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Removing Tax Subsidies for Foreign Investment

By James Kvaal

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This paper was prepared for the Options for Tax Reform conference held at the Center for American Progress in March. The full-day conference provided a forum for sharing proposals — both quick fixes and broad overhaul — and for open and engaged discussion. For more information on the conference, go to http://www.americanprogress.org.

The American tax code encourages American multinational corporations to invest 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. Multinationals can not only escape U.S. taxes, but the U.S. may actually pay them to invest offshore.

Tax benefits for foreign investment include credits for foreign taxes paid and the ability to indefinitely defer U.S. tax on foreign profits. In some cases, multinationals can deduct the costs of foreign investments without paying taxes on the resulting income. Foreign tax credits can spill over to shield U.S. business activity from U.S. taxation. Finally, multinationals can use aggressive accounting to shift income from the U.S. 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. No U.S. taxation is necessary to prevent tax disparities. 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. tax code should minimize the economic distortions caused by unequal tax rates, rather than exacerbating them through additional tax benefits for foreign investment.

One solution — 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 and could not be deferred. 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.

A partial exemption 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 hurt their competitiveness. However, subsidizing foreign subsidiaries of multinational corporations creates economic distortions and puts domestic companies at a competitive disadvantage. Treating foreign and domestic income identically would strengthen the U.S. economy as a whole.

The Problem of Tax Competition

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.[1]

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.[2] Based upon a review of the U.S. literature, James Hines suggests that a one percent increase in taxes reduces inbound foreign investment by 0.6 percent.[3] 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.''[4]

Second, incentives to invest overseas could reduce the amount of capital available in the U.S. A loss of capital would reduce wages of American workers and increase

[1]Congressional Budget Office, *Corporate Income Tax Rates: International Comparisons*, November 2005, at 6.

[2]U.S. Department of the Treasury, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations*, December 2000, at 178.

[3]James R. Hines Jr., ''Lessons from Behavioral Responses to International Taxation,'' *National Tax Journal*, June 1999, at 305-322. *See also* Harry Grubert and John Mutti, ''Do Taxes Influence Where U.S. Corporations Invest?'' *National Tax Journal*, December 2000, at 835 (''Host country average effective tax rates appear to have a highly significant effect on the location and investment decisions of U.S. manufacturing companies'').

[4]Hines, *supra* note 3, at 318.

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Ireland: Winning at Tax Competition, With Help From the U.S. Tax Code

Ireland vividly demonstrates 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 claim to earn in Ireland were probably earned elsewhere, according to Martin Sullivan.[a] In other words, each dollar of profit earned in Ireland allows companies to pay lower taxes on three additional dollars earned elsewhere. The resulting tax savings is equivalent to the U.S. subsidizing companies investing in Ireland by more than $1.9 billion a year.[b]

Microsoft is one company that has aggressively exploited these loopholes. Its four-year-old Irish subsidiary claimed $9 billion in licensing fees in 2004, helping Microsoft save at least $500 million in U.S. taxes.[c]

[a]Martin A. Sullivan, "The IRS Multibillion-Dollar Subsidy for Ireland," *Tax Notes*, July 18, 2005, at 287.
[b]Sullivan, *supra* note a.
[c]*Wall Street Journal*, "Irish Subsidiary Lets Microsoft Slash Taxes in US and Europe," Nov. 7, 2005, at A1.

the return to capital.[5] Lower wages would be particularly problematic at a time when, like now, real wages are stagnant or falling for most workers.[6]

Third, tax disparities could erode the American 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.[7] As a result, they will report less income to the IRS and pay fewer taxes than an identical company with all its operations 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.[8] 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.[9] The aggressive use of inter-company transfers helped U.S. companies reduce their taxes by $7 billion in 2002, compared to 1997.[10]

The erosion of the tax base would force the U.S. to shift its tax burden onto less mobile sources, such as workers' wages, or to cut spending.[11] In an era of tax competition, it is not surprising that corporate tax rates in OECD countries have fallen by a third over the past two decades.[12] The result has been an increasing reliance on consumption and wage taxes, which are more regressive.[13]

How the U.S. Tax Code Subsidizes 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 5 percent,[14] well below the statutory rate of 35 percent.

