



Tax Policy Center
Urban Institute and Brookings Institution

THE TAX POLICY

BRIEFING BOOK

*A Citizens' Guide for the
2008 Election and Beyond*

INTERNATIONAL TAXATION

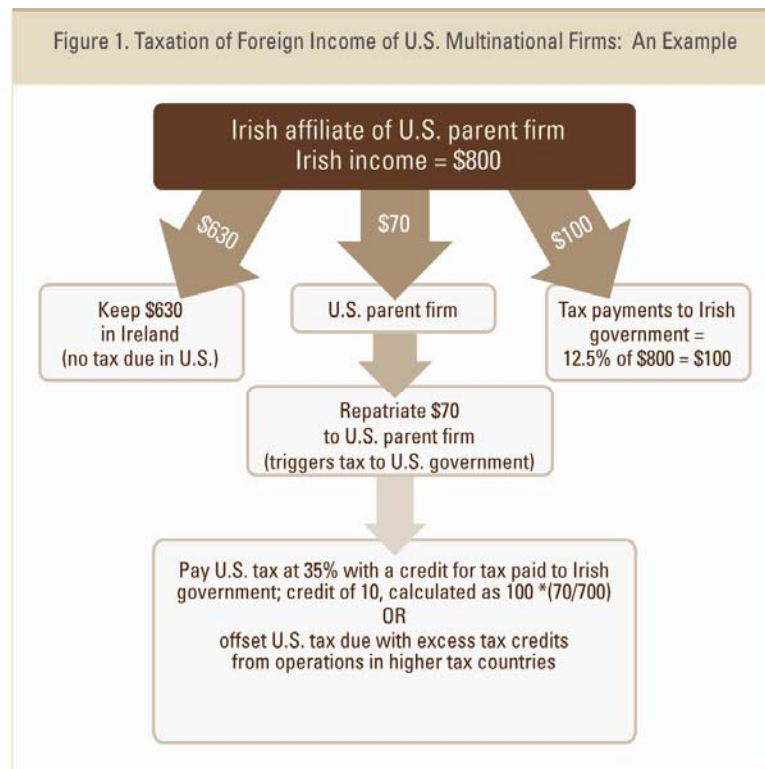
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International Taxation: How does the current system of international taxation work?

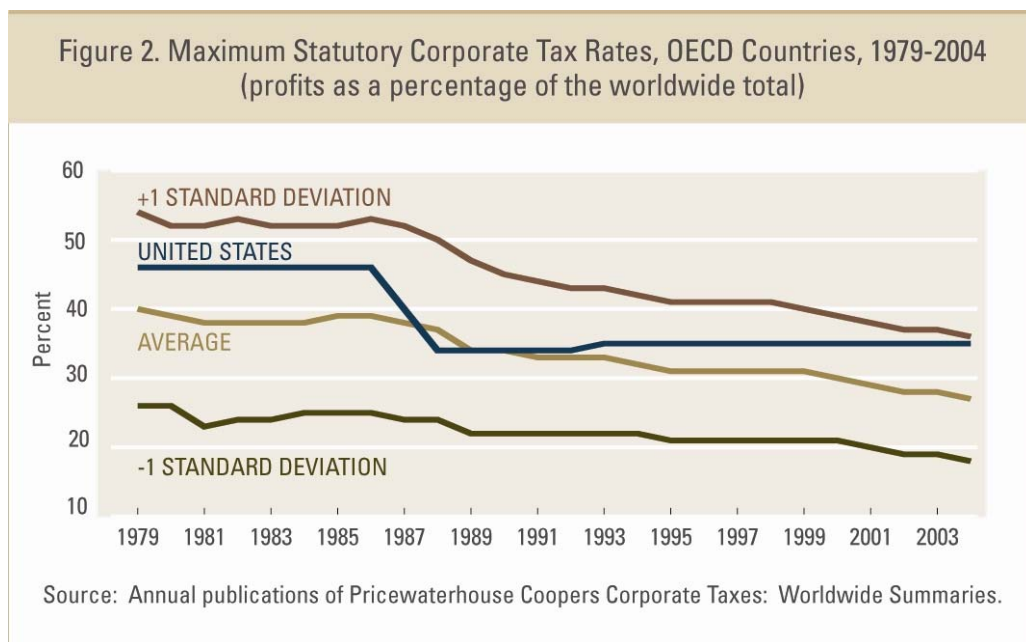
The federal government taxes U.S. resident multinational firms on their worldwide income, at the same rates as purely domestic firms. (The current maximum U.S. corporate tax rate is 35 percent.) U.S. multinationals may claim a tax credit for taxes paid to foreign governments on income earned abroad, but only up to their U.S. 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 U.S. tax due on income earned in low-tax countries.

