What are the consequences of the US International Tax System?

Current rules encourage US multinational firms to earn and report profits in low-tax foreign countries, enable both US- and foreign-based firms to shift profits earned in the United States to other countries, and encourage companies to incorporate in foreign jurisdictions.

INCENTIVES TO EARN AND REPORT PROFITS IN LOW-TAX COUNTRIES

Multinational corporations typically operate overseas through foreign subsidiaries that are mostly taxed as independent corporate entities. This separate entity system gives multinationals incentives to shift reported profits to their affiliates in low-tax jurisdictions by underpricing sales to them and overpricing purchases from them.

For tax reporting purposes, most governments require firms to use an "arm's length" standard, setting prices for transactions within the corporate group ("transfer prices") equal to the prices that would prevail if the transactions were between independent entities. Yet ample room remains for firms to manipulate transfer prices, especially for intangible assets such as patents that are unique to the firm and for which there is no easily established market price.

Leading multinationals often shift the ownership of their intangibles, which generate a large share of their worldwide profits, to affiliates in very low tax jurisdictions, such as Ireland and Singapore. Typically, multinationals generate very little real economic activity—as measured by output, sales, or investments in plant and equipment—in these jurisdictions.

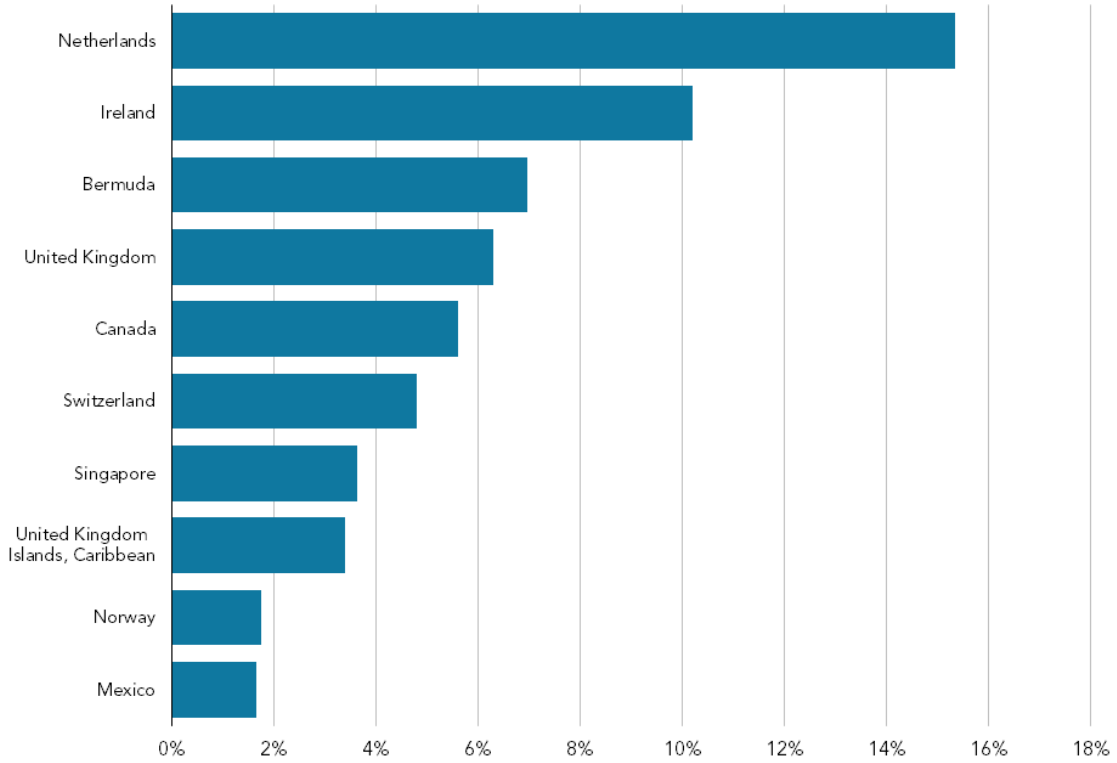
Multinationals can reduce their taxable income further through debt-equity swaps that strip profits from higher-tax countries where production facilities are located. US laws make it easier for US firms to strip profits from high-tax foreign countries than from the United States, which creates an incentive for firms to locate production facilities overseas.

US multinationals book a disproportionate share of profits in low-tax locations. In 2012, US multinationals reported one-third of their overseas profits in three low-tax countries: the Netherlands, Ireland, and Bermuda (figure 1). The top ten foreign locations of their profits, including other low-tax countries such as Switzerland, Singapore, and the US Caribbean Islands, accounted for 60 percent of their non-US profits.

FIGURE 1

Top Countries for Non-US Profits of US Multinationals

Profits as a percentage of total, 2012



Source: Bureau of Economic Analysis, 2014.