Through deferral, American multinationals can postpone U.S. taxes on foreign profits indefinitely. Taxes are not due until the income is paid back to the American parent corporation as a dividend ("repatriated"). In the meantime, 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. It costs the U.S. government about $12 billion a year.[15]

Corporations cannot defer the income of foreign branches that are not separately incorporated subsidiaries. Anti-abuse rules limit deferral on investment income and business income involving related parties, although sophisticated taxpayers can often structure their transactions to avoid these rules.[16]

[5]Congressional Budget Office, *supra* note 1; Jane G. Gravelle, "Foreign Tax Provisions of The American Jobs Act Of 1996," *Tax Notes*, Aug. 26, 1996, at 1165.

[6]Jared Bernstein, "What's Wedged between Productivity, Living Standards?" *The Providence Journal Bulletin*, Feb. 26, 2006.

[7]Congressional Budget Office, *supra* note 1.

[8]Martin A. Sullivan, "Latest IRS Data Show Jump in Tax Haven Profits," *Tax Notes*, Oct. 11, 2004, at 151.

[9]James Hines, "Effects of Tax Reform on Foreign Direct Investment," Presentation at *Tax Reform in an Open Economy*, The Brookings Institution, Dec. 2, 2005.

[10]Rosanne Altshuler and Harry Grubert, "Governments and Multinational Corporations in the Race to the Bottom," *Tax Notes*, Feb. 27, 2006, at 979.

[11]Reuven S. Avi-Yonah, "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare States," *Harvard Law Review*, May 2000, at 1577-1578.

[12]Congressional Budget Office, *supra* note 1, at xi. The 30 nations that are members of the OECD are all democracies with market economies.

[13]Avi-Yonah, *supra* note 11, at 1577.

[14]Harry Grubert and John Mutti, *Taxing International Business Income: Dividend Exemption versus the Current System*, 2001, at 2.

[15]Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2007*, at 287.

[16]For further discussion of the Subpart F and passive investment company rules, see U.S. Department of the Treasury, *supra*

(Footnote continued on next page.)

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The second major exception is the foreign tax credit, which reimburses multinationals for taxes paid to foreign governments. The foreign tax credit prevents 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.[17]

The foreign tax credit is limited to the amount of U.S. tax that would otherwise be imposed to prevent highly taxed foreign income from shielding other income from U.S. taxes. However, as discussed below, these limits often fail to achieve their objective.

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. However, deferral departs from economic efficiency 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 for foreign investment may be larger than the tax itself, 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 5 percent) in U.S. taxes on non-financial income they repatriated in 1996.[18] 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.[19] 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.

Total (U.S. and foreign) taxes on foreign income are often substantially lower than taxes on U.S. income. American multinationals have an incentive to move income-generating activities into 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 any foreign profits overseas. Not surprisingly, corporations rarely pay this voluntary tax. Only about 7 percent of all income earned in low-tax countries was returned to the U.S. in 1992.[20] U.S. companies in low-tax countries almost never return capital to the U.S. in their first 15 years.[21] 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.[22]

To encourage corporations to repatriate foreign profits, Congress enacted a tax holiday in 2004, temporarily cutting the tax rate from 35 percent to 5.25 percent. Multinationals have responded by bringing home foreign profits, but they are expected to resume stockpiling cash overseas as soon as the holiday is over.[23] The law was mocked for its other provisions — including bizarre corporate giveaways to dog tracks, cruise ships, and bow-and-arrow makers[24] — 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, "[T]he 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."[25]

By one estimate, a typical investment in a country that charges only 7 percent in taxes faces a total (U.S. and foreign) tax of only 5 percent.[26] The U.S. tax rate on these investments is -2 percent.

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note 2; Stephen E. Shay, "Exploring Alternatives to Subpart F," *Taxes*, March 2004; and J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay, "Deferral: Consider Ending it, Instead of Expanding It," *Tax Notes*, Feb. 7, 2000, at 837.

