How does the current system of international taxation work?

All countries tax income earned by multinational corporations within their borders. The United States also taxes the foreign-source income of US-based multinationals when it is repatriated to the US parent, with a credit for foreign income taxes they've paid. Most other countries simply exempt the foreign-source income of their multinationals.

HOW THE UNITED STATES TAXES FOREIGN-SOURCE INCOME

The federal government taxes US resident multinational firms on their worldwide income at the same rates applied to domestic firms; the current maximum tax rate—the rate that applies to most corporate income—is 35 percent. US multinationals may claim a credit for taxes paid to foreign governments on income earned abroad, but only up to their US tax liability on that income. Firms may, however, take advantage of cross-crediting, using excess credits from income earned in high-tax countries to offset US tax due on income earned in low-tax countries.

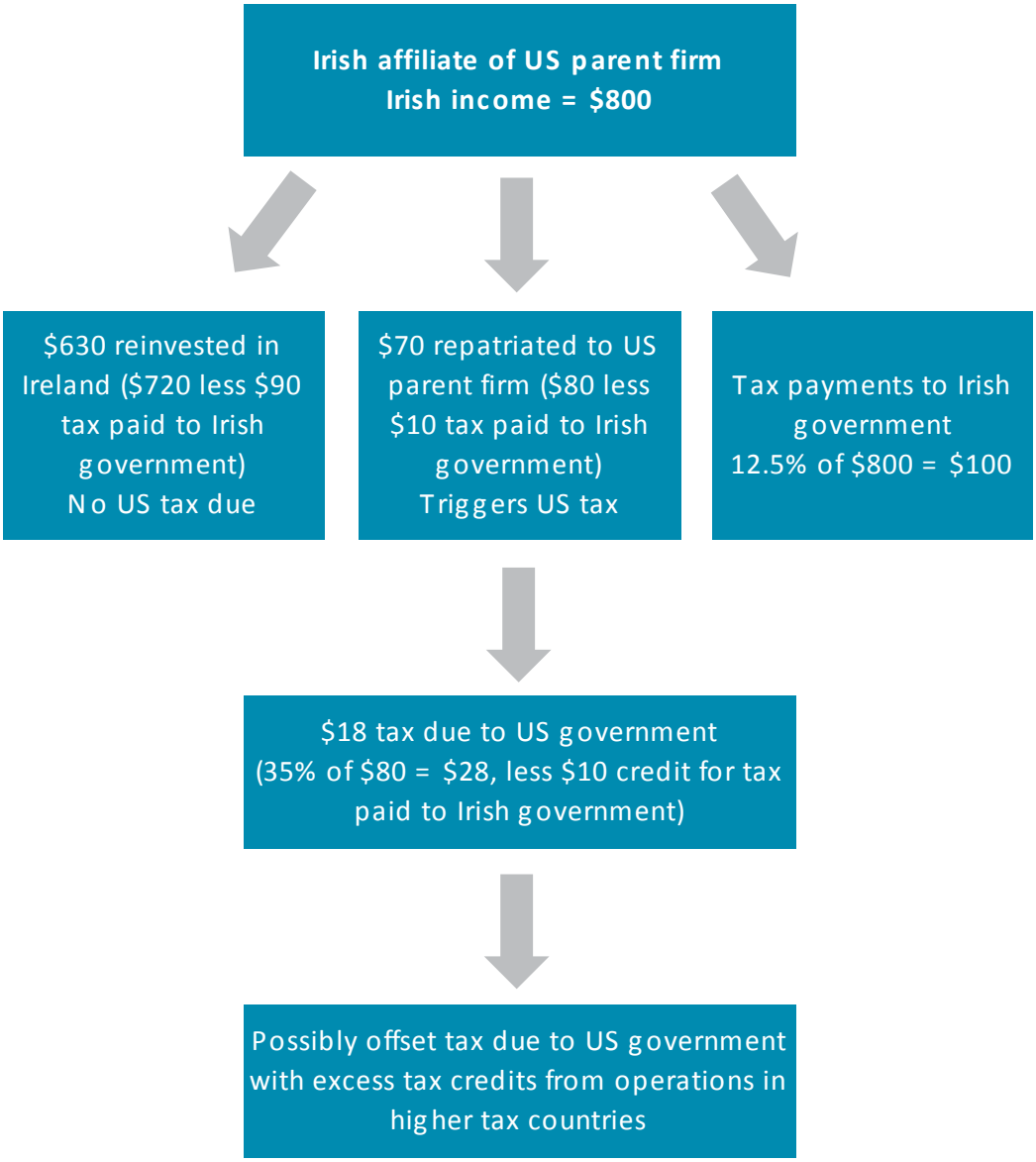
US multinationals generally pay tax on the income of their foreign subsidiaries only when they repatriate the income, a delay of taxation termed "deferral." Deferral, the credit limitation, and cross-crediting all provide strong incentives for firms to shift income from the United States and other high-tax countries to low-tax countries.

