

INTRODUCTION

The Center for American Progress is pleased to host a full-day conference with academic and policy experts from around the country who will highlight options for reforming the tax code. Many experts agree that the tax code is in need of repair. Yet it has been 20 years since the landmark 1986 reform. Given the growing complexity of the tax code, increased revenue pressures, and a changing economy; tax reform will likely be a central issue for 2006 and beyond. This conference will provide a forum for sharing proposals—both quick fixes and broad overhaul—and for open and engaged discussion.

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INTERNATIONAL TAX REFORM: REMOVING SUBSIDIES FOR FOREIGN INVESTMENT

By James Kvaal¹

The American tax code gives large subsidies to American multinational corporations for investing outside the United States. Corporations often pay little or no U.S. taxes on foreign profits. In some cases, tax benefits for foreign investment are larger than the U.S. tax due, creating an overall “negative” tax. In other words, multinationals not only escape U.S. taxes, but the U.S. actually pays them to invest offshore.

Tax benefits for foreign investment include tax credits for foreign taxes paid and the ability to indefinitely defer paying U.S. tax on foreign profits. In some cases, multinationals can deduct the costs of foreign investments without paying taxes on the resulting profit. Foreign tax credits can spill over to shield even U.S. business activity from U.S. taxation. Multinationals can also shift income to foreign subsidiaries in low-tax countries.

Reformers should begin by recognizing that not all countries are alike. Major industrialized nations like France, Germany, and Japan generally have tax systems comparable to our own. Therefore, no U.S. taxation is necessary to prevent tax disparities. Existing efforts to levy a tax generate little revenue and sometimes backfire by creating excess tax credits.

In contrast, tax havens and low-tax countries like Bermuda, the Cayman Islands, and Ireland offer large tax savings to U.S. multinationals. Incentives to shift business operations abroad may reduce American economic growth and wages. Even solely paper transactions — which reduce taxes but do not affect actual economic activity — erode the U.S. tax base and shift the tax burden onto other sources, such as workers’ wages. The U.S. should minimize the economic distortions caused by unequal tax rates, rather than exacerbating them through additional tax benefits for foreign investment.

A partial exemption system would not tax business income earned in countries with comparable tax systems. However, income earned in tax havens and other low-tax countries would be fully taxable. Such a system would ensure that all foreign income would be taxed once at a reasonable rate, whether by the U.S. or a foreign government.

¹ This paper has benefited from the guidance of John Buckley, Daniel Halperin, and Stephen Shay, as well as the comments of Michael Dannenberg, Sarah McGonigle, J.J. Prescott, and Emma Vadehra.

The proposal would greatly reduce incentives to invest overseas and shift income outside the U.S. It would create a positive incentive for countries to adopt responsible tax systems. Finally, it would raise substantial resources that could be reinvested in initiatives to raise the productivity and competitiveness of American workers.

No doubt, U.S. multinationals will argue that any higher taxes will endanger their competitiveness. However, subsidizing foreign subsidiaries of multinational corporations puts domestic companies at a competitive disadvantage and creates economic distortions. Treating foreign and domestic income the same would strengthen the U.S. economy as a whole.

HOW THE U.S. TAX CODE SUBSIDIES FOREIGN INVESTMENT

MECHANICS OF THE U.S. SYSTEM

In principle, the U.S. taxes American companies on all of their worldwide earnings. However, two major exceptions — deferral and foreign tax credits — largely swallow the basic rule. As a result, the effective tax rate on foreign non-financial income is below five percent,¹ well below the statutory rate of 35 percent.

Deferral allows American multinationals to postpone U.S. taxes on foreign profits indefinitely. Taxes on business income of foreign subsidiaries are not due until the income is transferred (“repatriated”) back to the American parent corporation as a dividend. Multinationals can build up foreign earnings tax-free indefinitely, as if they were invested in an IRA for offshore investing.

By removing the burden of U.S. taxes, deferral is intended to make U.S. corporations more competitive in foreign markets. Deferral costs the U.S. government about \$12 billion a year.²

Corporations cannot defer the income of foreign branches that are not separately incorporated. Anti-abuse rules also limit deferral on investment income and business income involving related parties, although sophisticated parties can largely structure their transactions to avoid these rules.³

The foreign tax credit reimburses multinationals for taxes paid to foreign governments, preventing income from being simultaneously taxed by two governments. Double taxation would distort the allocation of capital and reduce worldwide economic efficiency. U.S. corporations claimed \$41 billion in foreign tax credits in 2001.⁴

The foreign tax credit is limited to the amount of U.S. tax that would otherwise be imposed. The limit attempts to prevent highly taxed foreign income from shielding other income from U.S. taxes. However, as discussed below, excess credits can be problematic in practice.