U.S. 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 U.S.-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 U.S. 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 U.S. tax of \$18. If the firm has excess foreign tax credits from operations in high-tax countries, it can offset more, possibly all, of the U.S. tax due on its repatriated Irish profit. Meanwhile deferral allows the remaining profit (\$630) to grow abroad free of U.S. income tax until it is repatriated.

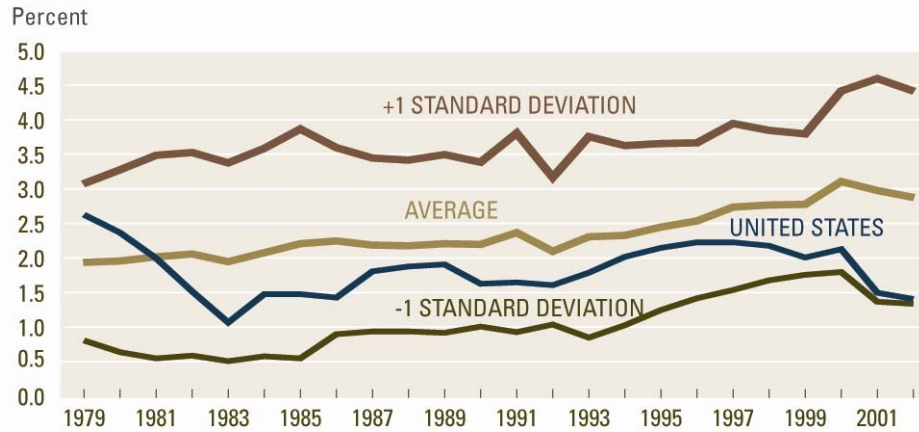


- Some countries (such as the United Kingdom and Japan) use a worldwide system with a foreign tax credit similar to the U.S. system. Others (such as France and the Netherlands) use a territorial system that exempts foreign income from taxation. Still others have hybrid systems that, for example, exempt foreign income only if the foreign country’s tax system is similar to that in the home country. In theory, such an exemption system provides an even stronger incentive than a pure worldwide system to earn income in low-tax countries, but some analysts argue that cross-crediting and deferral blur the distinction between these two systems.
- The U.S. statutory corporate tax rate has changed little since 1986. Meanwhile most other advanced industrial countries have lowered their tax rates, with the result that the U.S. rate is now substantially higher than the average tax rate among member countries of the Organization for Economic Cooperation and Development (OECD; figure 2).



- 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 lower tax rates. In the United States, revenue from the corporate income tax declined sharply in the most recent recession (2000-2002), but has since rebounded as corporate profits have surged. The U.S. share of corporate revenues in GDP remains relatively low, however, because of a narrower corporate 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 to shift reported income outside the United States to avoid the relatively high U.S. corporate tax rate.

Figure 3. Central Government Corporate Tax Revenues Relative to GDP,
OECD Countries, 1979-2002
(profits as a percentage of the worldwide total)



Source: Corporate tax revenue data are from the OECD revenue statistics. GDP data are from the World Bank's World Development Indicators database.