[17]Scott Luttrell, "Corporate Foreign Tax Credit, 2001," *Statistics of Income Bulletin*, Fall 2005, at 183.

[18]Grubert and Mutti, *supra* note 14.

[19]U.S. Department of the Treasury, *supra* note 2, at x.

[20]Grubert and Mutti, *supra* note 14, at 4.

[21]Grubert and Mutti, *supra* note 14, at 30.

[22]David Brumbaugh, *Tax Exemption for Repatriated Foreign Earnings*, Congressional Research Service, Oct. 22, 2003.

[23]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*, Sept. 20, 2004, at 1393; *New York Times*, "Drug Makers Reap Benefits of Tax Break," May 8, 2005, at A11.

[24]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," Oct. 15, 2004, at C1.

[25]U.S. Department of the Treasury, *supra* note 2, at 45.

[26]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.

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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.[27] Harry Grubert and John Mutti estimated that their territorial proposal would raise as much as $8 billion a year.[28]

There are several important sources of negative tax rates, including expense allocation, the cross-crediting of foreign tax credits, and transfer pricing.

A. Expense Allocation

Foreign investment creates expenses that multinationals can deduct against their U.S. taxes, such as interest, administrative overhead, and research and development. In principle, these expenses should only be deductible if they are related to taxable income. In practice, however, corporations can often avoid U.S. taxes on the resulting foreign income. The result is a negative tax: the foreign investment generates tax deductions but no tax liability.

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 by leaving it overseas. As the Joint Committee on Taxation put it, "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."[29]

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.[30] The result is to reduce eligibility for foreign tax credits and increase U.S. tax liability. However, the provision only affects multinationals bumping up against credit limits, a group that is already a minority[31] and is likely to shrink under new rules that allow corporations to carry unused credits forward for 10 years.

B. Cross-Crediting of Foreign Tax Credits

Foreign tax credits reimburse multinationals for the foreign taxes they pay, preventing double taxation. However, the credits can not only eliminate all U.S. taxes on an item of foreign income, but also be cross-credited to reduce U.S. taxes on completely separate income. Through cross-crediting, foreign profits generate a net reduction in U.S. taxes.

Investments in high-tax foreign countries generate excess foreign tax credits beyond what is necessary to eliminate all U.S. taxes on the resulting profits. For example, suppose a corporation earns $100 of foreign income and pays $50 in foreign taxes. 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 generate extra credits by exploiting "check the box" rules to claim foreign tax credits without recognizing foreign income for U.S. taxes.[32]

Once a multinational has excess credits, it can often use them to reduce U.S. taxes on other income. For example, it could invest in a low-tax country, paying little in foreign taxes while also using its excess credits to avoid most or all U.S. taxes.

Excess credits can even prevent U.S. taxes on income that is essentially earned within the U.S.[33] First, multinationals can move American-developed intellectual property offshore, pay royalties from the U.S. parent corporation to its foreign subsidiary, and use the excess credits to shield the foreign royalty income from U.S. taxes. Second, multinationals can also use the credits for half of income from exports produced in the U.S., even if no other country taxes that income. This rule costs about $2 billion a year alone.[34]

There are constraints on 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. However, starting next year, the number of baskets will be reduced to two — active income and passive income — allowing savvy multinationals to avoid nearly all U.S. taxes on foreign income through unlimited cross-crediting.[35]

C. Transfer Pricing

U.S. multinationals can stretch the accounting for their foreign subsidiaries to reduce reported U.S. income. When exchanging goods and services internally, they 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. Shifting profits into a low-tax foreign country increases the amount of income taxed at the low foreign rate, reducing the multinational's overall taxes.

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[27]Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, Jan. 27, 2005, at 186-197, 427.

[28]Grubert and Mutti, *supra* note 14, at 38.

[29]Joint Committee on Taxation, *supra* note 27, at 188.

[30]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.

[31]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 14, at 30.