The U.S. system is an unwieldy compromise among competing objectives. Worldwide taxation and the foreign tax credit promote economic efficiency by taxing income similarly, regardless of where it is earned. Deferral departs from economic efficiency, reducing taxes to promote the competitiveness of U.S. corporations' foreign subsidiaries. Finally, limits on both deferral and foreign tax credits protect the U.S. tax base at the cost of the other two objectives.

INCENTIVES FOR CORPORATIONS TO INVEST OFFSHORE

The U.S. tax code encourages multinationals to invest overseas in three ways. First, deferral allows them to enjoy lower foreign taxes while paying little or no U.S. taxes. Second, deferral also discourages multinationals from reinvesting foreign profits into the U.S. Finally, in some cases, tax benefits from deferral and foreign tax credits are larger than the U.S. tax, creating an overall negative tax on foreign income.

1. Lower Tax Rates on Offshore Investment

Multinationals pay little U.S. tax on their foreign profits. In some countries, they pay a comparable amount of foreign taxes, so they pay similar taxes whether they invest at home or abroad. In other countries, however, they pay little in either foreign or U.S. taxes.

Multinationals paid only \$5.2 billion (about five percent) in U.S. taxes on non-financial income they repatriated in 1996.⁵ The effective rate on all foreign income is even lower because not all foreign income is repatriated.

Foreign taxes are often too low to close the tax gap between foreign and domestic income. The average foreign tax rate on the income of foreign manufacturing subsidiaries was only 21 percent in 1996, compared to a domestic rate of 31 percent.⁶ Moreover, foreign taxes fell by almost one percentage point a year between 1980 and 1996, possibly due to increasingly aggressive tax planning and falling foreign corporate tax rates.

As a result, total (U.S. and foreign) taxes on foreign income are often substantially lower than taxes on U.S. income. Therefore, U.S. multinationals have an incentive to move business activities into low-tax countries and stretch the rules to report income as earned in low-tax countries.

2. “Repatriation Tax” Encourages Permanent Foreign Investment

Tying U.S. taxes to the voluntary act of repatriation gives U.S. multinationals an opportunity to avoid U.S. taxes simply by reinvesting their profits overseas. Not surprisingly, corporations rarely pay this voluntary tax. Only about seven percent of all income earned in low-tax countries was returned to the U.S. in 1992.⁷ U.S. companies in low-tax countries almost never return capital to the U.S. in their first 15 years.⁸ At the end of 2002, American companies held more than \$639 billion in profits in foreign subsidiaries, roughly three-quarters of which would be subject to U.S. tax if repatriated.⁹

To encourage corporations to repatriate foreign profits, Congress enacted a tax holiday in a larger 2004 law, temporarily cutting the repatriation tax rate from 35 percent to 5.25 percent. Multinationals have responded by bringing home foreign profits, but as soon as the holiday is over they are expected to resume stockpiling cash overseas.¹⁰ The law was mocked for its bizarre corporate giveaways to dog tracks, cruise ships, and bow-and-arrow makers,¹¹ but its tens of billions of dollars in tax breaks on foreign income may do far more damage to our economy.

3. Negative Tax Rates Affirmatively Subsidize Some Foreign Investment.

At times, the tax code not only imposes little or no tax on foreign investment, it affirmatively subsidizes foreign investment. Credits and deductions generated by foreign investment can be larger than the U.S. tax imposed on the foreign profits. As the U.S. Department of the Treasury put it, “The effective rate of the residual U.S. tax on foreign earnings is often negative. That is, the total foreign and U.S. tax on repatriated earnings (including dividends, interest, and royalties) may be less than the taxes imposed by the foreign host country.”¹²

By one estimate, a typical investment in a country that charges only seven percent in taxes faces a total (foreign and U.S.) tax of only five percent.¹³ In other words, the U.S. tax rate on these investments is negative two percent.

Negative taxes are an important reason why moving to a well-designed territorial system — which would not tax foreign business income at all — would actually *raise* revenue. The Joint Committee on Taxation estimated that a territorial

system would raise more than \$5 billion a year.¹⁴ Harry Grubert and John Mutti estimated that their territorial proposal would raise as much as \$8 billion a year.¹⁵

A. Expense Allocation

There are several important sources of negative tax rates. First, multinationals can deduct expenses of international investment without ever paying taxes on the resulting income. According to the Joint Committee on Taxation, “By maintaining deferral indefinitely, a taxpayer may achieve a result that is economically equivalent to 100 percent exemption of income, with no corresponding disallowance of expenses allocable to the exempt income.”¹⁶

For example, a U.S. multinational can borrow money and invest it in a foreign subsidiary. The American parent corporation can then deduct its interest payments from its U.S. taxes. At the same time, it can avoid U.S. taxes on the resulting foreign income through deferral or foreign tax credits.

