International Tax Policy Forum

International Tax Seminar for Congressional Staff

James R. Hines Jr.

February 20, 2009

Contents

Introduction

- The International Tax Policy Forum is a group of U.S.-based multinational companies representing a cross-section of U.S. industry. Founded in 1992, the Forum's primary purpose is to promote research and education regarding the taxation of income from cross-border investment. As a matter of policy, the Forum does not take positions on legislative or regulatory proposals. See www.ITPF.org.
- The following remarks represent views of the speaker (James Hines), not official positions of the International Tax Policy Forum.

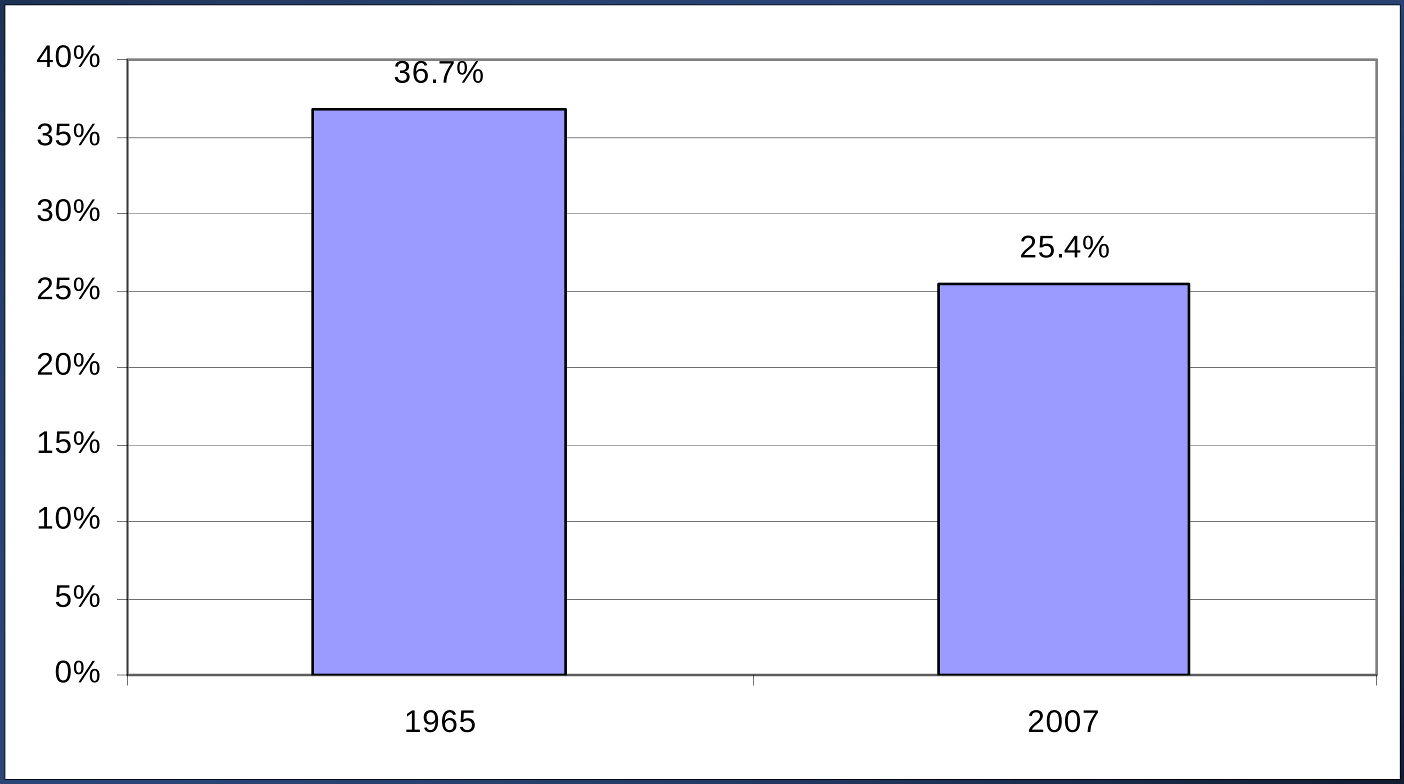
Overview

- 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.