[32]See *Guardian Industries Corp. v. United States*, 65 Fed. Cl. 50 (Mar. 31, 2005); American Bar Association Section of Taxation, "Report of the Task Force on International Tax Reform," forthcoming in *The Tax Lawyer*, Spring 2006.

[33]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 June 4, 2006).

[34]Office of Management and Budget, *supra* note 15.

[35]Robert J. Peroni, J. Clifton Fleming Jr., and Stephen E. Shay, "Reform and Simplification of the U.S. Foreign Tax Credit Rules," *Tax Notes*, Oct. 6, 2003, at 109.

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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 IRS 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 is very difficult to enforce.[36] 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.''[37]

A Better Way: A Partial Exemption System

American corporations should pay a similar tax rate, no matter where in the world they invest. Taxing all income at a reasonable rate would reduce investment distortions, incentives for corporations to shift investment overseas, and opportunities for aggressive tax planning. There is a simple way to get there: a system that exempts foreign income earned in countries with comparable tax systems but fully taxes income subject to low or no foreign taxes.

Under a partial exemption system, 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 countries with tax rates below 28 percent would be subject to full U.S. taxes without deferral. As under current law, multinationals could 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. The Joint Committee on Taxation's territorial proposal would raise $5 billion a year, and Senator John Kerry's proposal to end deferral would generate $12 billion a year.[38] The resulting resources could be invested in initiatives to improve the competitiveness and productivity of American workers, such as education, research, and technology.

Under President George H.W. Bush, the U.S. Treasury suggested a partial exemption system.[39] The Treasury proposal exempted business income earned in a ''designated jurisdiction'' from U.S. taxes. However, multinationals would have to pay taxes on all other business income as well as interest, rent, and royalties. They could continue to claim foreign tax credits, but not defer U.S. taxes. More recently, David Rosenbloom proposed an exemption only for income earned in jurisdictions with ''formal and serious'' tax systems.[40]

Other nations have similar provisions. For example, France generally does not tax foreign income unless it is subject to foreign taxes below half of the French rate.[41] Japanese multinationals cannot defer taxes on the income of foreign subsidiaries subject to foreign taxes below 25 percent, subject to certain exceptions.[42] 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).[43]

Advantages of a Partial Exemption System

First, a partial exemption system would reduce the tax bias in favor of overseas investment. In tax havens and other low-tax countries, U.S. taxation is necessary to reduce large tax disparities. Taxing income earned in low-tax countries, just as if it had been earned domestically, would greatly reduce incentives to shift investment to low-income countries.

In countries with comparable tax systems, an exemption would accomplish our goals more easily and efficiently. U.S. corporate tax rates are close to the G-7 average.[44] As a result, foreign tax credits shield income from these countries from foreign taxes anyway.

Moreover, highly taxed foreign income would no longer generate excess foreign tax credits. Fewer excess credits would be available to shelter other foreign income from U.S. taxes. Some cross-crediting may still occur if highly taxed income is nonetheless classified as taxable or through high withholding taxes on passive income. However, the situation would be greatly improved.

Second, a partial exemption would eliminate the barrier to reinvesting foreign profits in the U.S. Foreign income would no longer be subject to additional tax when repatriated. Unlike the tax holiday recently enacted by Congress, the proposal solves the problem without giving more benefits to corporations investing overseas.

Third, the proposal would take a first step to address tax competition. Currently, countries have incentives to cut corporate taxes below their neighbors' rates to attract foreign investment. The resulting race to the bottom undermines countries' sovereignty by impeding their

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[36]American Bar Association Section of Taxation, *supra* note 32; Martin A. Sullivan, ''Democratic Senators Eye Offshore Profits,'' *Tax Notes*, Feb. 6, 2006, at 590; Lee A. Sheppard, ''Draft Senate Finance Report Shows Incompetent IRS,'' *Tax Notes Today*, June 22, 2005, at 119.

[37]Lee A. Sheppard, ''News Analysis: A Look at the Tax Reform Plan's International Provisions,'' *Tax Notes*, Nov. 21, 2005, at 1002.

