R. Burton, "How Congress Should Reform Business Taxes," Heritage Foundation *Backgrounder* No. 3022, June 4, 2015, http://www.heritage.org/research/reports/2015/06/how-congress-should-reform-business-taxes.

together since they are all necessary to fully alleviate the burden business taxes put on the economy, but passing them separately would still move the tax code in a pro-growth direction.

Under the current worldwide system, businesses retain earnings abroad because they do not pay U.S. tax until they bring the money back to the U.S., a policy known as deferral. Businesses delay paying U.S. tax on those earnings because paying the extra U.S. tax on them would make them highly uncompetitive against their foreign competition.

Regardless of how Congress proceeds on tax reform, changes to repatriation policy should always be handled in conjunction with international reform that switches from the worldwide system to a territorial, or dividend-exemption, system.[2] The worldwide system has caused businesses to compile those earnings abroad. It only makes sense that changes to how they are taxed be used to repair the harm it causes.

The Joint Committee on Taxation (JCT) is likely to score switching to territorial as a tax cut, at least initially. A dynamic score, which it is now required to provide, should reduce the tax cut compared to a static score.

Some have estimated that U.S. corporations have earned an estimated $2.1 trillion overseas that has not been repatriated and subject to U.S. tax.[3] As part of moving toward a territorial tax system, this income should be deemed to be repatriated and taxed at a reasonable rate. The businesses that earned this foreign source income expected to pay tax on this money eventually and to exempt it from tax entirely would constitute an unwarranted windfall gain. However, because current law allows for deferral and because of the time value of money, taxing this income under a deemed repatriation at the full corporate rate would be equally unfair. The new revenue from this deemed repatriation can make a substantial contribution to funding other positive aspects of business tax reform.

One of those ways would be to help offset the resulting tax cut from switching to a territorial system. For instance, in his tax reform proposal, then-Chairman of the House Ways and Means Committee Dave Camp (R–MI) incorporated deemed repatriation as a transition method to a territorial system in his 2014 revenue-neutral tax reform proposal.[4] It is acceptable to do this because it is part of broader tax reform—it is not a tax hike and it makes way for a badly needed, and long overdue, territorial system.

An additional use for the revenue raised from repatriation within international reform would be to compensate those businesses that are harmed by tax reform. Tax reform creates winners that

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[2]Curtis S. Dubay, "Changes to Repatriation Policy Best Left to Tax Reform," Heritage Foundation *Issue Brief* No. 4347, February 17, 2015, http://www.heritage.org/research/reports/2015/02/changes-to-repatriation-policy-best-left-to-tax-reform.

[3]Richard Rubin, "U.S. Companies Are Stashing $2.1 Trillion Overseas to Avoid U.S. Taxes," Bloomberg, March 4, 2015, http://www.bloomberg.com/news/articles/2015-03-04/u-s-companies-are-stashing-2-1-trillion-overseas-to-avoid-taxes (accessed June 19, 2015).

[4]Curtis S. Dubay and David R. Burton, "Chairman Camp's Tax Reform Plan Keeps Debate Alive Despite Flaws," Heritage Foundation *Backgrounder* No. 2890, March 14, 2014, http://www.heritage.org/research/reports/2014/03/chairman-camps-tax-reform-plan-keeps-debate-alive-despite-flaws.

experience windfall gains and losers that see the decline in deferred tax assets, such as foreign tax credits, loss carrybacks, and others.

A territorial system would free U.S. businesses to invest more abroad by making investments profitable that are unprofitable under the current worldwide system. The increase in foreign investment would increase domestic investment by businesses in support of their foreign operations and their efficiency and competitiveness as well. This would create jobs and raise wages for U.S. workers.[5] It would be a tremendous benefit to the economy.

A territorial system requires a robust set of policies to prevent improper base erosion and profit shifting. Without such policies, U.S. businesses could shift income earned in the U.S. to countries with lower tax rates. Shifting income that should be taxable in the U.S. abroad would improperly narrow the tax base and force tax rates to be higher on domestic-only businesses and families. Higher tax rates hurt growth and are therefore antithetical to the core purpose of engaging in tax reform.

