



# International Tax Policy Forum

## International Tax Seminar for Congressional Staff

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April 4, 2011

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## Introduction

- Founded in 1992, the International Tax Policy Forum ([www.ITPF.org](http://www.ITPF.org)) is an independent group of approximately 40 major multinational companies with a diverse industry representation.
- The Forum's mission is to promote research and education on the taxation of cross-border investment.
- As a matter of policy, the Forum does not take positions on legislative or regulatory proposals.
- The presenter serves as ITPF's Research Director and is a member of its Board of Academic Advisors.



## Overview

- Efficient and effective international taxation requires balance.
- It would obviously be inefficient for the government to offer large tax subsidies for earning foreign income, since doing so distorts production and erodes revenues.
- Similarly, it would be inefficient to impose large tax penalties on earning foreign income, since doing so likewise distorts production and reduces the productivity of the U.S. economy.
- An efficient policy entails balance, which is not to say that we necessarily have struck the right balance currently.
- In order to understand the consequences of current policies and possible improvements, it helps to set the economic scene.

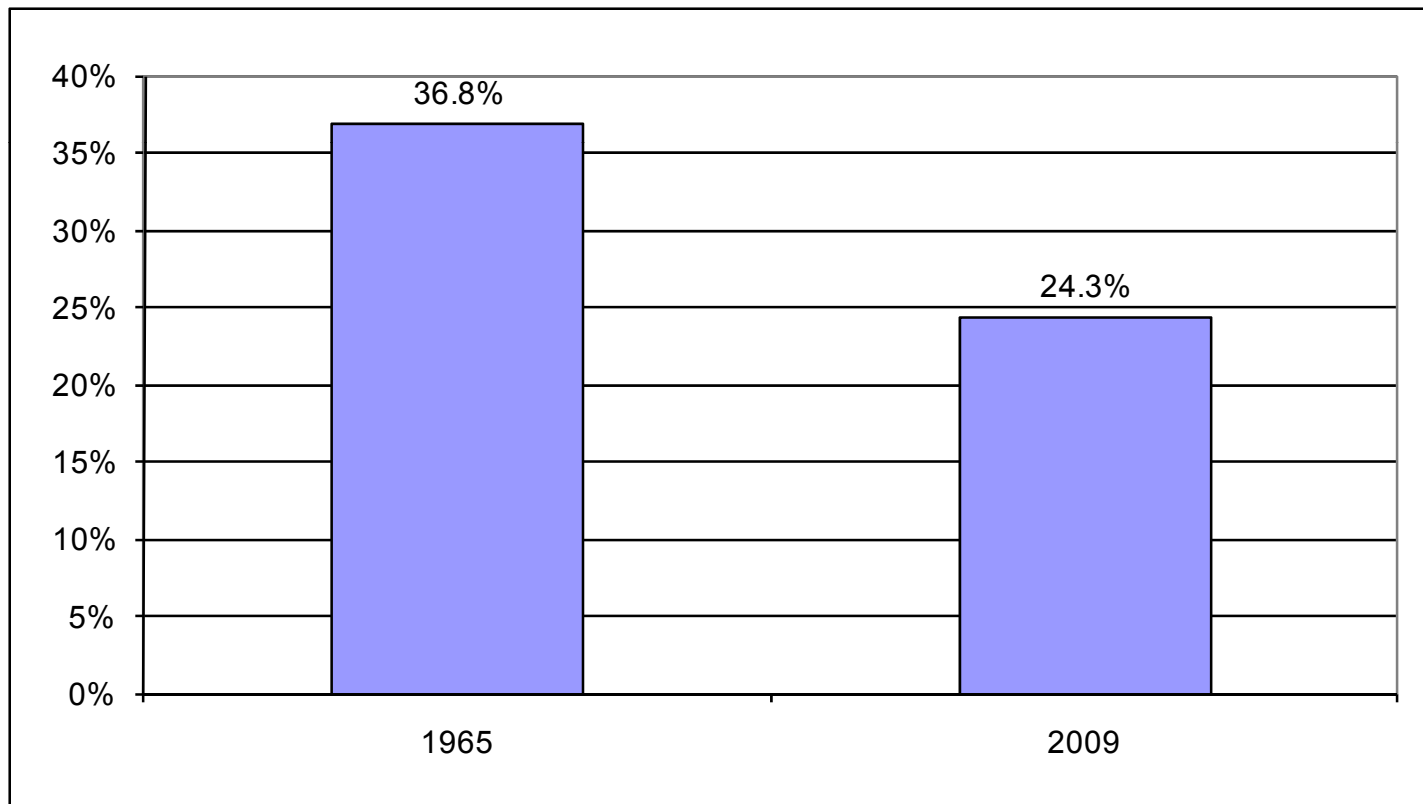




# Global Economic Trends

- U.S. share of world economy has declined over last four decades.
- This reflects rapid economic growth elsewhere.

## US GDP as a Share of World GDP



Source: World Bank, "World Development Indicators Online." (downloaded on 3/21/2011)

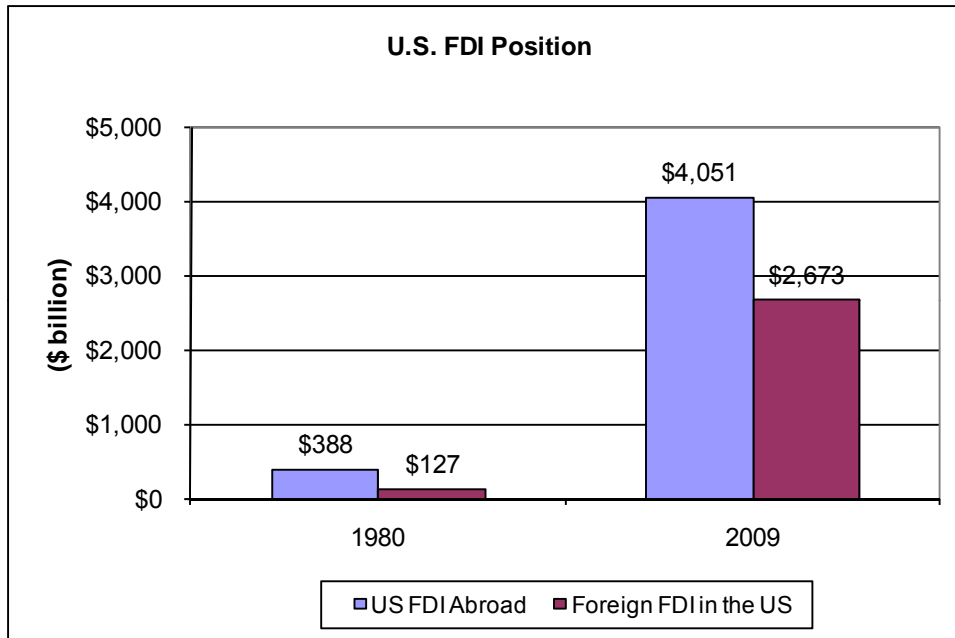
Defined as US GDP/World GDP, both in nominal US dollars

International Tax Policy Forum

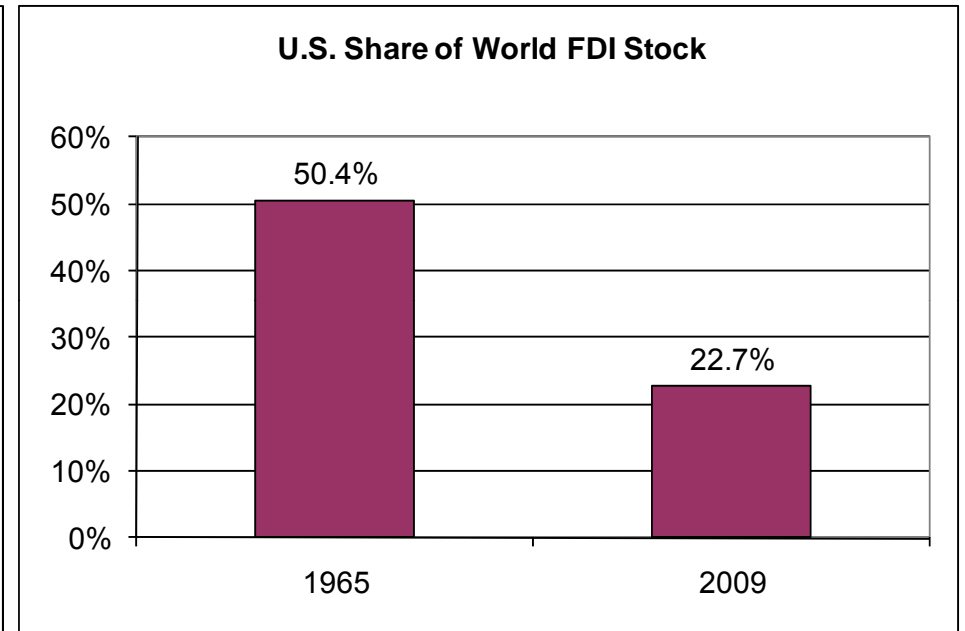


# Global Economic Trends

## US Foreign Direct



Source: Bureau of Economic Analysis, International Investment Position

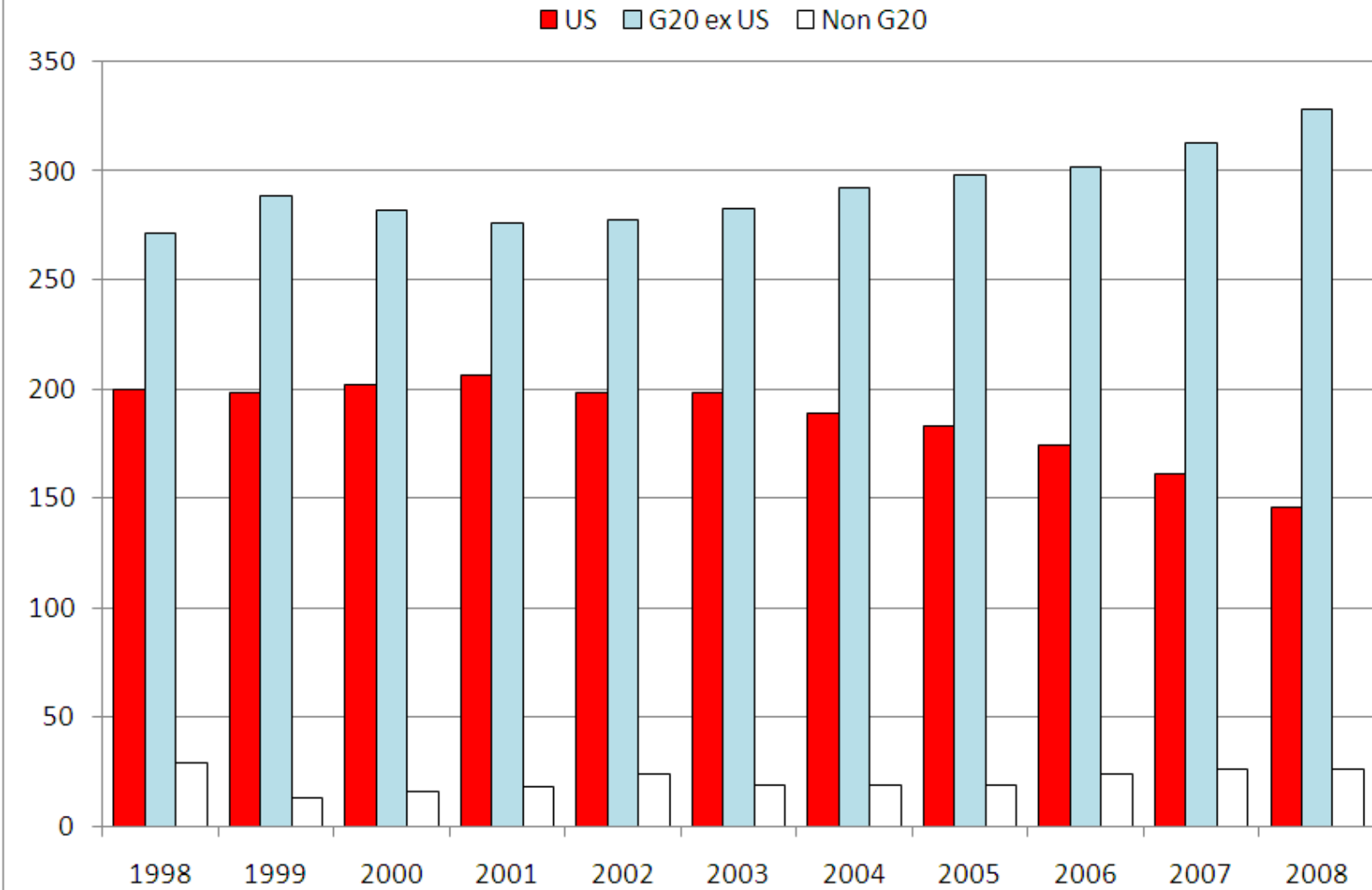


Source: UNCTAD, World Investment Report

- Outbound FDI has grown 10x and inbound FDI has grown 20x over last 30 years
- US MNC's share of world FDI has fallen from 50% in 1965 to less than 23%