Although the expenses remain fully deductible, current law partially addresses the problem through its methodology for calculating the foreign tax credit. The law allocates the interest expenses of the entire multinational group among countries proportionate to asset ownership, reducing net foreign income and therefore eligibility for foreign tax credits.¹⁷ Only a minority of multinationals bump up against credit limits,¹⁸ however, and this group will likely shrink under new rules that allow corporations to carry forward unused credits for 10 years.

**IRELAND:
WINNING AT TAX COMPETITION,
WITH HELP FROM THE U.S. TAX CODE**

Ireland is a vivid example of how the Internal Revenue Code magnifies the impact of low foreign tax rates, helping low-tax countries attract U.S. capital. The benefit of investing in Ireland is far greater than the difference between the U.S. rate of 35 percent and the Irish rate of 12.5 percent.

U.S. corporations can multiply their tax savings through aggressive transfer pricing and profit-shifting techniques. Nearly three-quarters of the profits that U.S. corporations earn in Ireland are probably the result of profit-shifting, according to Martin Sullivan.²⁵ In other words, each dollar of investment in Ireland allows an additional three dollars of profit to be artificially shifted into Ireland. The resulting tax savings is equivalent to the U.S. subsidizing companies investing in Ireland by more than \$1.9 billion a year.²⁶

Microsoft is one company that has aggressively exploited Ireland’s tax code. Its four-year-old Irish subsidiary reported \$9 billion in licensing fees in 2004, helping Microsoft save at least \$500 million in U.S. taxes.²⁷

Other expenses of foreign investment, including research and development costs and administrative overhead, also generate deductions that can reduce U.S. taxes. The expense allocation rules seem to assume foreign income is subject to U.S. taxes, when in practice much foreign income is never taxed by the U.S.

B. Cross-Crediting of Foreign Tax Credits

Investments in high-tax foreign countries generate excess foreign tax credits. For example, suppose a corporation pays \$50 in foreign taxes on \$100 of foreign income. It receives \$50 in foreign tax credits, which completely offset its U.S. tax bill of \$35 — leaving \$15 in extra credits. Sophisticated tax planners can also exploit the “check the box” rules to claim inconsistent treatment from U.S. and foreign governments, generating foreign tax credits without recognizing foreign income for U.S. taxes.¹⁹

These excess credits create incentives for further foreign investment. A multinational with excess credits has an incentive to generate income from a low-tax country, for example, to use the extra credits. More troublingly, excess credits can shield income essentially earned within the U.S. from U.S. taxation.²⁰ Multinationals can move American-developed intellectual property offshore, pay royalties from its foreign subsidiaries to the U.S. parent corporation, and shield royalty income from U.S. taxes through extra credits. Under the sales source rule, the credits can also be applied to taxes on half of income from exports produced in the U.S., even if this income is not taxed by any other country. The sales source rule alone costs about \$2 billion a year.²¹

There are limits intended to constrain this “cross-crediting.” A foreign tax credit can only be used against income of the same type as defined by nine “baskets,” such as passive income, financial services income, and general income. Starting next year, the number of baskets will be reduced to two: active income and passive income. Savvy multinationals may be able to use nearly unlimited cross-crediting to avoid any U.S. tax on their foreign-source income.²²

C. Transfer Pricing

U.S. multinationals can use foreign subsidiaries to reduce their reported U.S. income. When exchanging goods and services among subsidiaries, corporations can set their prices artificially high or low to increase profits in one location and decrease them in the other. For example, a multinational can generate higher foreign profits and lower U.S. profits by selling U.S. inventory to a foreign subsidiary at bargain-basement rates. The result of shifting profits into a low-tax

foreign country is to increase the amount of income taxed at the low foreign rate, reducing the multinational's overall taxes.

In theory, corporations are supposed to set transfer prices at fair market value based upon an objective, arm's-length evaluation of the transaction. In practice, however, the I.R.S. struggles to enforce the standard. The arm's-length method depends heavily upon context and subjective judgments, generates a large number of possible valuations, and as a result is very difficult to enforce.²³ According to Lee Sheppard, "Transfer pricing, as a mode of re-sourcing income, is the chief reason American multinationals don't pay tax on foreign income or U.S. income that has been shifted to foreign source."²⁴

IMPACT OF TAX BREAKS FOR FOREIGN INVESTMENT

The increasing integration of the world economy has magnified the impact of tax disparities between nations. Foreign tax havens and other low-tax countries are a growing threat to America's economy and tax base.