- The American Jobs Creation Act of 2004 replaced existing tax subsidies for exporting with new corporate tax benefits. Most prominent is the domestic production deduction, which effectively lowers the corporate tax rate by 3 percentage points on income from the domestic production activities of U.S. firms. A temporary 5.25 percent tax rate on dividend repatriations from low-tax countries provided a substantial one-year incentive to repatriate funds from such countries. Other provisions permanently reduced the taxation of foreign-source income by facilitating cross-crediting and changing the rules governing how interest expense is allocated across the countries in which a firm operates.

See Also

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Author: Kim Clausing
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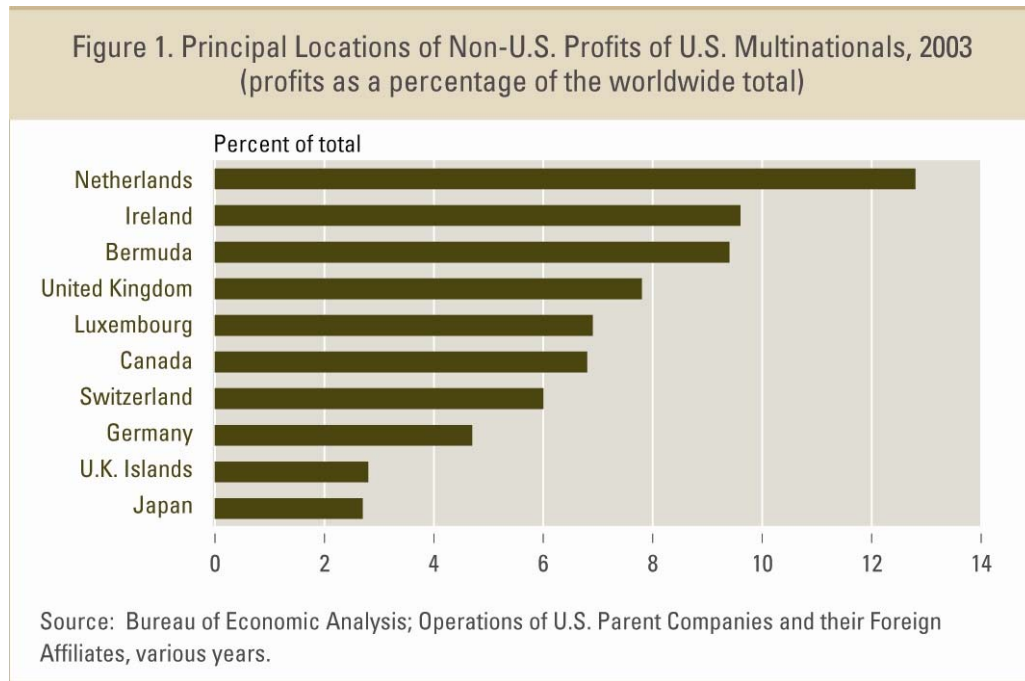
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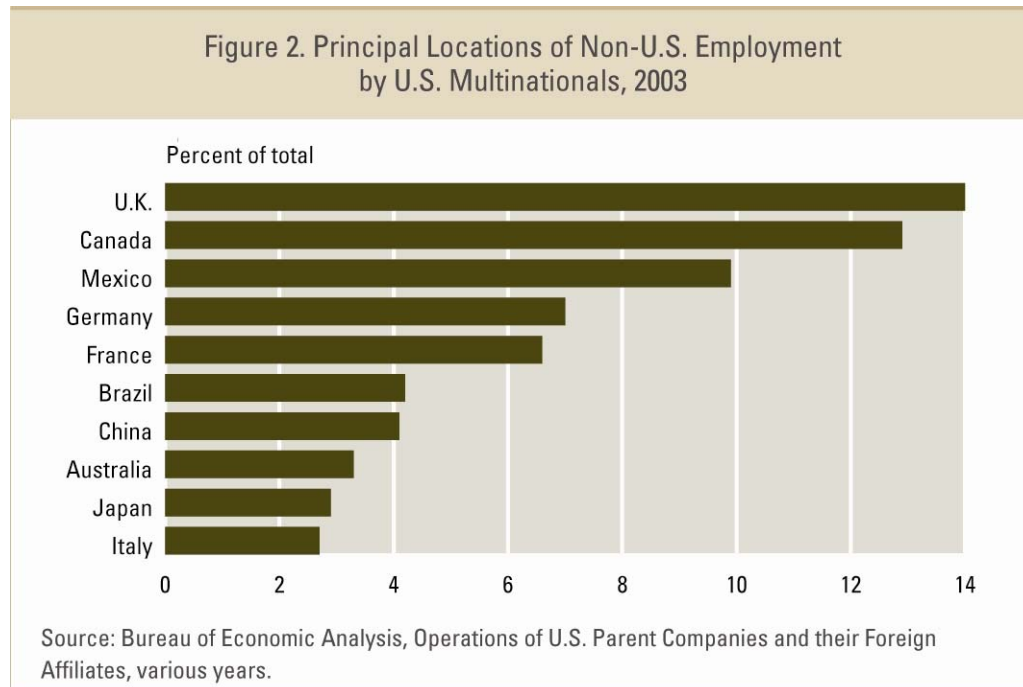
International Taxation: What are the consequences of the U.S. international tax system?