Companies in Global Top 500, 1998-2008



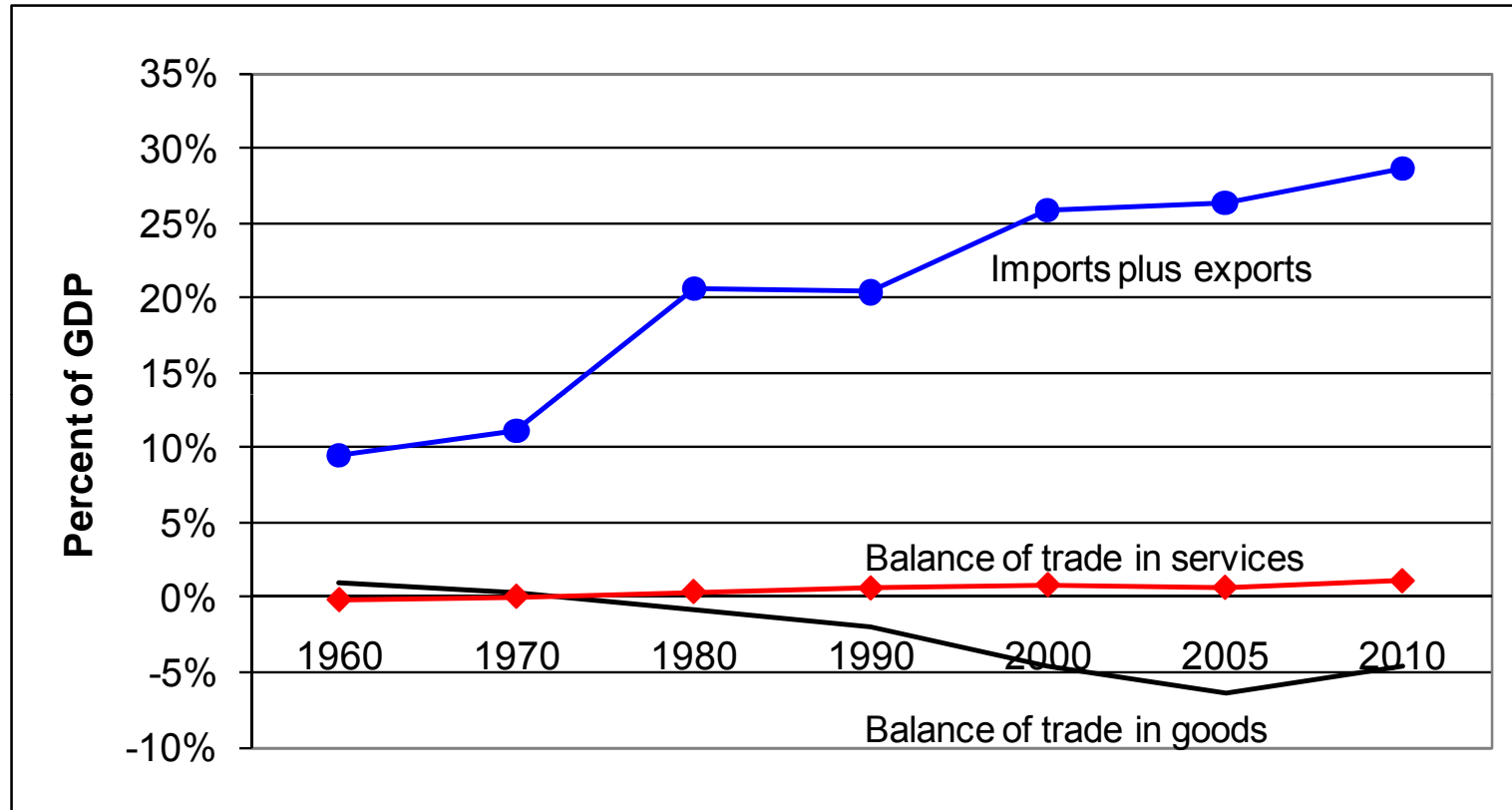
Source: Forbes 500s List, 1999-2003; International 800 List, 1999-2000; International 500 List, 2001-2003; Global 2000 List, 2004-2009. PwC calculations.





# Global Economic Trends

## US international trade



Source: Bureau of Economic Analysis, NIPA Table 1.1.5.

- US economy has become more open: imports + exports = 28.6% of GDP, up from less than 10% in 1960.
- This is a very low openness number, by world standards
- US has a trade deficit in goods (4.6% of GDP) and surplus in services (1.1% of GDP)

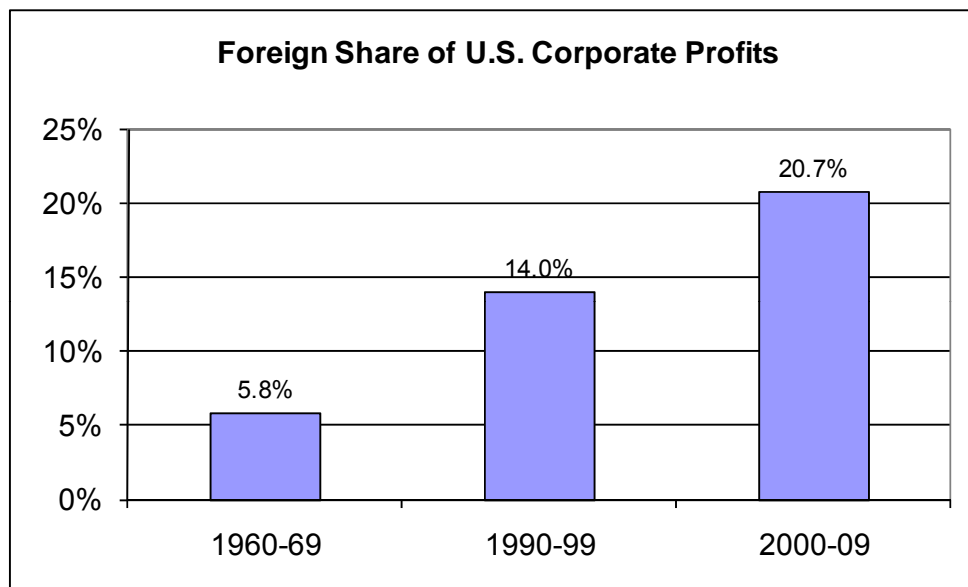


# Global Economic Trends

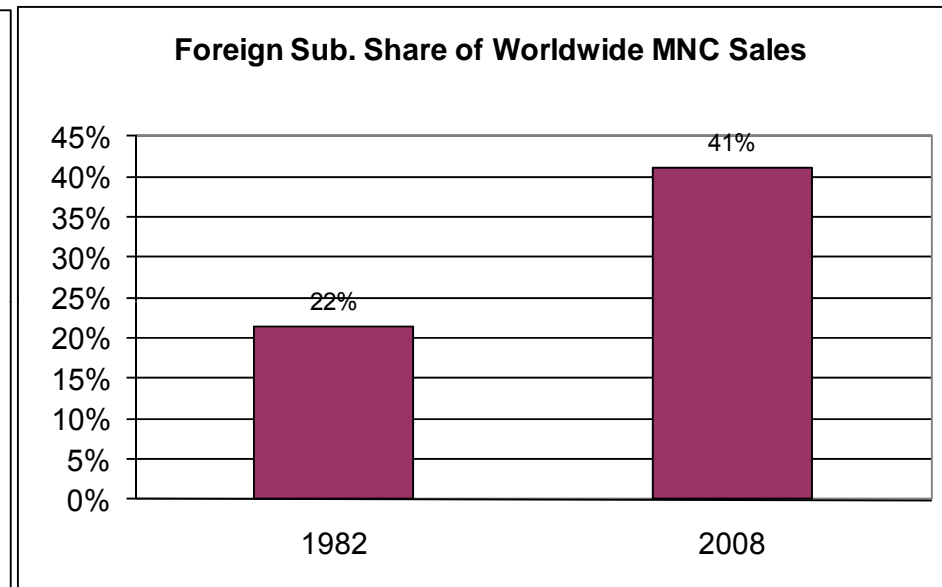
- **Non-tax reasons why US companies invest abroad**
  - Benefits of locating production close to final sales
  - Tariffs, local content requirements
  - Access to scarce natural resources and low cost inputs
  - Transactions costs and risks of relying on unrelated foreign partners to serve global markets
  - The same considerations apply to foreign investors in the US
- Taxes are also important; low tax rates reduce costs, particularly for high margin lines of business
- Technological change has made it easier to manage global enterprises (e.g., communications, computer processing)
- Development of market economies in Eastern Europe and Asia and privatization of state enterprises has created vast new investment opportunities abroad



# US Foreign Direct Investment



Source: Bureau of Economic Analysis, NIPA Table 6.16 (downloaded 3/21/09)



Source: Bureau of Economic Analysis, U.S. Multinational Companies, "Survey of Current Business, June 1994 and Aug 2010.

- Share of US corp. profits earned abroad has increased to nearly 21% in the last decade, up from 5.8% in the 1960s
- Share of US MNC worldwide sales through foreign affiliates has increased to 41% in 2008, up from 22% in 1982



# US Foreign Direct Investment

## Location

- **U.S. FDI primarily is located in developed countries<sup>1</sup>**
  - In 2008, 67% of foreign affiliate assets, 59% of sales, and 52% of employment were in developed countries (Canada, EU, and Japan)
- **U.S. FDI overwhelmingly supplies foreign, not US markets<sup>2</sup>**
  - In 2008, just 10% of sales of U.S.-controlled foreign corporations were made back to US (8% if Canada and Mexico are excluded)
- **FDI mostly represents acquisitions of existing companies<sup>3</sup>**
  - In 2008, 93% of new foreign investment in the U.S. was acquisitions of existing companies; the numbers are similar for other years

<sup>1</sup> Source: Bureau of Economic Analysis, "U.S. Multinational Companies, Operations in 2008" *Survey of Current Business*, Aug. 2010, Table 18.2

<sup>2</sup> Source: Bureau of Economic Analysis, "U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and Their Foreign Affiliates, Preliminary 2008 Estimates" Table III.F.2.

<sup>3</sup> Source: Bureau of Economic Analysis, "Foreign Direct Investment in the United States: New Investment in 2008" *Survey of Current Business*, June 2009, Table 1.