First, tax disparities distort investment decisions, diverting capital from its most productive use. Economic efficiency is maximized when taxes influence the allocation of capital as little as possible. Current law leads corporations to favor foreign investments with lower pre-tax returns to domestic investments with higher pre-tax returns, reducing overall economic efficiency.²⁸

Some observers argue that tax disparities are unimportant because they rarely decide investment locations. However, U.S. multinationals do invest more in countries with low tax burdens.²⁹ Based upon a review of the U.S. literature, Hines suggests that a one percent increase in taxes reduces inbound foreign investment by 0.6 percent.³⁰ These investments are not merely paper transactions, but include real items such as research and development, plants, and equipment. Hines concluded, "There is by now extensive quantitative evidence that international taxation influences the volume and location of foreign direct investment."³¹

Second, a loss of investment capital to other nations may reduce the job quality and wages of American workers.³² Exporting capital could reduce the amount of capital available for U.S. workers, reducing wages, and increasing the return to capital.³³

Third, tax differences can erode the U.S. tax base. Even if actual business activity does not move, corporations may stretch the rules to characterize as much income as possible as earned in low-tax countries.³⁴ The result is less taxable income in the U.S.

There is troubling evidence that tax havens are already seriously undermining the U.S. tax base. U.S. multinationals now earn almost half of their foreign profits in tax havens, suggesting aggressive income shifting.³⁵ Tax havens account for less than one percent of the world's population but more than eight percent of American multinational's foreign investments in property, plant, and equipment.³⁶ The aggressive use of inter-company transfers helped U.S. companies reduce their taxes by \$7 billion in 2002, compared to 1997.³⁷

As its tax base erodes, the U.S. will be forced to shift its tax burden onto less mobile sources, such as workers' wages or to cut spending.³⁸ Indeed, corporate tax rates in OECD countries have fallen by a third over the past two decades.³⁹ The result has been an increasing reliance on consumption and wage taxes, which are more regressive.⁴⁰

A BETTER WAY: A PARTIAL EXEMPTION SYSTEM

A partial exemption system would ensure that American corporations pay a similar tax rate, no matter where in the world they invest. It would tax foreign income only if a foreign government failed to tax it under a comparable tax system. As a result, corporate income would be taxed at a reasonable rate once and only once, reducing distortions in investment incentives and the rewards to aggressive tax planning.

A foreign tax system would be considered "comparable" if its tax rate were close to or higher than the U.S. rate. For example, a foreign rate of 28 percent or higher could be considered comparable to the U.S. rate of 35 percent. Income earned in these countries would be exempt from U.S. taxes. However, income earned in low-tax countries would be subject to full U.S. taxes without any deferral. As under current law, multinationals could still claim foreign tax credits against this taxable income.

The proposal would reduce tax subsidies for foreign investment. Like other recent international tax reform proposals, it would raise a significant amount of revenue. For example, the Joint Committee on Taxation proposal would raise \$5 billion a year, and Senator John Kerry's proposal would generate \$12 billion a year.⁴¹ These resources could be invested in initiatives to improve the competitiveness and productivity of American workers, such as education, research, and technology.

A partial exemption system was proposed by the U.S. Treasury under President George H. W. Bush.⁴² Under the Treasury proposal, active income earned

in a “designated jurisdiction” would be exempt. The U.S. parent would be taxed currently on all non-exempt active income as well as interest, rent, and royalties, subject to foreign tax credits. More recently, David Rosenbloom proposed an exemption for income earned in jurisdictions with “formal and serious” tax systems.⁴³

Other nations have similar provisions. For example, France generally exempts foreign income, unless it is subject to foreign taxes below half of the French rate.⁴⁴ Japanese multinationals cannot defer taxes on the income of foreign subsidiaries subject to foreign taxes below 25 percent, subject to certain exceptions.⁴⁵ In fact, most countries with foreign tax credit systems limit the benefit of deferral to countries on a white list (or absent from a black list).⁴⁶

ADVANTAGES OF A PARTIAL EXEMPTION

First, the proposal would greatly reduce incentives to invest overseas. In tax havens and other low-tax countries, U.S. taxation is a necessary to reduce large tax disparities. Therefore, the partial exemption system would tax income earned in low-tax countries without deferral, just as if it had been earned domestically. This equal treatment would greatly reduce incentives to shift taxes to low-income countries.