Suppose, for example, a US-based multinational firm facing the 35 percent maximum corporate income tax rate earns $800 in profits on its Irish subsidiary (figure 1). The 12.5 percent Irish corporate tax reduces the after-tax profit to $700. Suppose the firm then repatriates $70 of this profit and reinvests the remaining $630 in its Irish operations. The firm must then pay US tax on a base of $80 (the $70 plus the $10 in Irish tax paid on that portion of its profits), or $28, but it claims a credit for the $10 Irish tax, leaving a net US tax of $18. If the firm has excess foreign tax credits from operations in high-tax countries, it can offset more (or possibly all) of the US tax due on its repatriated Irish profit. Meanwhile, deferral allows the remaining profit ($630) to grow abroad, free of US income tax until it is repatriated.

FIGURE 1

Example for Taxing a US-Based Multinational Firm

2015



Most countries, including all other countries in the G7 (Canada, France, Germany, Italy, Japan, and the United Kingdom), use a territorial system that exempts most so-called "active" foreign income from taxation. Still others have hybrid systems that, for example, exempt foreign income only if the foreign country's tax system is similar to that in the home country. In general, an exemption system provides an even stronger incentive than the current US tax

system to earn income in low-tax countries because there is no residual domestic tax due upon repatriation of foreign profits.

Most countries, including the United States, also have rules in place intended to limit the ability of their resident corporations to shift profits to low-income countries. These rules, called Controlled Foreign Corporation (CFC) rules, tax some forms of income, typically "passive income," such as interest and dividends from portfolio investments, on a current basis. In that sense, even countries with a formal territorial system use a hybrid approach that subjects some foreign-source income to domestic tax.

Because of deferral, cross-crediting, and imperfect anti-avoidance rules, US multinationals pay little residual tax on their foreign-source income, making the system arguably no less favorable to US multinationals than a territorial system with stronger CFC rules.

