INTERNATIONAL TAX POLICY: ARE WE HEADING IN THE RIGHT DIRECTION?

Jane G. Gravelle, Congressional Research Service*

FOR A NUMBER OF YEARS, TWO VERY DIFFERENT approaches to revising the U.S. rules governing the tax treatment of income earned abroad by U.S. multinationals have been debated. The current system is governed by two major features: deferral and a foreign tax credit with cross crediting.

Deferral allows earnings of foreign incorporated subsidiaries to be subject to U.S. corporate tax only when earnings are repatriated (paid as dividends) to the U.S. parent. Foreign branch income, which is relatively unimportant, is taxed currently. Passive income that is easily subject to abuse (such as interest payments between related subsidiaries) is taxed currently under Subpart F of the income tax (although these rules have recently been made less effective through "check-the-box" regulations that permit firms to disregard separate entities).

Foreign taxes paid on income that is subject to tax can be credited against U.S. tax due, but the credit is limited to the overall U.S. tax on all foreign income. This overall limit is applied separately to passive and active income. The overall limit nevertheless permits some firms to offset U.S. tax due on earnings from low tax countries with excess credits from high tax countries.

Deferral and cross crediting make the U.S. tax system largely a territorial tax; a recent GAO study has estimated that foreign source income is subject to a four percent residual U.S. tax (GAO, 2008). The lower taxes imposed abroad encourage U.S. multinationals to make larger investment in low tax countries, and also encourage profit shifting, of which there is ample evidence (Gravelle, 2009b).

One approach, which has been supported by the business community, or some part of it, is to move the tax system towards a territorial system, where income earned abroad would be exempt. The business community has also argued for a reduction in the corporate tax rate, to make U.S. firms "more competitive." A territorial system has been most recently proposed by the National Commission on Fiscal Reform (2010). Most countries have effective territorial systems, although these systems may include anti-abuse rules similar to Subpart F, and rules allocating parent company expenses.

Alternatively, the Wyden Gregg tax reform proposal (S. 3018) moves in the direction of a world wide tax, by taxing all foreign income currently (eliminating deferral) and imposing a per country foreign tax credit limit.

Both of these proposals include a reduction in the corporate tax rate, but also include elimination of provisions such as accelerated depreciation so that the effective rate would not fall as much. Earlier bills introduced by Senator Wyden (S.1111 in the 1010th Congress and S. 1927 in the 109th Congress) did not include the rate reduction.

PRESIDENT OBAMA'S PROPOSALS

In both his FY2010 and FY2011 budget documents, President Obama proposed some changes to the tax treatment of income from foreign investments of U.S. multinationals, which move in the direction of a worldwide system.

The first provision would disallow the deduction of certain parent company expenses, primarily interest, to the extent that income of the firm is retained abroad in foreign subsidiaries. Currently firms may retain earnings in subsidiaries incorporated abroad, while continuing to deduct all parent company expenses against domestic income or repatriated dividends, even if some of the cost supports foreign operations where income is not taxed. This provision was projected to raise $3.3 billion in FY2013 and $25.6 billion over ten years (U.S. Department of Treasury, 2010).

The second provision would pool foreign tax credits. Firms would be allowed to credit the same share of foreign taxes as the share of total income repatriated. This provision limits the ability of firms to repatriate income from high tax countries and use excess foreign tax credits to shield income from low tax countries from the foreign tax credit. This provision was projected to raise $3.2 billion in FY2013 and $32 billion over ten years (U.S. Department of Treasury, 2010).

*The views in this study do not reflect the views of the Congressional Research Service.

The third provision (contained in the FY2010 proposals, but not in the FY2011 outline) would eliminate "check-the-box," a provision that allows firms to elect to treat subsidiaries as separate entities or disregarded entities. These regulations permit firms to avoid current taxation on certain income that would be subject to Subpart F anti-abuse rules (such as interest on loans from a subsidiary in a low tax country to a related subsidiary in a high tax country). This provision was originally projected to raise $86 billion over ten years (U.S. Department of Treasury, 2009).