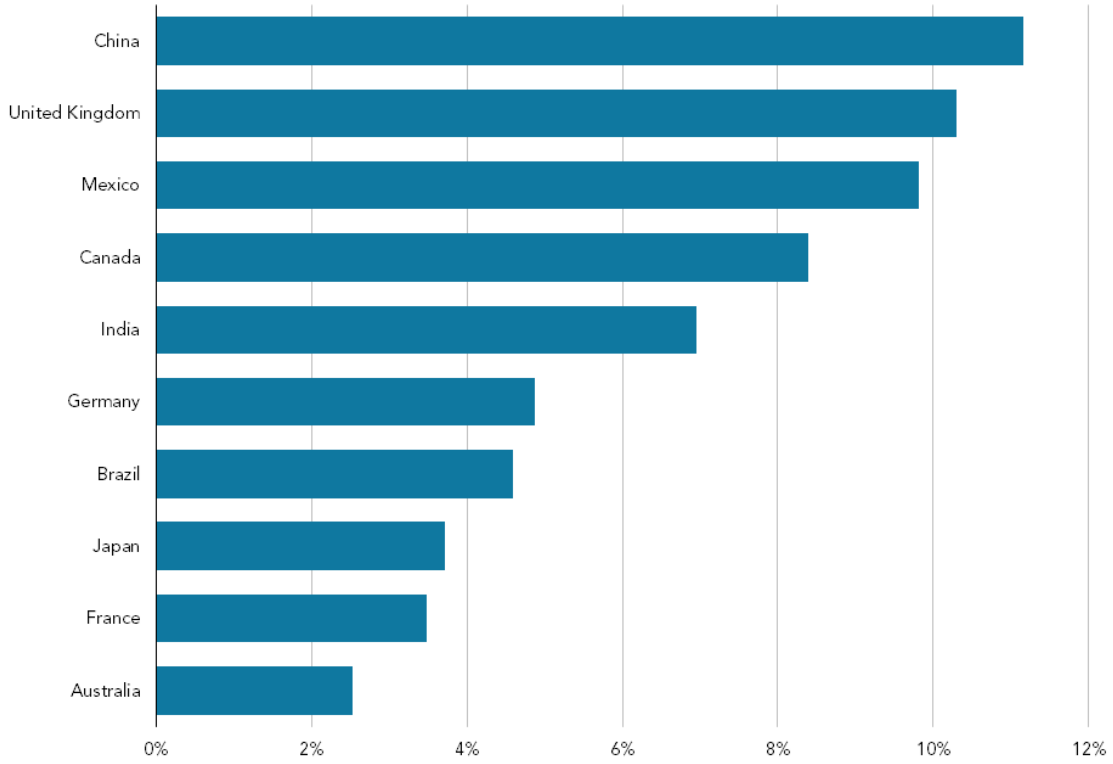
Most of the advanced industrial countries have lowered their corporate income tax rates in recent years at least in part to attract multinational businesses, while US rates have changed little. The increasing discrepancy between US and foreign rates has strengthened incentives to shift income and has reduced US tax revenue.

Despite evidence that firms shift the location of real investment in response to tax rate differences among countries, a substantial share of real activity of US multinationals remains in high-tax countries. These tend to be large economies with close economic ties to the United States (figure 2). Although their statutory rates have declined over time while the US corporate rate has remained unchanged, some of them allow less generous rules for capital recovery than the United States. As a result, their effective corporate tax rates on new investments are, on average, only slightly lower than the US rate.

FIGURE 2

Top Foreign Locations for Employment in US Multinationals

Employment as a percentage of total, 2012



Source: Bureau of Economic Analysis, 2014.

INCENTIVES TO ACCRUE CASH OVERSEAS

The combination of deferral and increased reporting of US multinationals' income in low-tax jurisdictions has led to a large buildup of overseas assets, as many firms no longer have enough foreign tax credits to offset US taxes when they repatriate foreign profits. Recent research suggests that this "lock-out" of foreign profits is equivalent to an implicit tax of between 5 and 7 percent on foreign-source income.

INCENTIVES TO INCORPORATE OVERSEAS

The current US system treats multinational enterprises whose parent companies are incorporated in the United States (US-resident multinationals) differently from those that are resident elsewhere. The United States taxes its multinationals on dividends they receive from their foreign affiliates, while our major trade partners have so-called territorial systems that exempt these dividends. In addition, US anti-abuse rules limit the ability of US-based multinationals to use debt-equity swaps to shift reported income out of the United States but do not apply similar limits to foreign-resident multinationals.

The United States bases its definition of corporate residence on place of incorporation. This definition need not be consistent with where a company's production is located, where its sales take place, where its shareholders reside, or even where its top managers live.

The benefits of foreign residence, combined with the lack of economic substance to the residence definition, have led some US-based multinationals to shift the formal incorporation of their parent companies overseas. This type of transaction ("inversion") can often be accomplished without changing the location of any real business activities.

Over the years, Congress has enacted rules to limit inversions. A company can still "re-domicile," though, by merging with a foreign-based company under certain conditions, including a requirement that the original foreign company contribute at least 20 percent of the shares of the new merged company if other conditions are not met.

A recent wave of inversion transactions, like previous waves, has generated considerable concern among US policymakers and led to proposals for additional limits on merger transactions. However, the formal residence of a corporation may be losing significance in an increasingly global economy where capital flows freely and a firm's research and development, production, and sales are often spread worldwide. The location of investment, jobs, research and development, and tax revenue matter more than the site of a multinational firm's parent company, although corporate residence does have some effect on US tax revenues and arguably may matter for research and development and other high-value activities often associated with a company's headquarters.

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