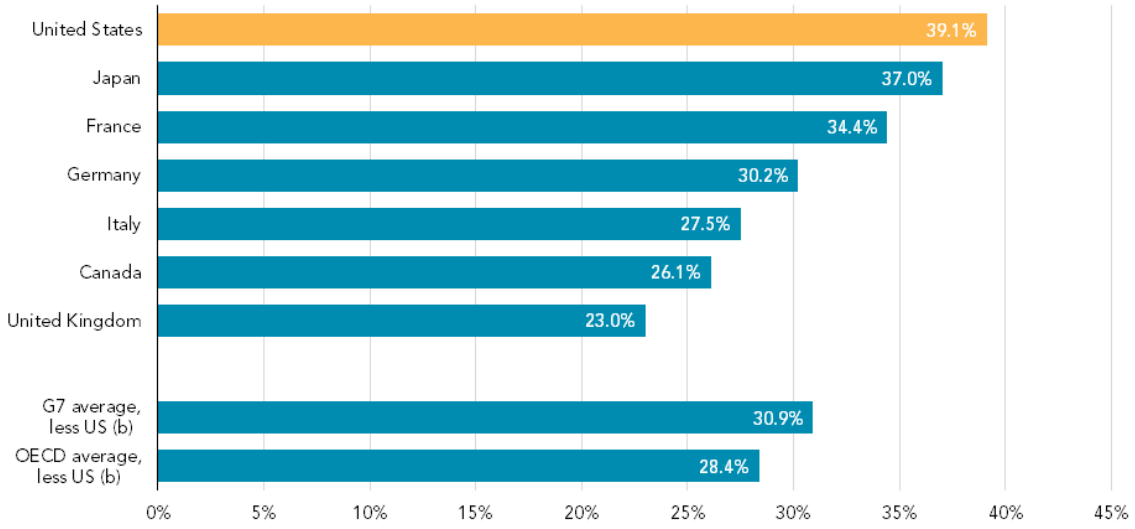
CORPORATE TAX RATES AND REVENUES

The US statutory corporate tax rate has changed little since 1986. Meanwhile, most other advanced industrial countries have lowered their tax rates. As a result, the top US corporate tax rate, including the average state corporate rate, is now higher than the top corporate tax rate of the other leading economies in the G7 and over 10 percentage points higher than the GDP-weighted average rate in the other Organisation of Economic Co-Operation and Development (OECD) countries (figure 2).

FIGURE 2

Maximum Corporate Tax Rates by Country[a]

Among leading economies, 2013



Sources: OECD (2013); TPC calculations.
(a) Includes taxes of sub-national governments.
(b) Weighted by GDP.

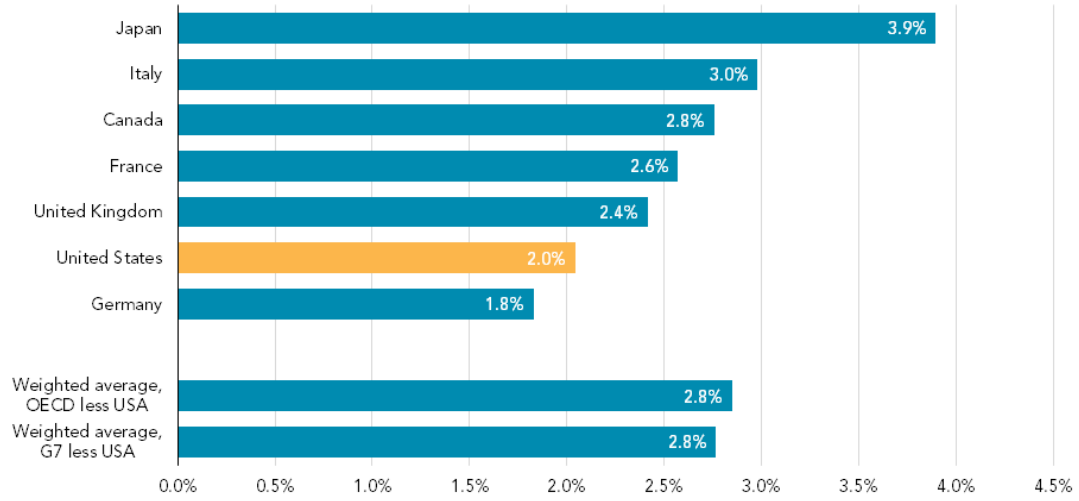
Despite its relatively high corporate tax rate, the United States raises less revenue from corporate income taxes as a share of GDP than other countries in the OECD. In recent years, revenue has increased as a share of GDP in most OECD countries because base-broadening measures that subject more income to tax have more than offset the cuts in tax rates. In the United States, revenue has varied significantly from year to year with economic conditions and the vagaries of temporary investment incentives, but revenue has remained at slightly over 2 percent of GDP in most years since the 1980s.

US corporate tax revenues lag behind other developed countries' because of a narrower tax base compared with other countries, an increasing share of business activity originating in businesses not subject to corporate tax (partnerships and subchapter S corporations), and increased incentives and opportunities for US companies, especially those with significant assets in intangible property, to shift reported income abroad.

FIGURE 3

Corporate Tax Revenue as Share of GDP by Country

Among leading economies, 2013



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