The fourth provision would treat excess income from intangibles as Subpart F income and assigns them to a separate foreign tax credit basket. This provision is projected to raise $1.6 billion in FY2013, and $15.5 billion over ten years (U.S. Department of Treasury, 2010) and was only in the FY2011 budget proposals. It may have been a substitute for "check-the-box" revisions.

The proposals also included a provision that would disallow foreign tax credits when the associated income is not received, as can occur with an arrangement termed a "reverse hybrids." This provision was adopted in 2010 (P.L.111-226). In addition to the provisions described here, there are several more narrowly focused provisions with a smaller revenue effect.

TWO ALTERNATIVES

To analyze whether the President's proposals are leaning in the right direct, this study analyzes the effects on welfare gain and revenue to the United States of two different approaches that represent contrasting directions. They would reduce the corporate rate from 35 percent to 25 percent and adopt a territorial system. Based on an estimate of corporate revenues of $350 billion in FY2013 (Congressional Budget Office, 2010) the rate reduction should reduce corporate revenues by 10/35, or $100 billion in that year.

As an alternative, the effect of a system which eliminates deferral and imposes per country foreign tax credit limits, is evaluated. According to information supplied by the office of Senator Ron Wyden, the Joint Committee on Taxation has estimated this change would raise $66 billion in FY2013. This change moves the tax system to a worldwide system, with the foreign tax credit limited in each county.

Optimal tax treatment of inbound investment, which maximizes national welfare, depends on the elasticity of capital inflow. Assuming there is no home country tax, the optimal tax rate is 1/(1+e) where e is the elasticity of capital flow with respect to the net of tax rate, 1-t, where t is the tax rate (Gravelle, 2009a). Optimal tax treatment for outbound investment, assuming no response from other countries, actually goes beyond what the worldwide system assesses as the second alternative and would allow a deduction for foreign taxes paid (Gravelle, 2009a). In this analysis, however, the options are restricted to those that have been proposed recently. (A proposal for a deduction was made in the early 1970s by Representative Burke and Senator Hartke). President Obama's proposals move in the direction of the second option, a worldwide tax.

NATIONAL WELFARE GAINS

To calculate the welfare gains from the two options the following assumptions are made. First, the effective tax rate on domestic capital is 25 percent, and the tax rate of foreign income of U.S. multinationals is 16 percent, with 4 percent of that amount a residual tax (GAO, 2008). The elasticity of capital inflows with respect to the net of tax return is assumed to be 3, based on a survey of empirical evidence (Gravelle, 2010). A standard assumption that 25 percent of income is capital income and a Cobb Douglas production function is used. Corporate capital is estimated to be half the U.S. capital stock and 2/3 of it is equity (Gravelle 1994, p. 293). Based on data from the Bureau of Economic Analysis on corporate profits, inbound capital is 4.4 percent of the capital stock (Bureau of Economic Analysis). Based on that data and supplementary data from the international accounts on profits retained abroad, outbound capital is 16 percent of the capital stock.

Consider the first option for lowering the corporate tax rate to 25 percent and instituting a territorial tax system. This option affects both inbound and outbound capital. For inbound capital, the tax rate in the U.S. falls (based on the fall in the statutory rate) from 25 percent to 18 percent. This amount is a 9.3 percent increase in the net of tax rate, (.07/(1-0.25)). The percentage change in the capital stock is 9.3 percent times the elasticity of 3,

times the initial capital stock share of 4.4 percent, or 1.23 percent. Based on a capital income share of 25 percent, the percentage change in output is 0.31 percent, which is about one tenth of a typical year's growth. The pretax return to capital falls by 0.9 percent (the labor share times the capital stock).

The output gain is relatively small; moreover, it accrues to foreign investors. Converting all the numbers to shares of output (so each number is multiplied by 0.25), the U.S. gains in the fall of the pre-tax return paid on the original capital stock (0.009 times 0.25 times 0.044). The U.S. gains taxes on the income from additional inbound investment but loses revenue from lower tax rates on additional income. Its old revenue is the original tax rate of 0.25 times the capital income associated with inbound investment (0.25 times 0.44). Its new revenue is on the new share of the capital stock, 5.63 percent, and is the tax rate of 0.18 times 0.25 times 0.0563 times 0.991. The last number reflects the smaller rate of return before tax. Adding these numbers result in a reduction in U.S. welfare equal to 0.01 percent of output.