# US Foreign Direct Investment

## US wages

- US plants of companies without foreign operations pay lower wages than domestic plants of US MNCs, controlling for industry, firm size, age of firm, and state location.
- Does it follow that foreign operations make a firm more profitable and therefore results in higher US wages? Possibly.

<b>US Plant Wages: Domestic Companies Compared to MNCs</b>		
<b>Worker type</b>	<b>Plant size</b>	
	<b>Small</b>	<b>Large</b>
Production workers	-15.2%	-9.5%
Non-production workers	-6.9%	-5.0%

Source: Mark Doms and Brad Jensen, 1996



# US Foreign Direct Investment

## US employment

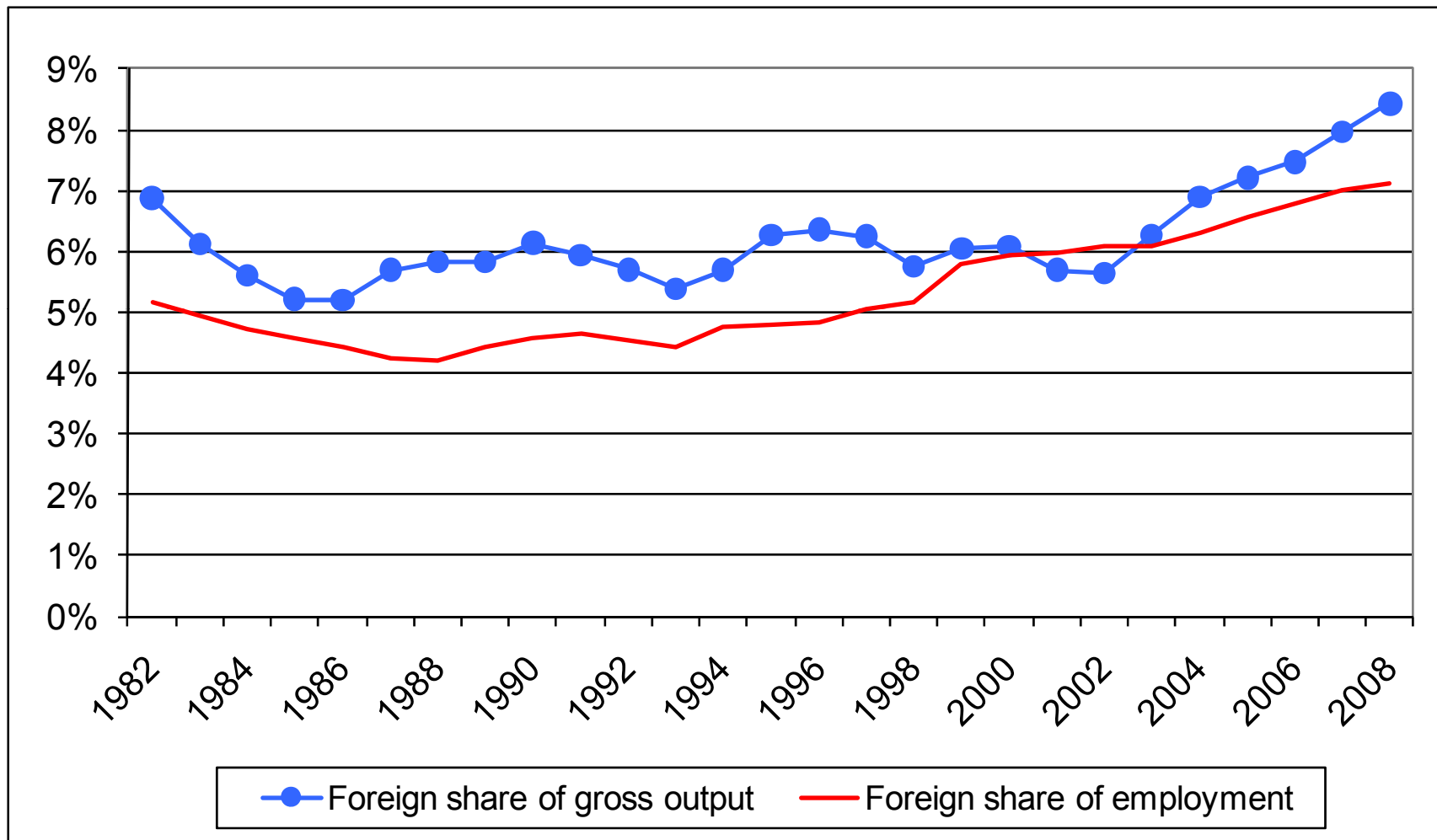
- Using firm-level Commerce Department data, recent research finds that foreign and domestic employment and investment of US MNCs are **complements** not substitutes
- Over the 1982-2004 period, Desai-Foley-Hines (2009) find that, on average, 10% greater foreign investment by US MNCs is associated with:<sup>1</sup>
  - 2.6% greater domestic investment,
  - 3.7% greater domestic employee compensation, and
  - 6.5% greater US exports.
  - “While there may be considerable individual variation, the average experience of all U.S. manufacturing firms over the last two decades is inconsistent with the simple story that all foreign expansions come at the cost of reduced domestic activity.”

<sup>1</sup> Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., “Domestic Effects of the Foreign Activities of US Multinationals,” *American Economic Journal: Economic Policy*, 2009, 1:1, 181–203



# US Foreign Direct Investment

## Foreign share of US



Source: PricewaterhouseCoopers calculations based on US Department of Commerce data.



# US Foreign Direct Investment

## Financing

- 2006 IRS data shows that foreign subs of US parents distributed \$189 billion or 46% of net foreign earnings and profits (including both previously taxed and not previously taxed foreign income)<sup>1</sup>
- 79% of U.S.-controlled foreign corporation financing (including retained earnings) is from foreign sources<sup>2</sup>

Sources:

<sup>1</sup> Internal Revenue Service, <http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96282,00.html>.

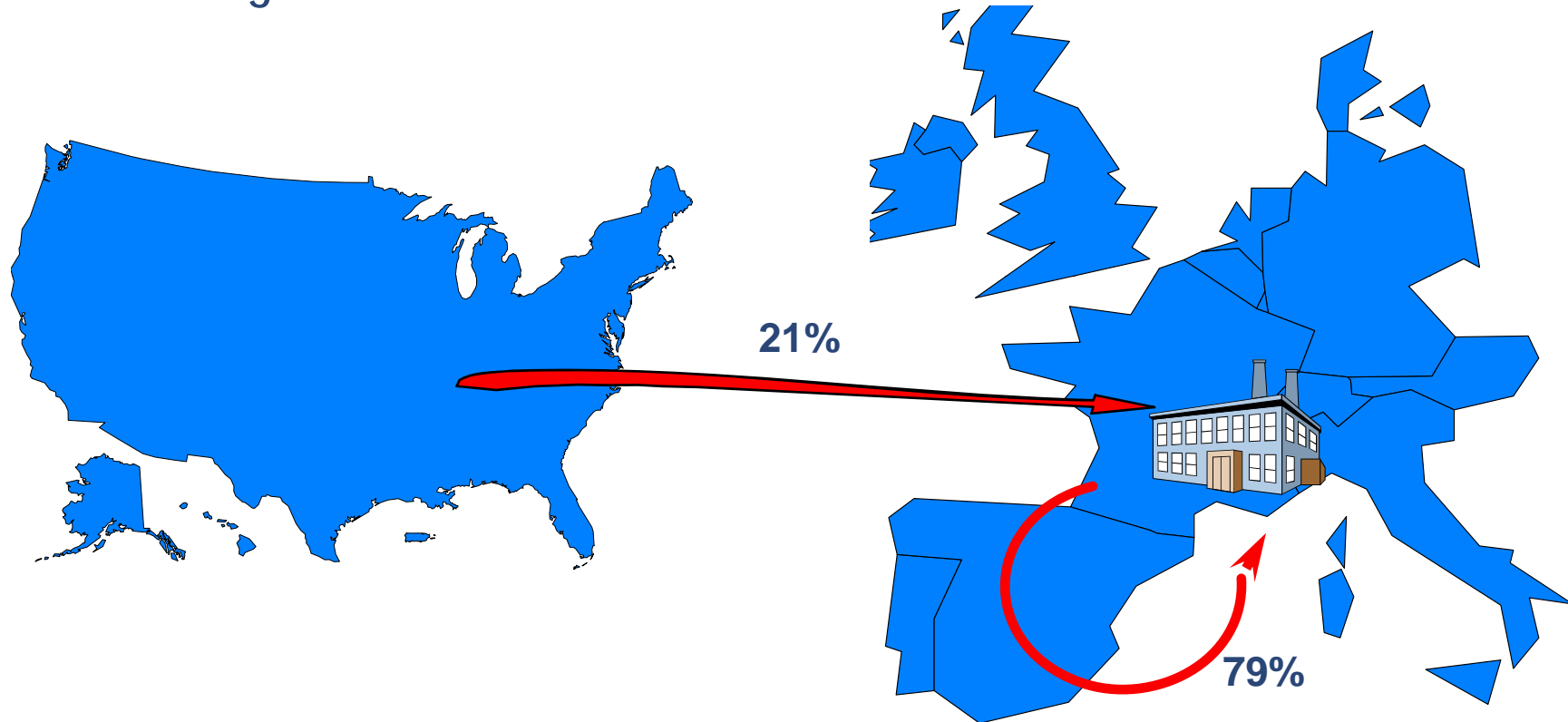
<sup>2</sup> Bureau of Economic Analysis, "U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and Their Foreign Affiliates, Preliminary 2008 Estimates." Tables III.C.1 and III.B.1-2.





# US Foreign Direct Investment

## Financing of CFCs

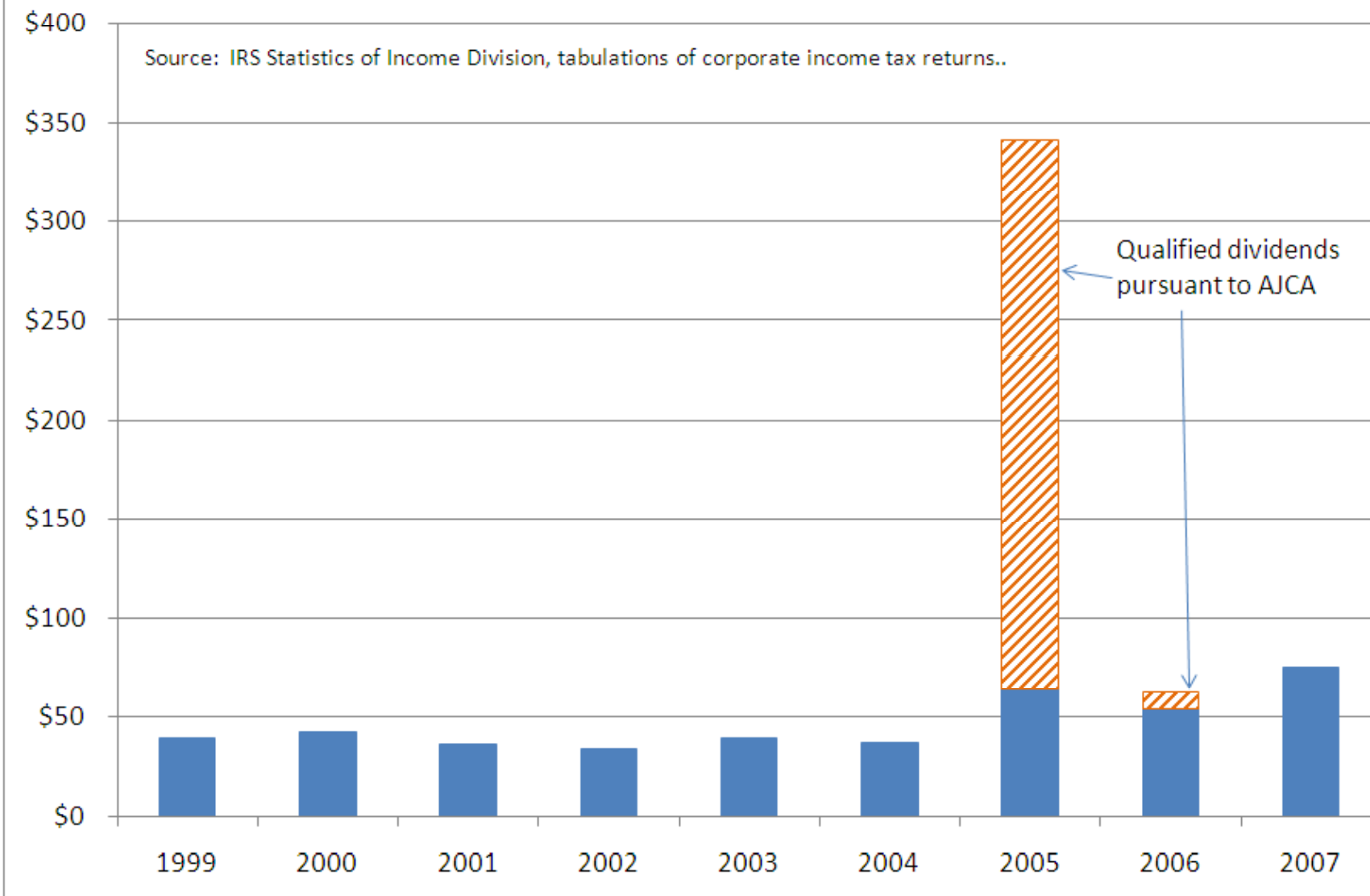


- In 2008, 79% of the financing of US-controlled foreign corporations comes from foreign sources -- not US parents