The situation is very different in countries with comparable tax systems. Because U.S. corporate tax rates are close to the average among G-7 countries,⁴⁷ other large industrialized nations’ tax systems do not distort investment decisions by U.S. multinationals. Moreover, the current U.S. system collects little revenue on income from these countries due to foreign tax credits. A partial exemption system would eliminate double taxation more easily and efficiently than tax credits, without creating cross-crediting problems.

Second, the partial exemption system would take a first step to address tax competition. Currently, countries have incentives to cut corporate taxes below their neighbors to attract foreign investment. The resulting “race to the bottom” undermines countries’ sovereignty by impeding their ability to fairly tax corporate income. Instead, the tax burden is shifted to less mobile — and more regressive — tax bases, such as wages and consumption.

The proposal would encourage low-tax countries to adopt responsible tax systems. A system that taxed U.S. multinationals at the lowest “comparable” rate would minimize American multinationals’ taxes. If the line were drawn at 28 percent, tax havens and other low-tax countries would have an incentive to *raise* their rates to 28 percent. Such a tax increase would qualify them for the exemption,

TABLE 1. Top Statutory Corporate Tax Rates in OECD Countries, 2003

Japan	40.9
Germany	39.6
United States	39.3
Italy	38.3
Canada	35.6
France	35.4
Greece	35.0
Spain	35.0
Netherlands	34.5
Austria	34.0
Belgium	34.0
Mexico	34.0
Switzerland	33.7
New Zealand	33.0
Portugal	33.0
Turkey	33.0
Czech Republic	31.0
Luxembourg	30.4
Australia	30.0
Denmark	30.0
United Kingdom	30.0
Republic of Korea	29.7
Finland	29.0
Sweden	28.0
Norway	28.0
Poland	27.0
Slovak Republic	25.0
Hungary	18.0
Iceland	18.0
Ireland	12.5

Congressional Budget Office, November 2005. Bolded countries are G-7 members. Includes state and other sub-national taxes.

making their countries more attractive to U.S. multinationals.

Third, the proposal would also eliminate the barrier to reinvesting foreign profits in the U.S. Unlike current law, foreign income would not be subject to any additional tax when repatriated. Unlike the tax holiday recently enacted by Congress, the proposal removes tax barriers to reinvesting foreign profits in the U.S. without providing greater rewards to corporations that chose to invest overseas.

Fourth, the plan would relieve the pressure on anti-abuse rules that allocate income among countries. As discussed above, the expense allocation and transfer pricing rules are not good tools to police the boundaries of the U.S. tax base. Taxing the income at a reasonable rate, no matter where it is earned, would greatly reduce the rewards to shifting income. As a result, multinationals would have less incentive to exploit these rules.

Although a partial exemption would not achieve full tax neutrality, it would greatly limit tax disparities. A corporation might still be able to choose the British tax rate of 30 percent instead of the U.S. rate of 35 percent, but it could no longer claim the Irish rate of 12.5 percent or the Bermudan rate of zero percent.

The system, like all tax regimes in the real world, may not be airtight. Some income may escape taxation due to differences in countries' tax systems. However, our tax treaty network provides a mechanism for coordinating tax laws to further the goal of taxing all income once and only once. The U.S. has negotiated 56 bilateral

income tax treaties defining what taxes are owed each country on trade and investment income. The U.S. treaties cover the vast majority of foreign trade and investment of U.S. companies.⁴⁸

Finally, the proposal would also limit opportunities for cross-crediting. Highly taxed foreign income would no longer generate excess foreign tax credits. While foreign income subject to low tax rates would generate credits, those credits would be used to offset immediate U.S. taxation on that income. Therefore, fewer excess credits would be available to shelter other foreign income from U.S. taxes.

Some cross-crediting might still occur. Corporations may attempt to convert exempt income to taxable income to generate excess credits. High foreign withholding taxes on passive income could also create excess credits. Nonetheless, the situation would be greatly improved.

DESIGNING A PARTIAL EXEMPTION SYSTEM

The most difficult decision in designing a partial exemption system is determining which countries have “comparable” tax systems. Countries differ in many relevant characteristics, including statutory rates, deductions for depreciation and interest expense, extent of tax collection efforts, and variations in sub-national taxes. Nonetheless, the difficulty of distinguishing between nations can be overstated. France, Japan, and other countries have managed the feat.