The current U.S. system of international taxation encourages U.S. multinational firms to earn and report profits in low-tax foreign countries, primarily by allowing them to defer U.S. tax on their foreign-source income until profits are repatriated. This and other incentives also encourage firms to locate physical assets, production, and jobs in such countries.

- Differences in taxation between countries give multinationals an incentive to alter their transfer prices from what a nonaffiliated customer would be charged. For example, by underpricing sales to their affiliates in low-tax countries and overpricing purchases from them, firms can shift reported profits to those countries, thus reducing their tax.
- To deal with this practice, for tax reporting purposes most governments require firms to use an "arm's length" standard, setting transfer prices equal to the prices that would prevail if the transaction were between independent entities. Yet ample room remains for firms to manipulate transfer prices, because arm's-length prices are often difficult to establish for many intermediate goods and services, including intangibles, such as patents, that are unique to the firm.
- Other provisions of U.S. tax law also encourage firms to shift profits to low-tax countries. For example, cross-crediting allows firms to use excess tax credits from operations in high-tax countries to offset tax due on repatriated profits from income earned in low-tax countries. In addition, the American Jobs Creation Act recently enacted a temporary tax break on repatriations of foreign income from low-tax countries.
- Multinational firms can shift income among their affiliates in different countries in other ways. For example, by borrowing money in high-tax countries to finance their overall operations, they can claim larger interest deductions in those countries and so report more profits in low-tax countries. The tax incentive to book profits in low-tax jurisdictions also affects decisions on the location of intangible property, the payment of royalties, and the timing of profit repatriation.
- U.S. multinational firms appear to book a disproportionate share of profits in low-tax locations. Seven of the ten countries with the largest shares of non-U.S. profits earned by U.S. multinationals in 2003 had effective tax rates under 10 percent (see figure 1). Studies have confirmed that the financial decisions of multinational firms are sensitive to international differences in corporate tax rates.



- Most of the advanced industrial countries have lowered their corporate income tax rates in recent years, while U.S. rates have changed little. The increasing discrepancy between U.S. and foreign rates has strengthened incentives to shift income and has reduced U.S. tax revenue. One study found that income shifting reduced U.S. corporate income tax revenue by approximately 35 percent in 2002.
- Despite evidence that firms shift the location of real investment in response to tax rate differences among countries, a substantial share of U.S. multinational activity remains in high-tax countries. These tend to be large economies with close economic ties to the United States (figure 2) whose effective corporate tax rates are, on average, quite similar to the U.S. rate.
- The current U.S. system treats multinational enterprises whose parent company is incorporated in the United States differently from those headquartered elsewhere. The former, but not the latter, are subject to U.S. corporate tax rules, including limitations on the foreign tax credit and deferral. This different treatment has led some U.S.-based multinationals to shift the formal incorporation of their parent company offshore without changing the location of any of their real business activities—a practice called inversion.