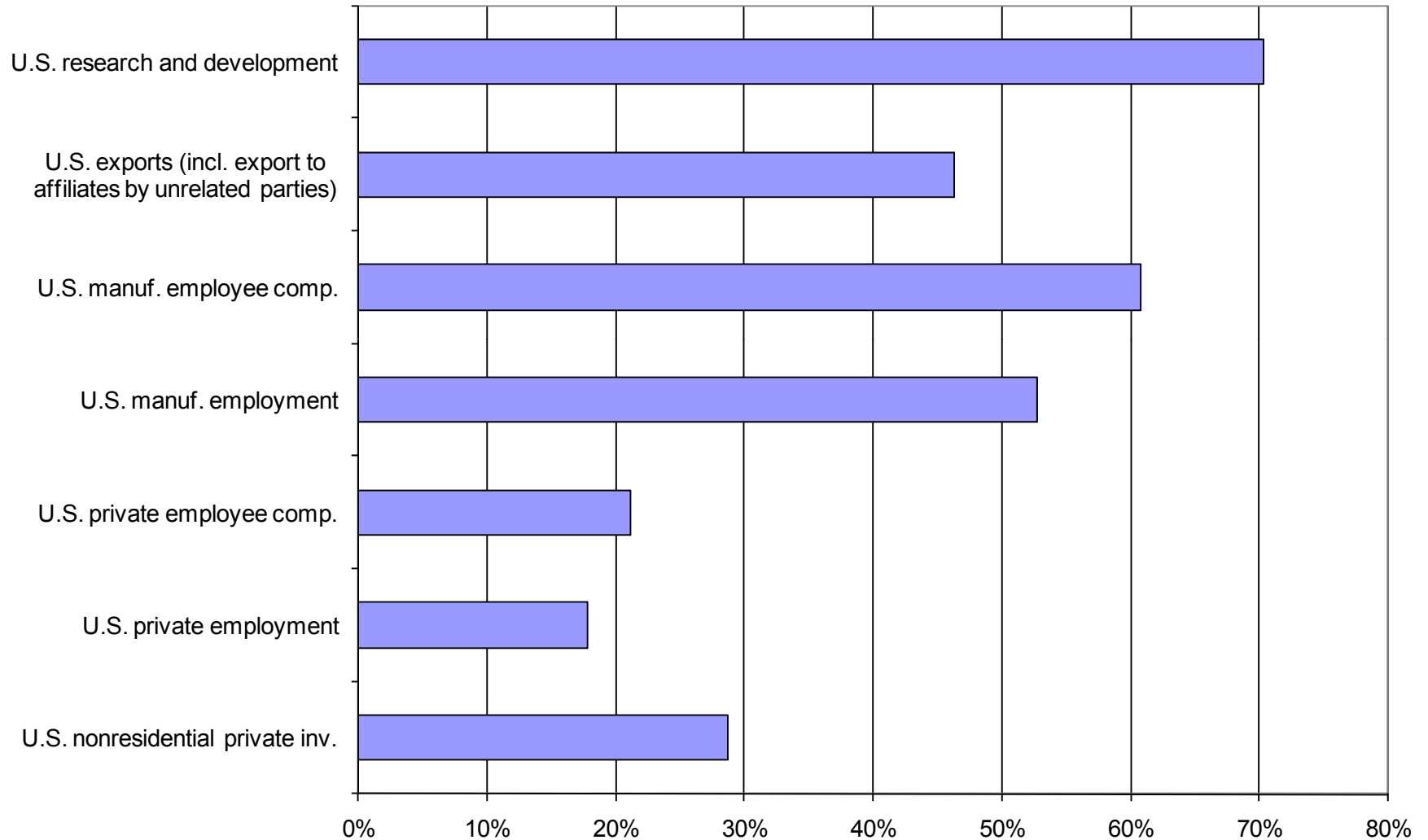


## Not Previously Taxed Foreign Source Dividends Reported on U.S. Corporate Tax Returns, 1999-2007 (\$ billions)

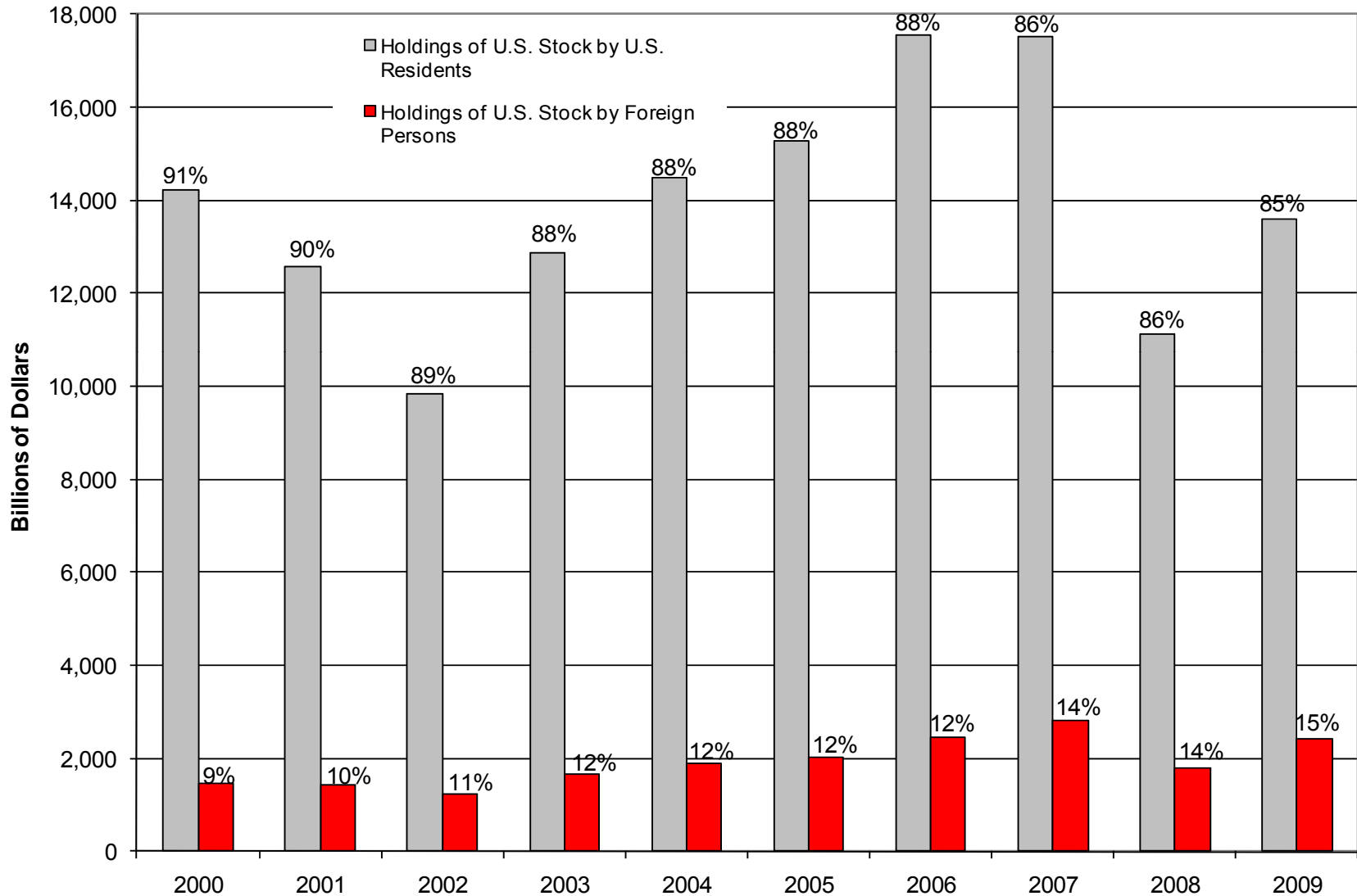
Source: IRS Statistics of Income Division, tabulations of corporate income tax returns..



### U.S. Parented Multinationals (Percent of U.S. Economy in 2008)



# U.S. stock ownership in publicly traded U.S. companies



# US Foreign Direct Investment

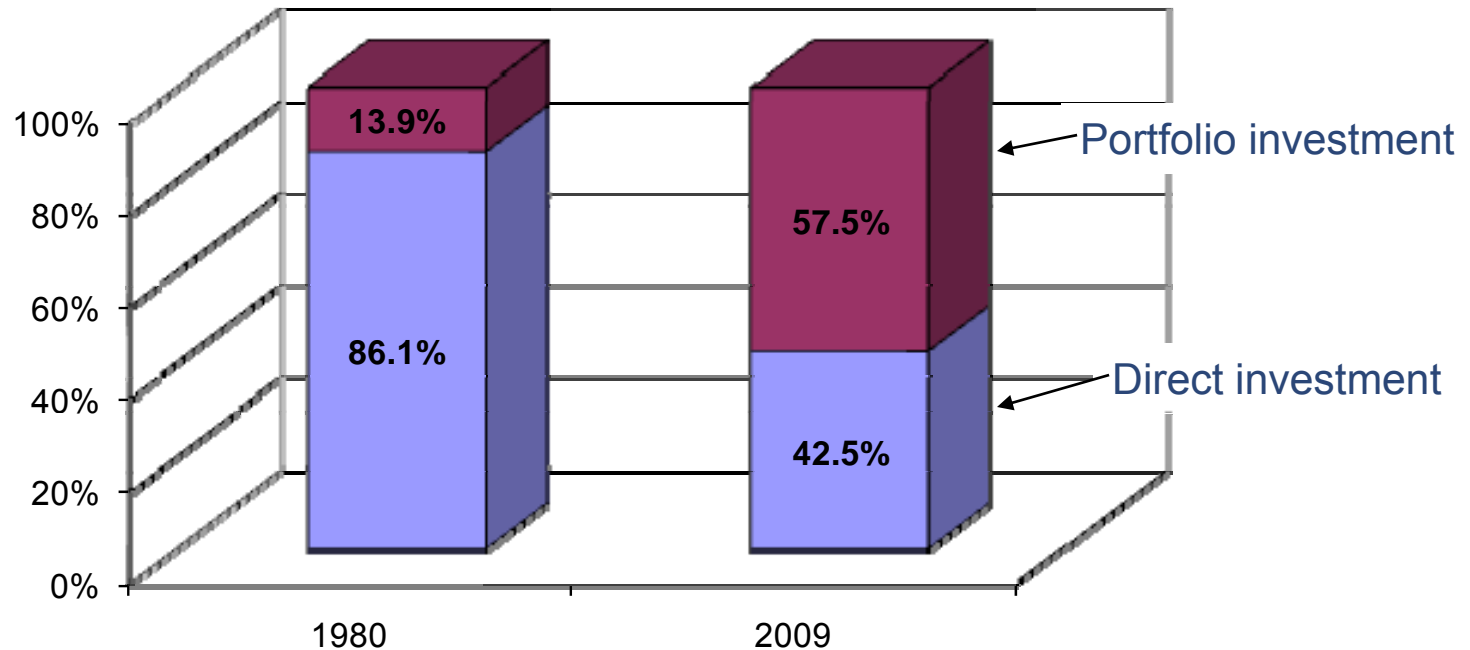
In summary, US direct investment abroad ...