The proposal designates all countries with a statutory rate of 28 percent or higher as presumptively “comparable.” This benchmark is 80 percent of the U.S. rate of 35 percent and roughly three-quarters of the combined federal and state rate of 39.3 percent. As shown in Table 1, it would include all G-7 countries and most OECD countries. The Treasury Department could adjust this list at the margin, based upon other features of tax systems.

Alternatively, the partial exemption proposal could require income to be actually taxed by a foreign government at a certain rate. However, requiring taxpayers to calculate taxes under two sets of rules would reduce certainty and dramatically increase compliance burdens. Therefore, following the Treasury Department and Rosenbloom, the proposal recommends categorizing countries rather than examining the actual tax levied on each item of income.

Foreign income would only be exempt from U.S. tax if it is likely to be taxed at a reasonable rate by a foreign country. Types of income that are not generally taxed abroad — including royalties, interest payments, certain personal services performed outside the U.S., shipping, telecommunications, and income from international waters and space — would be taxable. Investment income would also be taxable, except when earned by a business such as a financial services company. Income that is taxed today under Subpart F would remain taxable.

Foreign branches of multinationals would be treated the same as foreign subsidiaries on the principle that the corporate form is elective and has no economic significance. Corporations owning small shares in foreign corporations, as well as individual American shareholders, would not be eligible for the exemption.

Retaining the foreign tax credit on income from non-exempt countries is necessary to avoid double taxation. For example, a company investing in Hungary — where the tax rate is 18 percent — would owe the U.S. of 17 percent. Its total tax rate would be 35 percent, the same as if it invested at home, and not 53 percent, as it would be if it were fully taxed by both the U.S. and Hungary. Although Rosenbloom suggested allowing only deductions for foreign taxes,⁴⁹ such a step would distort investment by subjecting U.S. multinationals to higher taxes outside the U.S. than inside the U.S.

There is one difficult transition issue: the treatment of earnings accumulated under the old system. Applying the new system immediately would disrupt existing investment. Applying the new rules only to new income, while continuing to apply old rules to old income for years or decades, could be difficult to administer. A third possibility is to assess a one-time tax — say, at half the regular 35 percent rate — on all earnings held overseas.

COMPETITIVENESS CONCERNS

Multinational corporations may argue that raising taxes on foreign income would reduce their competitiveness. They argue that they could not compete in some markets if they must pay higher taxes than some foreign competitors pay. For example, they would pay the U.S. rate of 35 percent on their Irish profits while their foreign competitors might pay only the Irish rate of 12.5 percent.

However, American economic welfare is not improved by subsidizing foreign subsidiaries of multinational corporations and putting domestic operations at a competitive disadvantage. The economy benefits when taxes do not distort investment behavior. Removing tax subsidies for foreign investment would steer capital toward its economically optimal uses. Although some economists have recently disagreed,⁵⁰ the standard view has long been that countries should tax all worldwide income the same. As the Treasury Department concluded, “A policy that enhances the ability of domestic companies to compete abroad by subjecting their income from foreign investment to a lower rate of tax than their income from domestic investment could cause a decrease in overall economic welfare.”⁵¹

Nor does the competitiveness argument justify negative tax rates. U.S. multinationals not only can avoid U.S. tax on their foreign profits, but — as explained above — they often receive additional tax benefits subsidizing foreign investment. These negative taxes are not necessary to put U.S. multinationals on a level playing field with their foreign competitors.

Moreover, American competitiveness does not depend upon any single feature of the tax code. The U.S. is widely recognized as one of the most competitive nations in the world.⁵² U.S. corporations pay substantially less in taxes than their foreign competitors: U.S. corporate taxes account for 1.8 percent of the economy, only half the OECD average of 3.5 percent.⁵³ They constitute 176 of the largest 500 companies in the world and 313 of the largest 1,000 manufacturers.⁵⁴ Our corporations' continuing success in world markets does not depend upon any particular feature of the tax code.

If policymakers wish to accommodate competitiveness concerns, they could carve out an exception for foreign subsidiaries and branches that primarily serve the countries in which they are located. Exempting this income from U.S. tax would allow U.S. businesses to compete on a level playing field in low-tax countries, while limiting tax distortions to one particular situation where the concern for competitiveness is most pressing. Senator John Kerry made a similar exception in his international tax reform proposal.⁵⁵

However, a local market exception would maintain a substantial amount of tax distortions in favor of foreign investment. One analysis found that roughly two-thirds of sales by foreign affiliates are in the country where they are located.⁵⁶ Policing the boundaries of the exemption would also be difficult, creating problems of expense allocation and transfer pricing similar to current law.