[38]Joint Committee on Taxation, *supra* note 27, at 186-197, 427; John Kerry for President, ''Fact Sheet on John Kerry's Plan to Create 10 Million Jobs,'' Mar. 26, 2004, *available at* http://releases.usnewswire.com/GetRelease.asp?id=28000 (last visited June 4, 2006).

[39]U.S. Department of the Treasury, ''International Tax Reform: An Interim Report,'' Reprinted in *Tax Notes*, Jan. 15, 1993, at 15.

[40]H. David Rosenbloom, ''From the Bottom Up: Taxing the Income of Foreign Controlled Corporations,'' *Brooklyn Journal of International Law*, 2001, at 1525.

[41]Ambroise Bricet, ''French Finance Act Contains Major Corporate Tax Changes,'' *Tax Notes International*, Jan. 24, 2005, at 292.

[42]Ernst & Young, *Worldwide Corporate Tax Guide*, January 2005, at 451-457; Japanese Ministry of Finance, Tax Bureau, *An Outline of Japanese Taxes 2005*, December 2005, at 121.

[43]H. David Rosenbloom, Testimony before the U.S. Senate Committee on Finance, July 15, 2003, at 5.

[44]Congressional Budget Office, *supra* note 1.

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ability to fairly tax corporate income. Instead, they must shift the tax burden 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. Countries that wish to attract U.S. investment would have an incentive to adopt the lowest rate deemed comparable to 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, reducing taxes on U.S. multinationals from 35 percent (the U.S. rate that would apply without an exemption) to 28 percent (the foreign rate that would apply with an exemption).

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 poor tools for protecting 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 American rate of 35 percent, but it could no longer claim the Irish rate of 12.5 percent or the Bermudan rate of zero percent.

No tax regime in the real world is 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. The U.S. has negotiated 56 bilateral income tax treaties defining what taxes are owed each country on trade and investment income, covering the vast majority of foreign trade and investment of U.S. companies.[45]

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, treatment of depreciation and interest expense, effectiveness of tax collection, 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 as necessary.

The proposal categorizes countries rather than examining effective tax rates on each item of income. Comparing effective tax rates would require taxpayers to calculate taxes under two sets of rules, increasing uncertainty and compliance burdens. Both the Treasury Department and Rosenbloom also recommend categorizing countries rather than examining the actual tax levied.[46]

The U.S. would continue to tax 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. Investment income would also be taxable, except when earned by a business like 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. Since the corporate form is elective and without economic significance, it should not have tax consequences. Corporations owning small shares in foreign corporations, like individual American shareholders, would not be eligible for the exemption.

The foreign tax credit on income from low-tax countries would avoid double taxation. Although Rosenbloom suggests allowing only deductions for foreign taxes,[47] such a step would distort investment by subjecting U.S. multinationals to higher taxes on foreign income than on domestic income.

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, would be cumbersome. A third possibility is to assess a one-time tax — say, half the regular 35 percent rate — on all earnings currently held overseas.

Competitiveness Concerns

Multinational corporations may argue that raising taxes on foreign income would reduce their competitiveness. They would pay higher taxes in some markets than their foreign competitors. For example, they would pay the U.S. rate of 35 percent on their Irish profits while their Irish competitors would pay only 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,[48] the standard view has long been that countries should tax all income the same, no matter where in the world it is earned. As the Treasury Department concluded, ''A policy that enhances the

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[45]Barbara Angus, ''Pending Income Tax Agreements,'' Testimony before the Senate Committee on Foreign Relations, Mar. 5, 2003.

[46]U.S. Department of the Treasury, *supra* note 39; H. David Rosenbloom, *supra* note 40.

[47]H. David Rosenbloom, *supra* note 40, at 1548-1549.

[48]James R. Hines Jr. and Mihir A. Desai, ''Old Rules and New Realities: Corporate Tax Policy in a Global Setting,'' October 2004, *available at* http://ssrn.com/abstract=606222 (last visited June 4, 2006).

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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 subnational taxes.