- Appears to be complementary with US economic activity: is associated with greater US investment, US employment, and higher US wages
- Foreign operations sell over 90% into foreign (not US) markets
- FDI is predominantly acquisitions of existing firms in developed countries
- Appears to expand US exports
- Increases shareholder returns (if profitable...)
- Benefits foreign economies, too



# Foreign Portfolio Investment

U.S. Investment Abroad: Direct and Portfolio Shares



In 2009, 58 percent of U.S. investment abroad was portfolio investment, compared to less than one-seventh in 1980. (Portfolio investment entails less than 10% ownership in a foreign firm.)

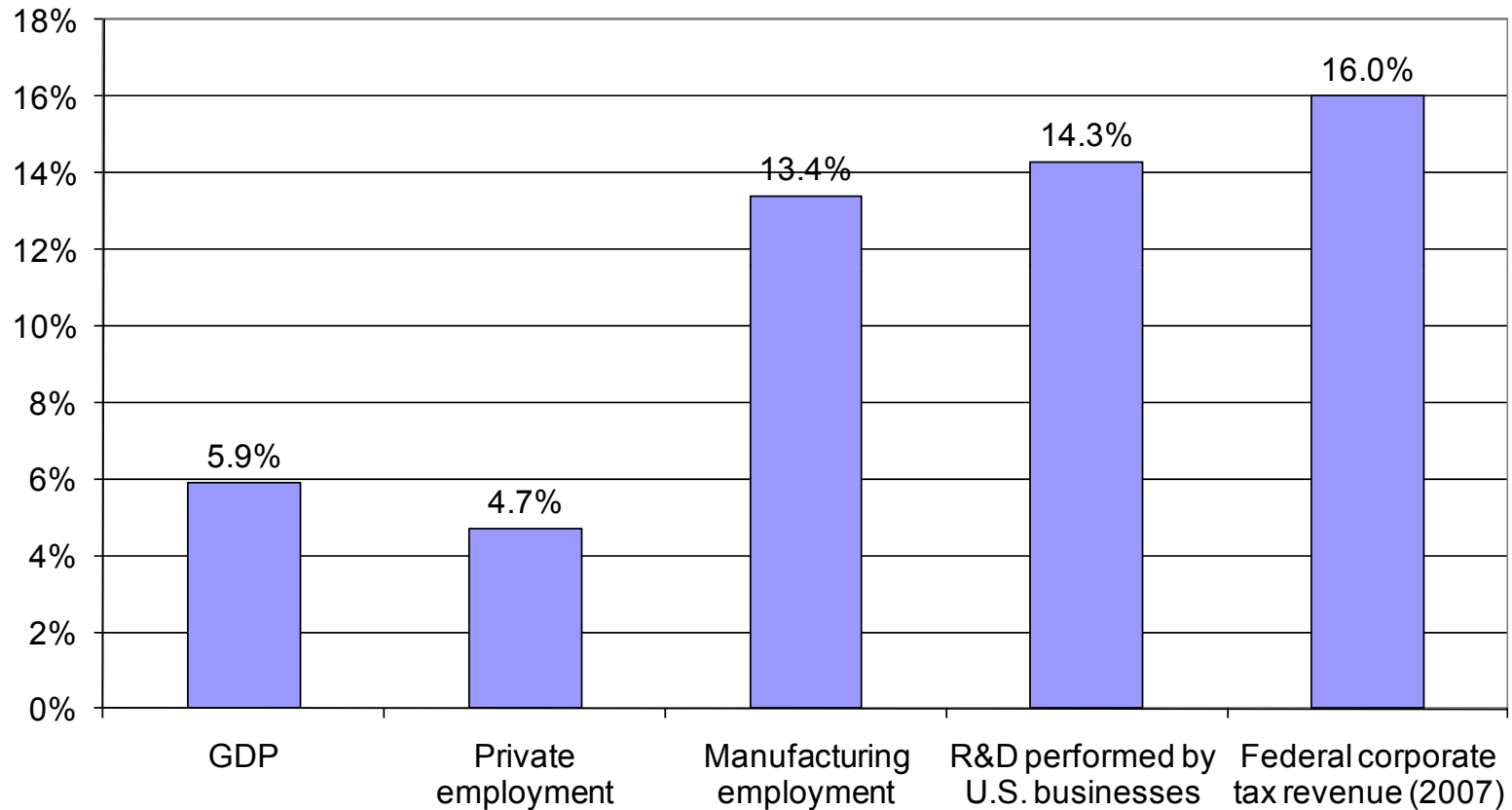
Source: Bureau of Economic Analysis, "International Investment Position" Table 2



# Foreign Direct Investment in the US

## Foreign Direct Investment in the US, 2008

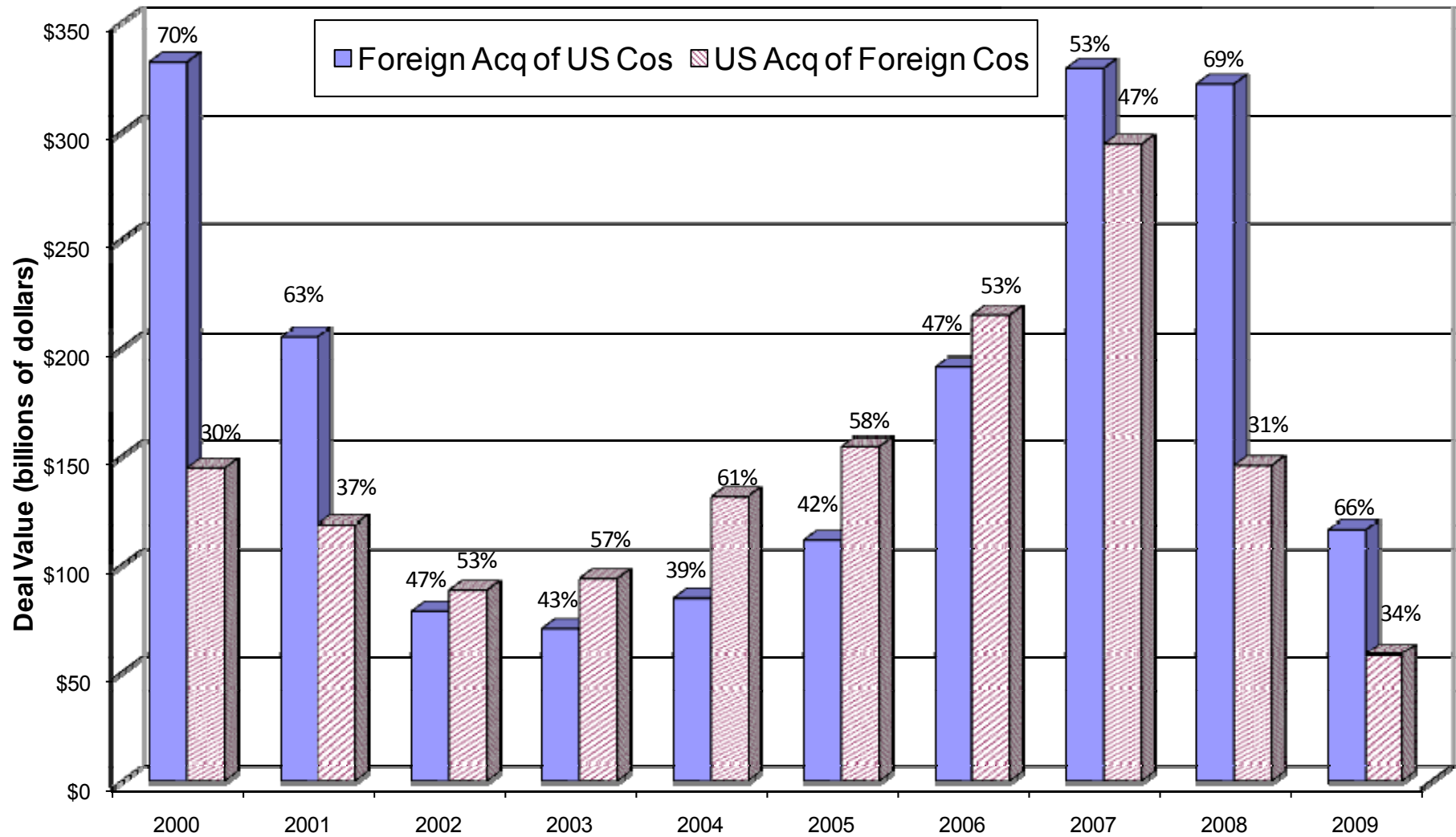
[Majority-owned affiliates other than corporate tax revenues, which are for all affiliates]



Sources: Bureau of Economic Analysis, "U.S. Affiliates of Foreign Companies: Operations in 2008." *Survey of Current Business*, November 2010 and SOI Bulletin, "Foreign-Controlled Domestic Corporations, 2007" Summer 2010.



## U.S. Cross-Border Mergers and Acquisitions, 2000-2009



Source: Mergers and Acquisitions: The Dealmaker's Journal, February 2010.