Multinationals also argue that high taxes create an incentive for them to abandon their U.S. citizenship, either reincorporating overseas or being sold to a foreign competitor. Farsighted founders of new corporations might incorporate overseas. Again, however, the location of corporations depends on many factors other than the ability to exploit tax havens and other low-tax countries. The U.S. can invest in its productivity and competitiveness in many ways without subsidizing multinationals for foreign investments.

In a world with diverse tax systems, it is impossible for the U.S. to ensure a completely level playing field. It cannot tax foreign and domestic income the same without running the risk that some U.S. corporation may face higher taxes than its foreign competitors. In the long run, diplomatic efforts may be

necessary to work with other countries to reduce these economic distortions. The Bush administration hobbled one such effort, the OECD project on harmful tax competition.⁵⁷ In the meantime, however, we should act immediately to ensure that our tax code no longer exacerbates incentives to move offshore.

OTHER APPROACHES TO REFORM

Two recent proposals would overhaul the taxation of international income. President Bush's Advisory Panel on Federal Tax Reform recommended exempting foreign business income from taxation.⁵⁸ During his presidential campaign, Senator John Kerry proposed ending deferral and taxing all foreign income immediately.⁵⁹ Although they sound like opposites, both proposals would be a substantial improvement over the current hybrid system.

The Advisory Panel plan would exempt from tax all business income earned by U.S. corporations overseas. It would tax passive investment income and payments from foreign affiliates other than dividends, such as royalties, interest, and payments for intra-company transfers. On income taxed by both the U.S. and foreign governments, it would retain a foreign tax credit to eliminate double taxation. The Advisory Panel recognized the need to enforce rules allocating deductions and governing transfer prices.⁶⁰ Research expenses would not be allocated to exempt income.⁶¹

Similar proposals from the Joint Committee on Taxation and Grubert and Mutti raise \$5 billion to \$8 billion a year.⁶² A territorial system raises revenue because it fully taxes royalty and interest income, reduces cross-crediting, and disallows expenses related to international income.

However, the Advisory Panel plan embraces the most undesirable feature of current law: large disparities in tax rates on U.S. and foreign income.⁶³ A new plant in Dublin would pay 12.5 percent in Irish taxes — and possibly no U.S. taxes at all — while a new plant in Detroit would be taxed at 35 percent. As described above, these disparities create incentives to shift business activities offshore and opportunities for aggressive tax planning that erode the U.S. tax base. Although similar incentives exist in current law, the Joint Committee on Taxation has concluded that “the adoption of a territorial system would not alleviate, and could very well exacerbate,” incentives to move plants and jobs overseas.⁶⁴

Moreover, eliminating all U.S. taxes would remove a barrier to tax competition, providing new momentum to the race to the bottom. Under current law, U.S. multinationals do not receive the full benefit of low tax rates because any earnings remain potentially subject to a repatriation tax. Foreign countries have an

incentive to impose some taxes, knowing that multinationals will be reimbursed by the foreign tax credit. A territorial system would remove these checks on a race to bottom.

Finally, a territorial system would place great pressure on rules policing the boundaries of the exemption.⁶⁵ Corporations will attempt to shift income overseas through aggressive exploitation of transfer pricing and expense allocation rules. Given past difficulties enforcing these rules, it may be unwise to rely upon such a blurry line as the main protection for the U.S. tax base. In contrast, the partial exemption proposal reduces reliance on these rules by taxing any item of income at a comparable rate, no matter where in the world it is claimed.

Senator Kerry's proposal would eliminate multinationals' ability to defer U.S. taxes. However, it would continue to allow deferral for companies that locate production in a foreign country and serve that country's markets. The plan also continues to allow deferral for past profits, but it encourages multinationals to repatriate these profits by temporarily cutting the tax rate from 35 percent to 10 percent. The plan also refers generally to restricting cross-crediting and the abuse of hybrid entities.⁶⁶

The Kerry plan would be a substantial improvement over current law. Although the tax holiday enacted by Congress is highly objectionable, a holiday accompanied by repeal of deferral provides a sensible transition without allowing multinationals to resume stockpiling profits overseas. However, it continues the foreign tax credit system, which raises little revenue from investments in high-tax countries while creating opportunities for cross-crediting, reducing taxes on essentially U.S. income.

CONCLUSION

The U.S. tax code compounds the problem of tax competition poses to American prosperity. Other countries attract U.S. multinationals by undercutting American tax rates, and the U.S. imposes little or no tax on the resulting income. In some cases, it affirmatively subsidizes foreign investment by providing tax benefits without any tax.