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.''[49]

Our corporations' continuing success in world markets does not depend upon any particular feature of the tax code. The U.S. is widely recognized as one of the most competitive nations in the world.[50] 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.[51] U.S. companies constitute 176 of the largest 500 companies in the world and 313 of the largest 1,000 manufacturers.[52]

Even if one accepts the competitiveness argument, reform is still needed to remove negative tax rates. There is no economic justification for large tax benefits that favor U.S. multinationals over their foreign competitors, but only if they invest outside America.

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. Again, however, the location of corporations depends on many factors other than the ability to exploit tax havens. The U.S. can invest in its productivity and competitiveness in many ways to attract and support successful businesses without subsidizing 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.[53] 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 all foreign business income from taxation.[54] During his presidential campaign, Senator John Kerry proposed ending deferral and taxing all foreign income immediately.[55] 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

[49]U.S. Department of the Treasury, *supra* note 2, at 56.
[50]U.S. Department of the Treasury, *supra* note 2, at 56.
[51]Congressional Budget Office, *supra* note 1.

[52]*Fortune Magazine*, ''The Global 500,'' Apr. 18, 2005; IndustryWeek, ''IW 1000: A Toast to 10 Years,'' June 1, 2005.
[53]*New York Times*, ''Former I.R.S. Chiefs Back Tax Haven Crackdown,'' June 9, 2001; *Financial Times*, ''Tax Haven Shelters Hold Out Against Reforms,'' Jan. 5, 2006.
[54]The President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, November 2005. The Advisory Panel also proposed a plan similar to a consumption tax, with a limited business tax, that is not discussed here on the assumption that it is unlikely to be enacted. Others recently proposing a territorial system include the Joint Committee on Taxation, *supra* note 27, at 186-197; Grubert and Mutti, *supra* note 14; and Michael J. Graetz and Paul W. Oosterhuis, ''Structuring an Exemption System for Foreign Income of U.S. Corporations,'' *National Tax Journal*, September 2001.
[55]John Kerry for President, *supra* note 38.

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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.[56] Research expenses would not be allocated to exempt income.[57]

Similar proposals raise an estimated $5 billion to $8 billion a year.[58] 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.[59] A new American 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.[60]

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.

Finally, a territorial system would place great pressure on rules policing the boundaries of the exemption.[61] 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 them as the main line of defense for the U.S. tax base.

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.[62]

The Kerry plan would be a substantial improvement over current law. Ending deferral would put foreign and domestic investments on more equal footing, reducing tax distortions. 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, in countries with similar tax systems, the Kerry proposal continues to rely upon foreign tax credits to prevent double taxation. The system of worldwide taxes with foreign tax credits raises revenue while creating cross-crediting opportunities that can undermine the U.S. tax base. Moreover, similar proposals have repeatedly failed to win enactment since the Kennedy Administration proposed repealing deferral more than 40 years ago. It may be time for a different approach.

Conclusion

Tax competition is a threat to American prosperity, and the problem is exacerbated by our tax code. Foreign countries attract U.S. investment by undercutting American tax rates, and the U.S. imposes little or no tax on the resulting income. In some cases, the U.S. 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.

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[56] The President's Advisory Panel, *supra* note 54.

[57] Rosanne Altshuler, "International Aspects of Federal Income Tax Reform Recommendations," Presentation at *Tax Reform in an Open Economy*, the Brookings Institution, Dec. 2, 2005.

[58] Joint Committee on Taxation, *supra* note 27, at 186-197; Grubert and Mutti, *supra* note 14.

[59] Gravelle, *supra* note 5; J. Clifton Fleming and Robert J. Peroni, "Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System," *Tax Notes*, Dec. 19, 2005, at 1557.

[60] Joint Committee on Taxation, *The U.S. International Tax Rules: Background and Selected Issues Related to the Competitiveness of U.S. Businesses Abroad*, July 14, 2003, at 6-7.

[61] Fleming and Peroni, *supra* note 59, at 1557.

[62] John Kerry for President, *supra* note 38.

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