*US Taxation of Foreign Source Income*

## Basic Concepts

- The US taxes the **worldwide** income of **US persons**
- For this purpose, US persons are:
  - US citizens and resident individuals
  - Corporations incorporated in the US (50 states and DC)
- The US generally asserts jurisdiction to tax **foreign persons** only on their **US source** income, i.e.
  - US source passive income (other than portfolio interest and certain other exceptions)
  - Income that is connected with a US trade or business



## Source of Income

<u>Type of income</u>	<u>Source</u>
Dividends from a US corp.	US
Dividends from a foreign corp.	Foreign
Interest payments from a US corp.	US (unless 80% foreign activity)
Interest payments from a foreign corp.	Foreign (unless business in US)
Interest payments from a partnership engaged in US trade or business	US
Interest payments from partnership not engaged in US trade or business	Foreign
Rents and royalties	Place of use
Services	Place of performance
Sale of purchased goods	Place of title passage
Sale of manufactured goods	Allocated between places of manufacture and sale



# Organizational Issues

- Entity classification
  - “Check the box” regulations effective 1/1/97 apply to US and foreign legal entities
- Gain recognition rules for transfer of certain property to foreign corporations are designed to prevent shifting domestic income out of the domestic tax base. Applies to:
  - Appreciated property
  - Intangibles
    - New cost sharing regulations revise rules for computing “buy ins” under qualified cost sharing agreements



# Prevention of Double Taxation

## The Foreign Tax Credit (“FTC”)

- Enacted in 1918, FTC mitigates double (US and foreign) taxation
  - The foreign tax credit permits taxpayers to claim credits against U.S. tax obligations for taxes paid to foreign governments.
- US taxpayer may elect to claim a credit for foreign **income taxes** paid or accrued with respect to foreign income
  - **Direct credit.**— Credit for foreign taxes directly imposed on US taxpayer, e.g., on branch operations or withheld on interest, dividends, royalties, etc. paid to US taxpayer
  - **Indirect or “deemed paid” credit.**—Credit for foreign taxes paid or accrued by foreign subsidiary. Limited to 10% or greater corporate owners of voting stock.
- “**Income tax**” is defined as a tax levied on income or in lieu of an income tax (excluding “soak up” taxes and taxes paid in exchange for specific government benefits)



# Foreign Tax Credit Limitation

- Enacted in 1921, the FTC limitation is intended to prevent FTCs from reducing US tax on US source income
- A formula is used to determine the FTC limitation
  - Formula uses US income concepts to measure foreign income
- FTC allowed is the lesser of (1) FTC Limit and (2) foreign taxes paid or accrued with respect to taxable foreign source income
- Excess FTCs may be carried back 1 year and forward 10 years

$$FTC\ Limit = \left\{ \frac{Foreign\ Source\ Net\ Income}{Worldwide\ Net\ Income} \right\} \times US\ Tax\ on\ Worldwide\ Income\ (before\ FTC)$$



# Foreign Tax Credit Limitation

- Historically, the US has had various rules for computing the FTC limit, including: overall limit; per-country limit; greater and lesser of overall and per-country limit; and separate limitations by type of income (e.g., passive and active).
- FTC limitation currently is calculated separately for two main categories:
  - Passive income
  - General income (i.e., other than passive)
- Additional limitations apply to certain income (e.g., oil & gas extraction income)
- The purpose of the FTC “baskets” is to prevent averaging of taxes among different types of income



# Expense Allocation Rules

- Definitely allocable deductions
- Other deductions
  - Interest
    - For taxable years beginning after 12/31/2020, election to allocate on worldwide basis
  - Research & Development
  - General & Administrative
  - State and local income tax
  - Other





## Example 1. No Expense Allocation

- US parent, USCo, has a foreign subsidiary, ForCo, that earns \$1,000 on which it pays Country X income tax at a rate of 35% (\$350)
  - US and Country X define income in the same way
- USCo earns \$1,000 taxable income in US
- All ForCo foreign earnings are distributed as a \$650 dividend to USCO
- No USCo expenses are allocated against foreign source income
- Since foreign and US tax rates are the same, the FTC eliminates any US tax due on foreign income



# Example 1. No Expense Allocation

## Example 1. No Expense Allocation

### ForCo

Country X taxable income	\$1,000
Country X income tax @ 35%	<u>\$350</u>
Net income	\$650

### USCo

US source income	\$1,000
Dividend from ForCo	\$650
Foreign tax gross up on dividend	<u>\$350</u>
Taxable income	\$2,000
US tax before FTC @ 35%	\$700
FTC limit*	\$350
FTC	<u>\$350</u>
US income tax after FTC	\$350

### Worldwide operations of USCo

Income	\$2,000
Income tax	\$700

$$* \text{ FTC Limit} = \left\{ \frac{\$1000 \text{ Foreign Source Net Inc.}}{\$2000 \text{ Worldwide Net Income}} \right\} \times \$700 \text{ US Tax on WW Inc. (before FTC)}$$



## Example 2. Expense Allocation

- Same as Example 1, except \$200 of USCo expenses are allocable against foreign income (which are not deductible by ForCo in calculating Country X tax)
- Effect of expense allocation is to reduce foreign tax credit limitation
  - As a result, taxpayer has \$70 of excess foreign tax credits and US tax liability increases from \$350 to \$420
  - For excess credit taxpayers, expense allocation is equivalent to denying a current deduction for the domestic expenses that are allocated to foreign source income (\$200 in this example)



## Example 2. Expense Allocation

### Example 2. \$200 of Expense Allocation

#### ForCo

Country X taxable income	\$1,000
Country X income tax @ 35%	<u>\$350</u>
Net income	\$650

#### USCo

US source income	\$1,000
Dividend from ForCo	\$650
Foreign tax gross up on dividend	<u>\$350</u>
Taxable income	\$2,000
US tax before FTC @ 35%	\$700
FTC limit*	\$280
FTC	<u>\$280</u>
US income tax after FTC	\$420

#### Worldwide operations of USCo

Income	\$2,000
Income tax	\$770

$$* \text{ FTC Limit} = \left\{ \frac{\$1000 \text{ For. Source Net Inc.} - \$200 \text{ Exp. Alloc.}}{\$2000 \text{ Worldwide Net Income}} \right\} \times \$700 \text{ US Tax on WW Inc.}$$



## Other Foreign Tax Credit Rules

- Look through rules for basketing income
- Indirect FTC applicable to dividends paid through no more than six tiers of foreign corporations
- Loss rules
  - Recharacterization of income between domestic and foreign source following domestic or overall foreign losses
  - Spreading of losses and recharacterization of income among foreign tax credit baskets
- Person that is allowed to claim FTC (“technical” taxpayer rule)
- Holding period requirements
- HIRE Act changes:
  - If foreign taxes and associated foreign income are separated, FTC is deferred until associated foreign income is subject to US tax.
  - If a foreign acquisitions results in a basis step up for US but not foreign law, the FTC is not allowed for the portion of foreign taxes corresponding to the excess of the foreign over the US tax base.



# Timing of Taxation: Anti-Deferral Regimes

## ➤ Domestic corporations

- In general, regular corporations and their shareholders are considered separate taxpayers
- Corporate income is potentially taxed twice—
  - At the corporate level. and
  - At the shareholder level when corporate income is received as a dividend or realized as gain on the sale of shares
- Corporate losses do not flow through to shareholders
- The taxation of shareholders on corporate income at the time of receipt as a dividend is referred to as “deferral”
  - The issue is not “whether” but “when” shareholders are taxed

## ➤ Foreign corporations

- The same principles generally apply to US shareholders of foreign corporations. Hence US taxes generally are deferred until foreign profits are repatriated to the United States
- Income from foreign branch and partnership income is taxed currently to US owners (and losses flow through)



## Timing of Taxation: Anti-Deferral Regimes

- In 1961, Kennedy Administration proposed to tax US shareholders on income currently earned by controlled foreign corporations (“CFCs”), except in developing countries
  - US exchange rate was fixed and investment abroad by US companies depleted US gold reserves
- Congress rejected Administration’s proposal as anti-competitive and, in 1962, adopted a more targeted “Subpart F” regime aimed at “passive” and “mobile” income
  - **Passive** income provisions intended to address “incorporated pocketbook,” i.e., shifting of passive income abroad
  - **Active** income provisions intended to serve as a “backstop” to the rudimentary arm’s-length pricing rules then in force
  - At the time, no other country had a similar anti-deferral regime



## Subpart F Regime

- Subpart F treats certain types of income (“Subpart F income”) earned by controlled foreign corporations (“CFCs”) as distributed pro rata to certain US shareholders for US tax purposes
  - Applies to US persons owning at least 10% of the voting stock of a CFC (“10% shareholders”)
  - A **CFC** is defined as a foreign corporation that is more than 50% owned, by vote or value, by 10% shareholders
- US shareholder is taxed on pro rata share of Subpart F income whether or not actually distributed by the foreign corporation
  - Corporate shareholders generally may claim an indirect FTC with respect to Subpart F income as if actually distributed
  - Actual distributions made out of such previously taxed Subpart F income are not taxable to the shareholder





## Subpart F Income

- Subpart F income includes Foreign Base Company Income and certain other types of income
- Foreign Base Company (“FBC”) Income includes:
  - Foreign personal holding company income
  - Foreign base company sales, services, and oil-related income
- Special rules applicable to foreign base company income
  - **De minimis rule.**—If FBC income is less than \$1 million or 5% of CFC income then none of the income is treated as FBC income
  - **“De maximis” rule.**—If more than 70% of CFC’s income is FBC income then all of the CFC’s income is treated as FBC income
  - **High tax exception.**—If CFC receives FBC income that is taxed at a rate more than 90% of the US rate, such income is not treated as subpart F income



## Subpart F Income (cont'd)

- Foreign Personal Holding Company (“FPHC”) Income
  - FPHC income consists mainly of passive income, such as: interest, dividends, rents, and royalties as well as certain income from commodities, factoring, foreign currency, and notional principal contract transactions
  - Exceptions and special rules
    - Same country exception
    - Unrelated party active rent and royalty exception
    - Active finance exception (expires after 2011)
    - CFC look-through rule (expires after 2011)



## Subpart F Income (cont'd.)

- Foreign Base Company Sales Income
  - Arises when a CFC sells goods that are both made and sold for use outside its country of incorporation and are either purchased from, or sold to a related party, except if CFC is **manufacturer**
    - New regulations tighten definition of manufacturing
  - Among other things, this creates an incentive to establish separate distributors in every country rather than use a regional distributor
- Foreign Base Company Services Income
  - Arises when CFC performs services outside its country of incorporation for a related person or on behalf of a related person
- Foreign Base Company Oil-related income
- Other types of Subpart F income
  - Subpart F insurance income (sec. 953)
  - Investments in US Property (sec. 956)
  - Bribes and income from proscribed countries



## Other Anti-Deferral Regimes

- Personal Holding Company (1934)
- Passive Foreign Investment Company (1986)
  - Overlap with CFC regime eliminated in 1997
- “Excess” passive asset regime (1993-96)



# Related Party Transactions

- Sec. 482 authorizes the IRS to re-determine the income arising between related parties “in order to prevent the evasion of taxes or clearly to reflect the income ...”
- Similar principles have been adopted in virtually all developed countries and are embodied in OECD Guidelines
- Home and host countries each have an incentive to make certain that transfer prices do not inappropriately shift income outside of their territory
  - Conflicts between home and host country tax authorities may be resolved by Competent Authorities pursuant to bilateral treaties or in advance through Advance Pricing Agreements



## Related Party Transactions

- IRS regulations provide detailed rules regarding how a taxpayer should establish and document transfer prices, including selection of transfer pricing methodology by reference to “best method” rule.
- Taxpayers who fail to select, apply and document their transfer pricing methodologies properly may be subject to substantial accuracy-related penalties
  - 20% substantial valuation misstatement penalty
  - 40% gross valuation misstatement penalty
- The IRS instituted an Advance Pricing Agreement procedure under which transfer prices for particular transactions are pre-approved for a fixed period of time. APAs allow taxpayers to avoid disputes with the IRS (and other participating tax authorities) and penalties.



# Comparison of Anti-Deferral Rules

Canada, France, Germany, Japan, the Netherlands and UK<sup>1</sup>

- Two general approaches
  - Transaction-based systems (like Subpart F) used in US, Canada and Germany
  - Jurisdiction or entity-based approach used in France, Japan, and UK
  - Exemptions in both systems tend to reduce differences in practice
- Other than the US, countries with transactions-based anti-deferral regimes generally exempt active business income, such as foreign base company sales and service income
- Jurisdiction-based anti-deferral regimes generally tax all income of subsidiaries in low-tax countries, but generally exempt active business income that has some local connection

<sup>1</sup> Based on National Foreign Trade Council, Inc., *International Tax Policy for the 21<sup>st</sup> Century*, Volume 1, 67-92 (2001).