Congress should craft its own set of base erosion and profit-shifting policies. It should not be beholden to international efforts such as are ongoing currently with the OECD's Base Erosion and Profit Shifting project.

Stand-Alone Changes to Repatriation to Fund HTF Would Be Poor Policy

Making changes to repatriation policy within tax reform that establishes a territorial system stands in stark contrast to the other set of options on the table, which would use repatriation changes to fund the HTF without moving to a territorial system. Changing repatriation policy without establishing a territorial system would make achieving territoriality more difficult in the future because the revenue that could be raised will no longer be available to aid in transition.

Furthermore, the HTF is based on the sensible user-pays principle. Drivers pay the federal gas tax which is supposed to fund highway spending, although a large portion of it is diverted to spending in other areas. The more drivers use the highways, and the more wear and tear they put on roads based on the size and weight of their vehicle, the more gas they buy. When they buy more gas, they pay more tax. This is a fair and practical way to pay for highway spending.

Taxing the overseas earnings of U.S. businesses to fund the HTF would break the user-pays principle. There is no connection between U.S. multinational businesses and domestic highway use.

A repatriation holiday is one of the policies offered by some under the stand-alone option. Under a repatriation holiday, businesses choose whether they want to exploit a lower tax rate on their foreign earnings Congress offers them during a set period of time, for instance 2 years.

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[5]Curtis S. Dubay, "A Territorial Tax System Would Create Jobs and Raise Wages for U.S. Workers," Heritage Foundation *Backgrounder* No. 2843, September 12, 2013, http://www.heritage.org/research/reports/2013/09/a-territorial-tax-system-would-create-jobs-and-raise-wages-for-us-workers.

However, it is highly questionable whether a holiday would lower or raise revenues in the traditional 10-year budget window. Whether it does or does not depends almost entirely on how much foreign income the JCT anticipates businesses will repatriate over the next decade under current law. Given a one-year or two-year span, there is little doubt that a holiday would shift revenue forward to those years. Hence, a holiday could raise more revenue in those years even though it would cut taxes over the entire 10-year period relative to the current baseline.

Since Congress is beholden to the 10-year window, some have floated a more troubling change to repatriation policy that would unambiguously raise revenue in that window. In order for Congress to make sure it would raise revenue through changes to repatriation policy, it would have to treat U.S. businesses' overseas earnings as deemed repatriated without making other changes to the international tax system.

Under deemed repatriation, unlike a repatriation holiday, businesses have no choice whether to pay tax on their foreign earnings. Instead, it assumes they have already brought all their accumulated foreign earnings back to the U.S. and applies a tax on that income immediately, even if businesses never actually bring the money back to the U.S. or never intended to do so.

As a stand-alone measure, deemed repatriation is a tax hike, even though the rate applied to the overseas income would likely be less than under current law. It would be a tax hike because it would force businesses to pay tax on their foreign income before they planned to, and it would tax income that these businesses never planned to repatriate, and thus would never have paid U.S. tax on. This makes a stand-alone deemed repatriation yet another tax-and-spend scheme. In addition to that, it is also more troubling than a holiday because it is compulsory rather than voluntary.

Either a repatriation holiday or deemed repatriation (as a stand-alone option) would be a temporary fix. Congress would be back looking for other sources of revenue in a few years if it took this path. It should instead focus on other reforms to the highway program that would be sustainable, would not break the user-pays principle, and would not raise taxes.

Conclusion

This year, in addition to making certain expiring provisions permanent, such as 50 percent expensing, which is often called bonus depreciation, Congress has the chance to advance the cause of tax reform by improving the way the tax code handles international taxation. Finally moving to a territorial system would be strongly pro-growth and improve opportunities for American families of all income levels.

If Congress changed repatriation policy as a stand-alone measure to cover a hole in the HTF, it would create less incentive to change the tax policy from a worldwide system to a territorial system. Instead, Congress should focus on establishing a territorial system and reserve changes to repatriation policy for aiding that sizeable improvement to the tax code.