The formal residence of a corporation may be losing significance in an increasingly global economy where capital flows freely and a firm's R&D, production, and sales are often spread worldwide. The location of investment, jobs, R&D, and tax revenue matter more than the site of a multinational firm's headquarters

See Also

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International Taxation: What are the options for reform?

International Taxation: How would formulary apportionment work?

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International Taxation: How does the tax system impact U.S. competitiveness?

"International competitiveness" can mean many things. It can mean the ability of a domestic firm or industry to compete with foreign firms in a global marketplace, or a country's ability to maintain positive or at least sustainable balances in its international accounts, or its ability to maintain a high standard of living for its population.

There is little that U.S. international tax policy can do directly to increase U.S. international competitiveness under any of these definitions. But tax policy can increase U.S. competitiveness in a different sense, namely, that of making the United States more attractive, relative to other countries, as a site for new investment, new production, and new jobs. Does the tax system make the United States a good place for multinational firms to earn profits? Does it place firms headquartered in the United States at an advantage relative to those headquartered in other countries?

Today the answer to both questions is no. The current U.S. tax system actually encourages U.S. multinationals to locate assets and economic activity, and earn and realize profit, in other countries where taxes are lower. The current system also may disadvantage firms headquartered in the United States relative to those that are headquartered in countries that exempt foreign income from taxation. These undesirable consequences of the tax system may indirectly contribute to weaker U.S. competitiveness in the other senses of the term.

- Some observers maintain that the U.S. international tax system could do more to promote the health of the U.S. economy, including the level of output and jobs. National output fundamentally depends on such variables as the capital stock, the size and quality of the labor force, and the technological capabilities of the economy. The international tax system affects only the first of these factors directly and can thus affect output only by influencing the location of capital investment.
- Tax policy might enhance the domestic capital stock by favoring investment in the United States relative to investment outside the country. One way to do this would be to treat foreign tax payments by U.S.-based multinationals as a deductible expense associated with doing business abroad, rather than allow firms a tax credit for such payments as at present, and to require current taxation of foreign income in place of the present rule that taxes that income only when it is repatriated.
- Such a policy has two crucial drawbacks. First, it makes double taxation of income likely, as both the United States and the country hosting the investment might both tax the same income. From a worldwide perspective, such a policy would lead to too little foreign investment, because investments abroad would be tax disadvantaged. Second, such treatment would amount to a beggar-thy-neighbor tax policy and could encourage other governments to pursue similar policies in retaliation. This would lead to less foreign investment in the United States, further reducing both world and national welfare.
- Some economists would use international tax policy to improve the U.S. trade balance. For example, Gary Hufbauer has argued that the U.S. tax system puts U.S. goods and services at a disadvantage relative to those from countries that rely more heavily on value-added taxes (VAT). A VAT is typically charged on a country's imports, whereas its exports receive VAT rebates. That suggests that U.S. adoption of a VAT system might encourage exports relative to imports, thus improving the U.S. trade balance.