# Comparison of Foreign Tax Credit Rules

## Home Country Tax Treatment of Foreign-Source Dividend Income Received by Resident Corporations, 2010

Dividend Exemption							Foreign Tax Credit				
No.	Country	Exemption %	Comb. corp. tax rate	No.	Country	Exemption %	Comb. corp. tax rate	No.	Country	Exemption %	Comb. corp. tax rate
1.	Australia*	100%	30.0%	14.	Japan	95%	39.5%	1.	Chile	n/a	17.0%
2.	Austria*	100%	25.0%	15.	Luxembourg	100%	28.6%	2.	Greece	n/a	24.0%
3.	Belgium	95%	34.0%	16.	Netherlands	100%	25.5%	3.	Ireland	n/a	12.5%
4.	Canada*	100%	29.5%	17.	New Zealand	100%	30.0%	4.	Israel	n/a	25.0%
5.	Czech Republic*	100%	19.0%	18.	Norway	97%	28.0%	5.	Korea	n/a	24.2%
6.	Denmark	100%	25.0%	19.	Portugal*	100%	26.5%	6.	Mexico	n/a	30.0%
7.	Estonia	100%	0.0%	20.	Slovak Republic	100%	19.0%	7.	Poland	n/a	19.0%
8.	Finland	100%	26.0%	21.	Slovenia	95%	20.0%	8.	<b>United States</b>	<b>n/a</b>	<b>39.2%</b>
9.	France	≥ 95%	34.4%	22.	Spain	100%	30.0%				
10.	Germany	95%	30.2%	23.	Sweden	100%	26.3%				
11.	Hungary	100%	19.0%	24.	Switzerland	≤ 95%	21.2%				
12.	Iceland	100%	15.0%	25.	Turkey	100%	20.0%				
13.	Italy	95%	27.5%	26.	UK	100%	28.0%				

\* Exemption by treaty arrangement.

Note 1. Tax rates for Greece and Estonia are for retained corporate income. Canada, Japan, New Zealand, and UK have announced or enacted lower rates taking effect after 2010.

Note 2. In general, tax treatment depends on qualifying criteria (e.g. minimum ownership level, minimum holding period, the host country tax rate, etc.) and applicable CFC rules. The table reports the most generous treatment of foreign direct dividends in each case for income not subject to CFC regime (if any). Swiss participation exemption is reduced by allocated interest expense.

Sources: OECD, Revenue Statistics, 2010 Edition; PwC, Worldwide Tax Summaries: Corporate Taxes 2010/11.





## Policy Issues

### US international tax policy reflects a balance among different goals:

- **Neutrality.** US owners should bear same total income tax burden (home and host) on foreign and domestic investment (so-called “capital export neutrality” or “CEN”)
  - A variant, “national neutrality” holds that the same **home** income tax should apply to domestic and foreign investment. This would entail permitting taxpayers only to deduct foreign income taxes, not credit them
- **Competitiveness.** US companies should not pay more (home and host) income taxes than foreign competitors (so-called “capital import neutrality” or “CIN”)
- **Harmonization.** US should follow international tax norms
- **Simplicity.** US should minimize administration and compliance costs
- **Protect US tax base.** Foreign activities of US companies should not reduce US tax on US source income.



# Policy Issues

- CEN could be achieved by
  - Taxing foreign subsidiary income when earned (no deferral)
  - With unlimited foreign tax credit
- CIN could be achieved by
  - Exempting active income earned abroad
- US System more closely follows CEN by taxing worldwide income, but
  - Limits foreign tax credit (to project US tax base)
  - Generally defers tax until income remitted (for competitiveness)
- CEN and CIN cannot simultaneously be achieved unless all countries adopt the same corporate income tax rate and base



## Policy Issues

- Some argue that US policy should move closer to CEN by further limiting deferral.
  - Would it enhance American prosperity to subject US companies to heavier taxation of foreign income than any other country does?
  - US tax rules affect incentives for ownership of business assets, and ownership in turn affects the productivity of business operations in the United States and abroad.
  - Suppose that the US were to adopt very heavy taxation of foreign income, thereby distorting ownership so that US companies do extremely little FDI, particularly in low-tax places. What would happen to domestic business operations?
    - The domestic operations of US firms would become less profitable, thereby also reducing the productivity, and wages, of labor in the United States.



## Policy Issues (cont'd)

- Does the US tax system give strong incentives for American companies to locate operations in low-tax foreign countries?
  - Yes and no.
  - For a **given level** of pre-tax profitability, of course the taxpayer saves by earning that money in a low-tax, rather than high-tax place.
  - On the other hand, German, Dutch, Canadian, French, etc. investors have even stronger incentives to locate in low-tax places, since their territorial tax systems imply that they keep every dollar of foreign tax savings.
  - Competition from these territorial investors makes it more expensive for Americans to acquire assets in low-tax jurisdictions, and in doing so, the US tax system puts Americans at a disadvantage in these places.



## Ownership Neutrality

- What are the implications of concern over ownership neutrality, providing incentives for value-maximizing asset ownership?
- From the standpoint of world welfare, what matters is that every jurisdiction tax foreign income in the same manner (not necessarily at the same rate): either all exempt, or all tax and permit FTCs. This is “Capital Ownership Neutrality.”
- From the standpoint of any individual country, their welfare-maximizing ownership regime is one in which they exempt foreign income from taxation. This regime does not penalize domestic ownership, and thereby increases the productivity of all domestic economic factors, primarily labor. This is “National Ownership Neutrality.”



## Policy Tradeoffs

- Economic prosperity is enhanced by having an efficient tax system.
- Too heavy a tax burden on foreign income reduces prosperity, but so would tax subsidies for foreign investment.
- It matters what other countries do, since US firms compete with foreign firms, and this competition affects prices.
- The recent trendy thinking (“Ownership Neutrality”) is that taxing foreign investment more heavily than other countries reduces efficiency by distorting the world pattern of asset ownership.
- The efficiency of US tax policies is reflected in wages and land prices in the United States.
- There are other, related, issues; some tax systems permit easier enforcement of transfer pricing rules, for example. But most of the analysis suggests that efficient tax systems produce the greatest benefits for everyone.



## United States in the World Economy: 1960-2009

	<u>1960-9</u>	<u>1970-9</u>	<u>1980-9</u>	<u>1990-9</u>	<u>2000-4</u>	<u>2005-9</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
<b>U.S. International Trade (percent of GDP)<sup>1</sup></b>											
Exports	5.2%	7.4%	8.4%	10.4%	9.9%	11.4%	10.3%	11.0%	11.8%	12.8%	11.2%
Imports	4.5%	7.6%	10.2%	11.7%	14.2%	16.3%	16.0%	16.7%	16.9%	17.8%	13.9%
Trade openness: Exports plus imports	9.7%	15.0%	18.6%	22.2%	24.1%	27.7%	26.4%	27.7%	28.7%	30.6%	25.1%
<b>U.S. International Investment Position (\$ billions)<sup>2</sup></b>		<u>1980</u>	<u>1985</u>	<u>1990</u>	<u>1995</u>	<u>2000</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
Net international investment position		\$360	\$62	-\$230	-\$430	-\$1,337	-\$1,932	-\$2,192	-\$1,916	-\$3,494	-\$2,738
Net private international investment position		\$233	-\$53	-\$159	\$113	-\$469	\$78	\$458	\$1,148	-\$265	\$736
Private U.S.-owned assets abroad*:											
U.S. direct investment abroad		\$388	\$371	\$617	\$886	\$1,532	\$2,652	\$2,948	\$3,553	\$3,743	\$4,051
U.S. portfolio investment abroad		\$62	\$119	\$342	\$1,204	\$2,426	\$4,329	\$5,604	\$6,835	\$3,986	\$5,471
Private foreign-owned assets in the United States*:											
Foreign direct investment in the United States		\$127	\$247	\$505	\$680	\$1,421	\$1,906	\$2,154	\$2,411	\$2,521	\$2,673
Foreign portfolio investment in the United States		\$90	\$296	\$613	\$1,297	\$3,005	\$4,997	\$5,940	\$6,830	\$5,472	\$6,113
<b>U.S. Corporate Profits<sup>3</sup></b>	<u>1960-9</u>	<u>1970-9</u>	<u>1980-9</u>	<u>1990-9</u>	<u>2000-4</u>	<u>2005-9</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
Gross receipts from foreign sources as share of total	7.1%	13.4%	16.7%	17.5%	24.6%	34.1%	26.4%	27.0%	33.8%	45.3%	38.2%
Net receipts from foreign sources as share of total	5.8%	10.9%	13.8%	14.0%	18.2%	23.2%	16.4%	16.0%	23.2%	32.6%	28.0%
<b>Gross Domestic Product (GDP)<sup>4</sup></b>	<u>1960-9</u>	<u>1970-9</u>	<u>1980-9</u>	<u>1990-9</u>	<u>2000-4</u>	<u>2005-9</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
U.S. share of world total	37.5%	30.1%	29.2%	26.7%	30.4%	25.5%	27.6%	27.0%	25.2%	23.4%	24.3%
<b>Population<sup>4</sup></b>	<u>1960</u>	<u>1970</u>	<u>1980</u>	<u>1990</u>	<u>2000</u>		<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
U.S. share of world total	6.0%	5.6%	5.1%	4.7%	4.6%		4.6%	4.6%	4.6%	4.5%	4.5%
<b>Merchandise Exports<sup>5</sup></b>	<u>1960-9</u>	<u>1970-9</u>	<u>1980-9</u>	<u>1990-9</u>	<u>2000-4</u>	<u>2005-9</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2008</u>
U.S. share of world total	14.7%	12.1%	11.5%	12.2%	10.7%	8.5%	8.7%	8.6%	8.4%	8.1%	8.5%
<b>Total Exports of Goods and Services<sup>4</sup></b>	<u>1960-9</u>	<u>1970-9</u>	<u>1980-9</u>	<u>1990-9</u>	<u>2000-4</u>	<u>2005-9</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
U.S. share of world total	16.1%	13.2%	12.7%	13.1%	12.1%	9.7%	10.0%	9.8%	9.5%	9.3%	9.9%
<b>Direct Investment Stock<sup>6</sup></b>		<u>1970-9</u>	<u>1980-9</u>	<u>1990-9</u>	<u>2000-4</u>	<u>2005-9</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
U.S. share of world outward direct investment flows		45.1%	20.8%	21.3%	21.6%	14.9%	1.7%	15.9%	17.4%	17.1%	22.5%
U.S. share of world outward direct investment stock		n.a.	41.3%	37.8%	29.4%	25.4%	29.3%	28.5%	27.3%	19.2%	22.7%
<b>World's 20 Largest Corps. (ranked by sales)<sup>7</sup></b>	<u>1960</u>	<u>1980</u>	<u>1990</u>	<u>2000</u>			<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
Number of U.S.-headquartered corporations	18	11	7	8			9	10	8	7	8

\*Private U.S.-owned assets abroad does not include U.S. official reserves and government assets, claims on unaffiliated foreigners, claims on foreigners reported by U.S. banks, or ownership of foreign financial derivatives by U.S. persons. Similarly, private foreign-owned assets in the U.S. does not include foreign official assets, U.S. liabilities to unaffiliated foreigners, liabilities to foreigners reported by U.S. banks, or ownership of U.S. currency and financial derivatives by foreign persons. Foreign portfolio investment in the U.S. does include foreign ownership of Treasury securities.

PricewaterhouseCoopers LLP tabulations of data obtained from cited sources.

<sup>1</sup> PwC calculations based on data from the BEA, Table 1.1.5 "Gross Domestic Product"

<sup>2</sup> U.S. Department of Commerce, International Investment Position of the U.S. at Yearend: <http://www.bea.gov/international/index.htm#iip>

<sup>3</sup> PwC calculations based on data from the U.S. Department of Commerce: NIPA Table 6.16. Gross receipts include receipts by U.S. corporations of earnings from their foreign affiliates plus dividends received by U.S. residents from unaffiliated foreign corporations. Net receipts are gross receipts reduced by payments by U.S. affiliates of earnings to their foreign parents and by dividends paid by U.S. corporations to unaffiliated foreign residents.

<sup>4</sup> World Bank, World Development Indicators Online.

<sup>5</sup> International Monetary Fund, "International Financial Statistics Database."