A partial exemption system would remove incentives for U.S. multinationals to move to tax havens and other low-tax countries by fully taxing the resulting income. Exempting income earned in other countries would reward responsible tax systems and reduce cross-crediting. Finally, taxing all worldwide income once, and only once, at a responsible rate would reduce the rewards from paper transactions that shift income for tax purposes.

ENDNOTES

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- ⁴ Scott Luttrell, “Corporate Foreign Tax Credit, 2001,” Statistics of Income Bulletin, Fall 2005, at 183.
- ⁵ Grubert and Mutti, supra note 1.
- ⁶ U.S. Department of the Treasury, supra note 2, at x.
- ⁷ Grubert and Mutti, supra note 1, at 4.
- ⁸ Grubert and Mutti, supra note 1, at 30.
- ⁹ David Brumbaugh, Tax Exemption for Repatriated Foreign Earnings, Congressional Research Service, October 22, 2003.
- ¹⁰ J. Clifton Fleming Jr. and Robert J. Peroni, “Eviscerating the Foreign Tax Credit Limitations and Cutting the Repatriation Tax — What’s ETI Repeal Got to Do with It?” Tax Notes, September 20, 2004, at 1412; New York Times, “Drug Makers Reap Benefits of Tax Break,” May 8, 2005, at A11.
- ¹¹ See, e.g., New York Times, “Just the Subsidy Cuts, Please” (editorial), May 5, 2004, at A26; New York Times, “Congress’ Embarrassment of Pork” (editorial), June 19, 2004, at A16; and New York Times, “Multinational Companies Get a Tax Break, as Do Foreign Gamblers,” October 15, 2004, at C1.
- ¹² U.S. Department of the Treasury, supra note 2, at 45.
- ¹³ Rosanne Altshuler and Harry Grubert, “Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations,” National Tax Journal, December 2001, at 787-809.
- ¹⁴ Joint Committee on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures, January 27, 2005, at 186-97, 427.
- ¹⁵ Grubert and Mutti, supra note 1, at 38.
- ¹⁶ Joint Committee on Taxation, supra note 14, at 188.
- ¹⁷ Before 2004, corporations were required to use the “water’s edge” method that considered only U.S. interest expense and ignored the interest expenses of foreign subsidiaries. Multinationals can now elect the “worldwide” approach, which is generally more favorable to taxpayers.
- ¹⁸ In 1994, 75 percent of all manufacturing income was “in excess limit,” meaning the corporation had remaining eligibility for foreign tax credits. Grubert and Mutti, supra note 1, at 30.
- ¹⁹ See Guardian Industries Corp. v. United States, 65 Fed. Cl. 50 (March 31, 2005); American Bar Association Section of Taxation, Task Force on International Tax Reform, Report on Selected Structural Issues in the Taxation of the U.S. Persons’ Foreign Business Income, forthcoming.
- ²⁰ Charles B. Rangel and John Buckley, Current International Tax Rules Provide Incentives for Moving Jobs Offshore, March 2004, available at http://www.house.gov/waysandmeans_democrats/trade/3_22_dear_colleague.pdf (last visited March 13, 2006).
- ²¹ Office of Management and Budget, supra note 3.
- ²² Robert J. Peroni, J. Clifton Fleming Jr., and Stephen E. Shay, “Reform and Simplification of the U.S. Foreign Tax Credit Rules,” Tax Notes, October 6, 2003, at 109.
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³² Congressional Budget Office, supra note 28.

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³⁴ Congressional Budget Office, supra note 28.

³⁵ Martin A. Sullivan, “Economic Analysis: Latest IRS Data Show Jump in Tax Haven Profits,” Tax Notes, October 11, 2004, at 151.

³⁶ James Hines, “Effects of Tax Reform on Foreign Direct Investment,” Presentation at Tax Reform in an Open Economy, the Brookings Institution, December 2, 2005.

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³⁸ Reuven S. Avi-Yonah, “Globalization, Tax Competition, and the Fiscal Crisis of the Welfare States,” Harvard Law Review, May 2000, at 1577-78.

³⁹ Congressional Budget Office, supra note 28, at xi. The 30 nations that are members of the Organization for Economic Cooperation and Development (OECD) are democracies with market economies.

⁴⁰ Avi-Yonah, supra note 38, at 1577.

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⁴⁴ Ambroise Bricet, “French Finance Act Contains Major Corporate Tax Changes,” Tax Notes International, January 24, 2005, at 294-95.

⁴⁵ Ernst & Young, Worldwide Corporate Tax Guide, January 2005, at 451-57; Japanese Ministry of Finance, Tax Bureau, An Outline of Japanese Taxes 2005, December 2005, at 121.

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