- But there are offsetting considerations. The resulting growth in exports relative to imports might lead to an appreciation of the dollar, which in turn, by making exports more expensive to foreigners, might undo any export advantage the VAT creates. Recent empirical research indicates that countries that rely heavily on VATs for revenue actually have lower export performance than other countries.
- Persistent U.S. trade deficits make tax solutions seem attractive, but neither border tax adjustments, nor a move to a VAT, nor export tax incentives will likely affect the U.S. trade balance, which stems ultimately from a shortfall of national saving. If the U.S. is borrowing money from foreigners to cover government deficits and an excess of domestic investment over domestic saving, then as a mathematical identity it must be using these funds to import more than it exports. Reducing the federal budget deficit would increase national saving directly and thus be a more effective solution to the trade deficit than attempting to subsidize exports or tax imports.
- Concerns about the competitiveness of U.S. multinational firms often derive from the assumption that these firms generate external, or spillover, benefits for the economy where they are headquartered. For example, the knowledge created by the R&D that these firms conduct (typically at headquarters) often gets diffused to other domestic producers, boosting their competitiveness. If such benefits matter, U.S. international tax policy should favor foreign income, to make sure that U.S.-based multinational firms are not at a disadvantage relative to competitors in other countries that tax foreign income more lightly or not at all. Exempting foreign income from U.S. taxes could promote this goal, but it would work against the optimal location of world investment, causing too much capital to locate in low-tax countries.
- Although the promise of beneficial spillovers from R&D and other headquarters activities is a strong argument for using the tax code to promote them, lower taxes on such activities might lead to a shortchanging of other activities in the economy (such as education, health, and infrastructure) that also provide beneficial external effects. More direct incentives, such as subsidies for R&D, might better encourage the desired spillovers.
- In any case, the effective tax burden on the foreign income of U.S. multinational firms is currently small and is likely to have little impact on the competitiveness of U.S. firms. One study found that the effective U.S. tax rate on active foreign income in 1990 was quite low, approximately 2.7 percent, and less under certain assumptions.

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Author: Kimberly Clausing

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International Taxation: How would formulary apportionment work?

Under the current U.S. system of international taxation, U.S. resident multinational firms must determine their profits separately in each tax jurisdiction in which they operate. A system of formulary apportionment would replace this separate accounting method with a formula that allocates a multinational firm's worldwide income across countries. The formula would reflect the distribution of the firm's worldwide economic activity, as measured by some combination of sales, payroll, and capital stock. The firm would then pay U.S. taxes only on the share of world income that is allocated to the United States.

Moving to formulary apportionment would address many problems of the current U.S. system. It would dramatically reduce incentives to shift economic activity or income to low-tax countries, it would treat similar firms similarly regardless of where they are incorporated, and it would eliminate much administrative complexity. But because it would have major effects on virtually all multinational firms, any shift to formulary apportionment should occur in cooperation with other countries.

- Under formulary apportionment, the U.S. tax base for a multinational firm would equal a formula-based fraction of the firm's worldwide income. The fraction could be an average of U.S. shares of the firm's worldwide sales, assets, and payroll, or it could be simply the fraction of worldwide sales destined for U.S. customers. Reuven Avi-Yonah and Kimberly Clausing have proposed one such system.
- Formulary apportionment is similar to the method that U.S. states already use to allocate national income across states. The state system was motivated by the widespread perception that states are so highly integrated economically that it is impractical to try to determine how much of a firm's income is earned in one state and how much in another. Similarly, in an increasingly globalized world economy, it is ever more difficult to assign profits to individual countries, and attempts to do so are fraught with opportunities for tax avoidance.
- Formulary apportionment would remove the current artificial incentives to shift reported income to low-tax locations, because it would base firms' tax liabilities on a measure or measures of their real economic activity in each location. These measures are far more difficult to manipulate for tax purposes than the location of income.
- The United States and other high-tax countries would gain substantial revenue under formulary apportionment, because under the current system firms' shares of real economic activity in such countries typically exceed the shares of income they report as originating there. The move to formulary apportionment could be made revenue neutral by substantially reducing the corporate tax rate.
- Because it would make an operation's tax liability independent of both its legal residence and its legal form (for example, branch or subsidiary), formulary apportionment would also remove any incentive for corporate inversion.
- Formulary apportionment would reduce the tax system's complexity and the administrative burden it imposes on firms. Firms would no longer have to allocate income or expenses across countries, or worry about subpart F and the foreign tax credit (because there would be no deferral and no U.S. taxation of foreign-source income), or cope with cumbersome transfer pricing regimes.