<sup>6</sup> United Nations Conference on Trade and Development, *UNCTADstat* database.

<sup>7</sup> 1985 to 2001 calculated by combining the Forbes 500 list with the Forbes International 500 list. 2004 to 2009 from the Forbes 2000 list.

**Multinationals in the U.S. Economy: 1994-2008**

	<u>1994-99</u>	<u>2000 - 2004</u>	<u>2005-2008</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
<b>Employment (% of U.S. Private Industry Employment)</b>								
U.S. parent companies	19.4%	20.2%	18.8%	19.3%	19.2%	18.9%	18.7%	18.5%
Majority-owned affiliates of nonbank foreign companies	<u>4.3%</u>	<u>4.9%</u>	<u>4.7%</u>	<u>4.7%</u>	<u>4.6%</u>	<u>4.7%</u>	<u>4.7%</u>	<u>4.8%</u>
All multinationals	23.7%	25.2%	23.5%	24.0%	23.8%	23.6%	23.4%	23.2%
<b>Manufacturing Employment (% of U.S. Total)</b>								
U.S. parent companies	51.3%	53.7%	53.5%	53.3%	56.4%	52.7%	52.0%	52.8%
Majority-owned affiliates of nonbank foreign companies	<u>11.2%</u>	<u>12.1%</u>	<u>12.7%</u>	<u>11.9%</u>	<u>12.1%</u>	<u>12.2%</u>	<u>12.8%</u>	<u>13.6%</u>
All multinationals	62.5%	65.8%	66.2%	65.2%	68.5%	64.9%	64.8%	66.5%
<b>Value-Added (% of U.S. GDP)</b>								
U.S. parent companies	18.9%	18.6%	18.0%	18.3%	18.4%	18.9%	18.1%	16.7%
Majority-owned affiliates of nonbank foreign companies	<u>3.8%</u>	<u>4.3%</u>	<u>4.5%</u>	<u>4.3%</u>	<u>4.3%</u>	<u>4.6%</u>	<u>4.7%</u>	<u>4.5%</u>
All multinationals	22.7%	22.9%	22.5%	22.6%	22.7%	23.5%	22.8%	21.2%
<b>Exports (% of U.S. Totals)</b>								
U.S. parent companies	59.7%	52.6%	46.0%	50.6%	50.3%	48.3%	44.6%	42.5%
Majority-owned affiliates of nonbank foreign companies	<u>20.1%</u>	<u>19.7%</u>	<u>18.7%</u>	<u>19.0%</u>	<u>19.2%</u>	<u>19.3%</u>	<u>18.7%</u>	<u>17.9%</u>
All multinationals	79.8%	72.2%	64.8%	69.6%	69.5%	67.6%	63.3%	60.5%
<i>Memo:</i>								
Exports to foreign affiliates of U.S. MNCs by U.S. persons other than the U.S. parent	4.8%	3.8%	3.6%	3.6%	3.7%	3.7%	3.6%	3.4%
<b>Imports (% of U.S. Totals)</b>								
U.S. parent companies	35.3%	33.3%	33.6%	33.1%	34.7%	33.8%	33.2%	32.9%
Majority-owned affiliates of nonbank foreign companies	<u>30.1%</u>	<u>27.7%</u>	<u>26.1%</u>	<u>26.3%</u>	<u>26.3%</u>	<u>26.7%</u>	<u>26.7%</u>	<u>24.8%</u>
All multinationals	65.4%	61.1%	59.7%	59.4%	61.0%	60.5%	59.8%	57.7%
<i>Memo:</i>								
Imports from foreign affiliates of U.S. MNCs by U.S. persons other than the U.S. parent	3.2%	2.9%	2.9%	2.9%	2.9%	3.1%	2.8%	2.8%
<b>R&amp;D Expenditures (% of Total Industrial R&amp;D)</b>								
U.S. parent companies	70.8%	71.9%	74.5%	78.8%	78.5%	74.5%	75.6%	70.3%
Majority-owned affiliates of nonbank foreign companies	<u>11.9%</u>	<u>14.0%</u>	<u>14.3%</u>	<u>14.4%</u>	<u>13.8%</u>	<u>14.0%</u>	<u>15.2%</u>	<u>14.3%</u>
All multinationals	82.7%	85.9%	88.9%	93.3%	92.3%	88.4%	90.9%	84.6%
<b>Assets (% of U.S. Total)</b>								
U.S. parent companies	27.3%	28.3%	24.5%	26.8%	25.9%	25.5%	24.9%	21.9%
Majority-owned affiliates of nonbank foreign companies	<u>8.2%</u>	<u>9.3%</u>	<u>10.1%</u>	<u>9.2%</u>	<u>9.0%</u>	<u>9.3%</u>	<u>10.9%</u>	<u>10.9%</u>
All multinationals	35.5%	37.6%	34.6%	36.1%	34.8%	34.8%	35.8%	32.8%
<b>Capital Expenditures (% of U.S. Nonresidential Private Investment)</b>								
U.S. parent companies	31.6%	32.3%	29.2%	27.8%	28.0%	29.6%	30.3%	28.8%
Majority-owned affiliates of nonbank foreign companies	<u>9.2%</u>	<u>9.5%</u>	<u>10.8%</u>	<u>9.2%</u>	<u>9.8%</u>	<u>10.7%</u>	<u>11.5%</u>	<u>11.1%</u>
All multinationals	40.8%	41.7%	40.0%	36.9%	37.7%	40.3%	41.8%	39.9%
<b>Compensation of Employees (% of Total Private Industry Compensation)</b>								
U.S. parent companies	24.1%	23.3%	21.9%	22.9%	22.4%	22.5%	21.8%	21.2%
Majority-owned affiliates of nonbank foreign companies	<u>5.3%</u>	<u>6.2%</u>	<u>6.1%</u>	<u>6.0%</u>	<u>5.9%</u>	<u>6.0%</u>	<u>6.2%</u>	<u>6.1%</u>
All multinationals	29.4%	29.5%	28.0%	28.9%	28.3%	28.5%	28.0%	27.3%
<b>Compensation of Manufacturing Employees (% of U.S. Total)</b>								
U.S. parent companies	60.8%	59.6%	61.1%	61.0%	61.0%	61.7%	60.7%	60.8%
Majority-owned affiliates of nonbank foreign companies	n.a.	<u>16.6%</u>	<u>17.1%</u>	<u>16.4%</u>	<u>16.0%</u>	<u>16.9%</u>	<u>17.5%</u>	<u>17.8%</u>
All multinationals	n.a.	76.2%	78.1%	77.4%	77.0%	78.5%	78.3%	78.6%

PricewaterhouseCoopers LLP tabulations of data obtained from the following sources:

- All data on U.S. parent company operations are from the U.S. Bureau of Economic Analysis, "U.S. Multinational Companies", *Survey of Current Business*, various issues, and associated online data.
- All data on majority-owned affiliates of foreign companies are from the U.S. Bureau of Economic Analysis, "U.S. Affiliates of Foreign Companies", *Survey of Current Business*, various issues, and associated online data.
- Aggregate data for the U.S. is from:
  - Employment: U.S. Bureau of Labor Statistics, "Current Employment Statistics Database"
  - Value-added, Exports and Imports: U.S. Bureau of Economic Analysis, National Income and Product Accounts Table 1.1.5
  - Industrial R&D: National Science Foundation, *National Patterns of R&D Resources: 2007 data update* and BEA, "U.S. Multinational Companies: Operations in the United States and Abroad in 2008"
  - Assets: Internal Revenue Service, *Statistics of Income Bulletin* Fall 2010, Appendix Table 13. 2008 total from Corporation Sourcebook.
  - Capital Expenditures: U.S. Bureau of Economic Analysis, National Income and Product Accounts Table 5.3.5
  - Compensation of Employees: U.S. Bureau of Economic Analysis, Annual Industry Accounts, "Components of Value Added by Industry".



### Foreign Affiliates of U.S. Multinationals: 1994-2008

	<u>1994-99</u>	<u>2000 - 2004</u>	<u>2005-2008</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
<b>Foreign Affiliate Employment</b>								
Share of U.S. MNC worldwide employment	28.5%	30.6%	34.6%	32.2%	33.1%	34.0%	35.3%	36.0%
As a percent of total private sector employment in U.S.	7.8%	8.9%	10.0%	9.2%	9.5%	9.8%	10.2%	10.4%
<b>Foreign Affiliate Employee Compensation</b>								
Share of total U.S. MNC worldwide employee compensation	22.2%	21.9%	25.1%	23.4%	24.0%	24.2%	25.6%	26.3%
As a percent of total private industry compensation in U.S.	6.9%	6.5%	7.3%	7.0%	7.1%	7.2%	7.5%	7.6%
<b>Foreign Affiliate Assets</b>								
Share of U.S. MNC worldwide assets	28.1%	32.4%	40.4%	36.7%	37.6%	39.4%	41.6%	42.6%
As a percent of total private non-residential assets in U.S.	10.7%	13.6%	16.3%	15.6%	15.6%	16.6%	17.7%	15.3%
<b>Majority-Owned Foreign Affiliate Capital Expenditures</b>								
Share of U.S. MNC worldwide capital expenditures	23.2%	24.2%	26.1%	28.5%	25.7%	25.8%	25.6%	27.2%
As a percent of total nonresidential private investment in U.S.	9.3%	9.6%	10.3%	10.1%	9.7%	10.3%	10.4%	10.8%
<b>Majority-Owned Foreign Affiliate Value Added</b>								
Share of U.S. MNC worldwide value-added	24.3%	24.8%	30.2%	27.4%	28.2%	28.3%	30.5%	33.6%
As a percent of total value-added in U.S. (GDP)	6.1%	6.1%	7.8%	6.9%	7.2%	7.5%	8.0%	8.4%
<b>Majority-Owned Foreign Affiliate R&amp;D Expenditures</b>								
Share of U.S. MNC worldwide R&D expenditures	12.0%	13.2%	14.4%	13.6%	13.5%	13.8%	14.5%	15.7%
As a percent of total industrial R&D in U.S.	9.6%	10.9%	12.5%	12.4%	12.2%	11.9%	12.8%	13.1%
<b>Foreign Affiliate Net Income</b>								
Share of U.S. MNC worldwide net income	32.1%	37.6%	57.1%	50.0%	49.7%	48.3%	53.8%	81.2%
As a percent of total U.S. corporation U.S. net income	17.8%	37.6%	47.4%	44.7%	33.4%	37.6%	46.0%	97.2%

PricewaterhouseCoopers LLP tabulations of data obtained from the following sources:

1. All data on the operations of foreign affiliates of U.S. MNCs are from the U.S. Bureau of Economic Analysis, "U.S. Multinational Companies", *Survey of Current Business*, various issues.
2. Aggregate data for the U.S. is from:
  - (a) Employment: U.S. Bureau of Labor Statistics, "Current Employment Statistics Database"
  - (b) Value-added: U.S. Bureau of Economic Analysis, National Income and Product Accounts Table 1.1.5
  - (c) Industrial R&D: National Science Foundation, *National Patterns of R&D Resources: 2007 data update* and BEA, "U.S. Multinational Companies: Operations in the United States and Abroad in 2008"
  - (d) Assets: Internal Revenue Service, *Statistics of Income Bulletin* Spring 2009, Appendix Table 13. 2007 total from Corporation Sourcebook.
  - (e) Capital Expenditures: U.S. Bureau of Economic Analysis, National Income and Product Accounts Table 5.3.5
  - (f) Compensation of Employees: U.S. Bureau of Economic Analysis, Annual Industry Accounts, "Components of Value Added by Industry Group".
  - (g) Corporate Net Income: Internal Revenue Service, *Statistics of Income Bulletin*, Fall 2010, Appendix Table 13, 2008 total from Corporation Sourcebook.