If the rate change were not accompanied by change in the international tax system, outbound capital would contract and the capital stock would rise just as in the case of inbound capital which, because it is larger, would lead to a 4.48 percent increase in the capital stock and a 1.1 percent change in output. Because this capital income is owned by U.S. firms, there are no gains due to changes in income. However, the U.S. collects the tax formerly paid to foreign countries (the aggregate tax rate of 16 percent minus the 4 percent residual tax) leading to a gain of 0.13 percent in output (the 0.12 tax differences times 0.25 times .0448).

Moving at the same time to a territorial tax, however, undermines this gain. While the return in the United States rises by 9.3 percent, the return abroad also rises because there is no longer a residual U.S. tax collected. This increase is 4.76 percent (0.04/(1-0.16). Thus the net gain in the United States increases by the difference, 4.57 percent. Multiplying by the elasticity and the share of the capital stock, the percentage increase in the capital stock is 2.2 percent and the percentage change in output is 0.55 percent. As before, however, the U.S. gain is the tax paid to foreigners (0.12) times the change in the capital stock (0.022) times the capital income share, for a gain of 0.07 percent of output.

The net overall gain for both inbound and outbound capital is, therefore, 0.06 percent of output. Note that the shift to a territorial system without the rate reduction produces a loss in welfare of 0.12 times 0.25 times .0479, or 0.14 percent of output.

Consider the alternative of moving to a worldwide tax system with a foreign tax credit limit. The tax on income abroad would rise from 16 percent to 25 percent, which would cause the return abroad to fall relative to the return in the U.S. by 10.7 percent ((0.25-0.16)/(1-0.16)). Based on the share of capital and the elasticity the capital stock would rise by 5.1 percent (3 times 0.107 times 0.16), and output would rise by 1.28 percent. The gain to the U.S. as a whole (since the income belongs to U.S. firms regardless of where they are located) would be the collection of U.S. rather than foreign taxes on the shift in income, which is 0.15 percent of output (0.12 times 0.25 times 0.051).

WHAT DOES THIS ANALYSIS SUGGEST?

Given both the need for revenue and the estimated welfare gains, the second alternative appears superior. Both alternatives have welfare gains, although both are extremely modest. However, the second alternative is estimated to gain about two and a half times the gain of the first: 0.15 percent compared to 0.06 percent. Moreover, the first alternative loses $100 billion in revenue, while the second one gains $66 billion, an important feature given budgetary pressures. Therefore, it appears that the President's proposals are moving in a more optimal direction.

References

Bureau of Economic Analysis, National Income and Product, Corporate Profits. http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=239&ViewSeries=NO&Java=no&Request3Place=N&3Place=N&FromView=YES&Freq=Year&FirstYear=2004&LastYear=2009&3Place=N&Update=Update&JavaBox=nohttp://www.bea.gov/international/index.htm. International Accounts, http://www.bea.gov/international/index.htm.

Congressional Budget Office. Economic and Budget Outlook, Washington, DC, 2010.

Gravelle, Jane G.
Economic Effects of Taxing Capital Income. Cam bridge: MIT Press, 1994.
International Corporate Income Tax Reform: Issues and Proposals," *Florida Tax Review* 9 (No. 5, 2009a): 471-495.
Tax Havens: International Tax Avoidance and Evasion. *National Tax Journal* 62 (December, 2009): 736-740.
Gravelle, Jennifer C. Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis. Congressional Budget Office. Washington, D.C., Congressional Budget Office, 2010. Working paper 2010-03.
National Commission on Fiscal Responsibility and Reform. The Moment of Truth. Washington, D.C., The White House, December 2010.
U.S. Department of Treasury.
General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (Green Book), Washington, DC, 2009.
General Explanations of the Administrations Fiscal Year 2011 Revenue Proposals (Green Book), Washington, DC, February 2010.
U.S. Government Accountability Office. U.S. Multinational Corporations: Effective Tax Rates are Correlated with Where Income is Reported. GAO-08-950, USGAO, Washington, D.C., 2008.