- A U.S. shift to formulary apportionment could result in double taxation (or exemption of some income in both the U.S. and overseas) if other countries do not adopt similar schemes. However, other countries might well choose to follow a U.S. lead for two reasons. First, the European Union is already considering a move to formulary apportionment, and joint leadership by the United States and the European Union could spur still broader cooperation. Second, a multinational firm operating both in countries with and in countries without formulary apportionment would have an incentive to shift reported income to the former, because their tax liability in such countries would no longer depend on the income reported there. The consequent loss of tax revenue in the nonadopting countries would give them a strong incentive to adopt formulary apportionment.
- The transition to and some permanent aspects of formulary apportionment could prove complicated. Potential problems include defining the unitary business, determining the appropriate apportionment formula, insulating against possible behavioral responses to the chosen formula weights, creating common accounting standards (or reconciling differences between standards), and handling international tax treaty issues.

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Author: Kimberly Clausing
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International Taxation: What are the options for reform?

The current U.S. system of international taxation has four significant flaws: it provides artificial tax incentives for firms to locate real economic activity and report profits in low-tax countries; it places U.S.-headquartered firms at a competitive disadvantage; it is unworkably complex; and it raises relatively little revenue, even though the U.S. corporate tax rate exceeds that in most other advanced industrial countries.

Two proposed (and mutually exclusive) changes might improve the situation: the first would eliminate deferral of U.S. taxation on the foreign income of U.S.-based multinational firms, and the second would replace the current tax system with a territorial system that exempts foreign income from taxation altogether. A third option, formulary apportionment, would involve a more fundamental reform and is discussed in a separate brief.

- Eliminating deferral of U.S. taxation on unrepatriated income would substantially reduce the incentive to earn income in or shift profits to low-tax countries and would thus increase revenue. Presidential candidate John Kerry proposed a similar, but partial, change in 2004.
- Eliminating deferral could, however, reduce the international competitiveness of U.S.-based multinationals by increasing their tax disadvantage in low-tax markets relative to firms based in other countries. U.S. firms would face a greater incentive than under current law to shift their residence overseas, although Congress could try to discourage such inversions through legislative action. Competitiveness concerns could be allayed by combining elimination of deferral with a large, revenue-neutral reduction in the U.S. corporate income tax rate.
- Roseanne Altshuler and Harry Grubert have proposed a "burden-neutral worldwide taxation" plan that would tax all foreign income currently, would require no allocation of expenses to foreign income, and would lower the U.S. corporate tax rate to maintain the current overall tax burden on foreign income. This system would effectively end deferral for U.S. resident multinationals and thus dramatically reduce incentives to shift income.
- Altshuler and Grubert estimate that the U.S. corporate tax rate on foreign income would have to be cut to 28 percent (the top rate is now 35 percent) for their proposal to be burden neutral. This, however, is a "static" estimate that does not account for behavioral responses, such as changes in income shifting behavior or reduced incentives for firms to lower their foreign tax liability.
- The proposal would not completely eliminate incentives for foreign-based multinationals to shift income, and U.S. multinationals would still have an incentive to change the location of corporate ownership through inversions. In addition, U.S. multinational firms with excess foreign tax credits would still benefit from income shifting.
- A territorial system would exempt the foreign income of U.S. multinational firms from taxation. Such a system would likely enhance the competitiveness of U.S. firms in low-tax countries, potentially increasing the external benefits associated with multinationals' activity in the United States.
- The most important argument against a territorial system is that, by exempting foreign income, it would reinforce an already strong tax incentive to locate both economic activity and profits in

low-tax countries. Such tax-motivated changes in behavior are generally economically inefficient and could further erode the U.S. corporate income tax base.

- Depending on its design, a territorial system could bring in less tax revenue than the existing system. One recent study found evidence that, among industrial countries, those with territorial systems raise less corporate income tax revenue than countries with a tax credit system, all else equal. Harry Grubert and John Mutti have suggested that revenue could increase, however, if taxes are raised on interest and royalty income from abroad and interest allocation rules are changed.
- A territorial system could simplify taxation of international income, because exempting foreign income from taxation would reduce the need for tax planning regarding foreign income repatriation. However, firms under the new system would still have to distinguish between foreign and domestic income, identify passive income, and appropriately allocate expenses to their operations in different countries. In addition, stronger incentives to shift income would exert even greater pressure on existing transfer pricing rules.

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