Economic Background

Global Economic Trends

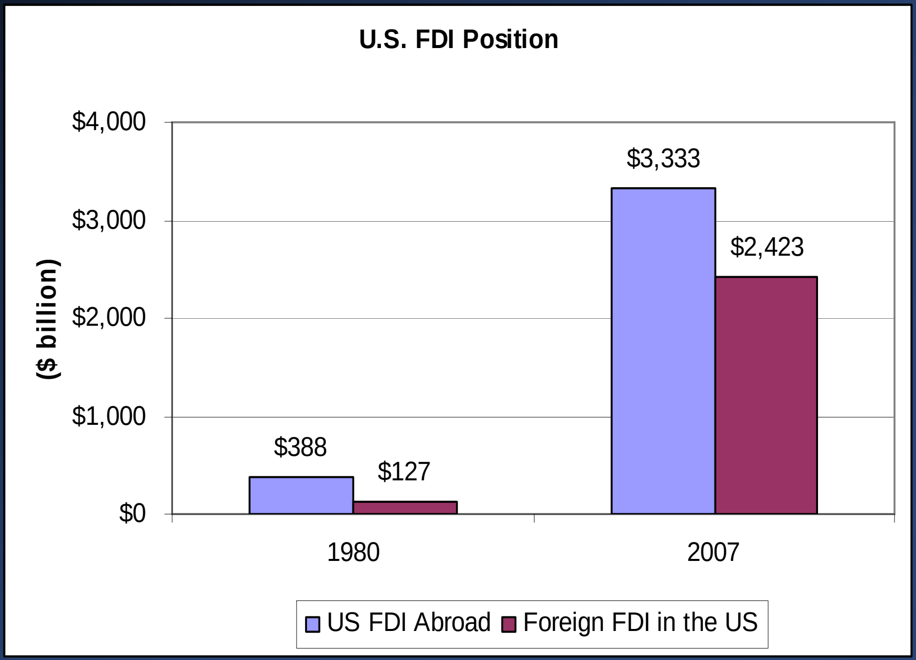
- The U.S. share of the world economy has declined over the last four decades.
- This reflects rapid economic growth elsewhere.



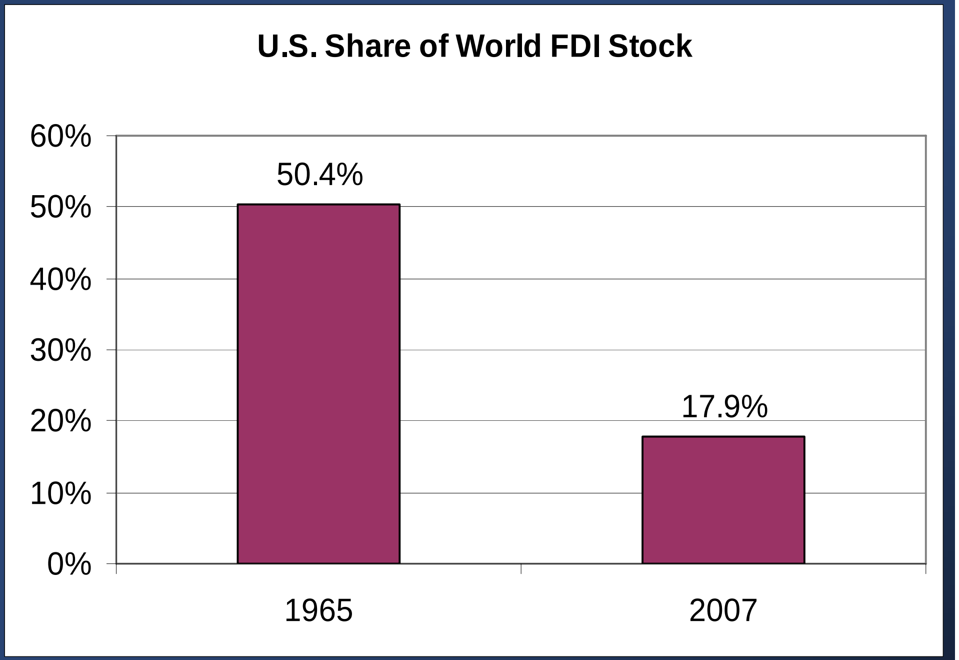
Source: World Bank, "World Development Indicators Online." (downloaded on 1/7/2009)
Defined as US GDP/World GDP, both in nominal US dollars

Global Economic Trends

US Foreign Direct Investment ("FDI") in the world economy



Source: Bureau of Economic Analysis, International Investment Position

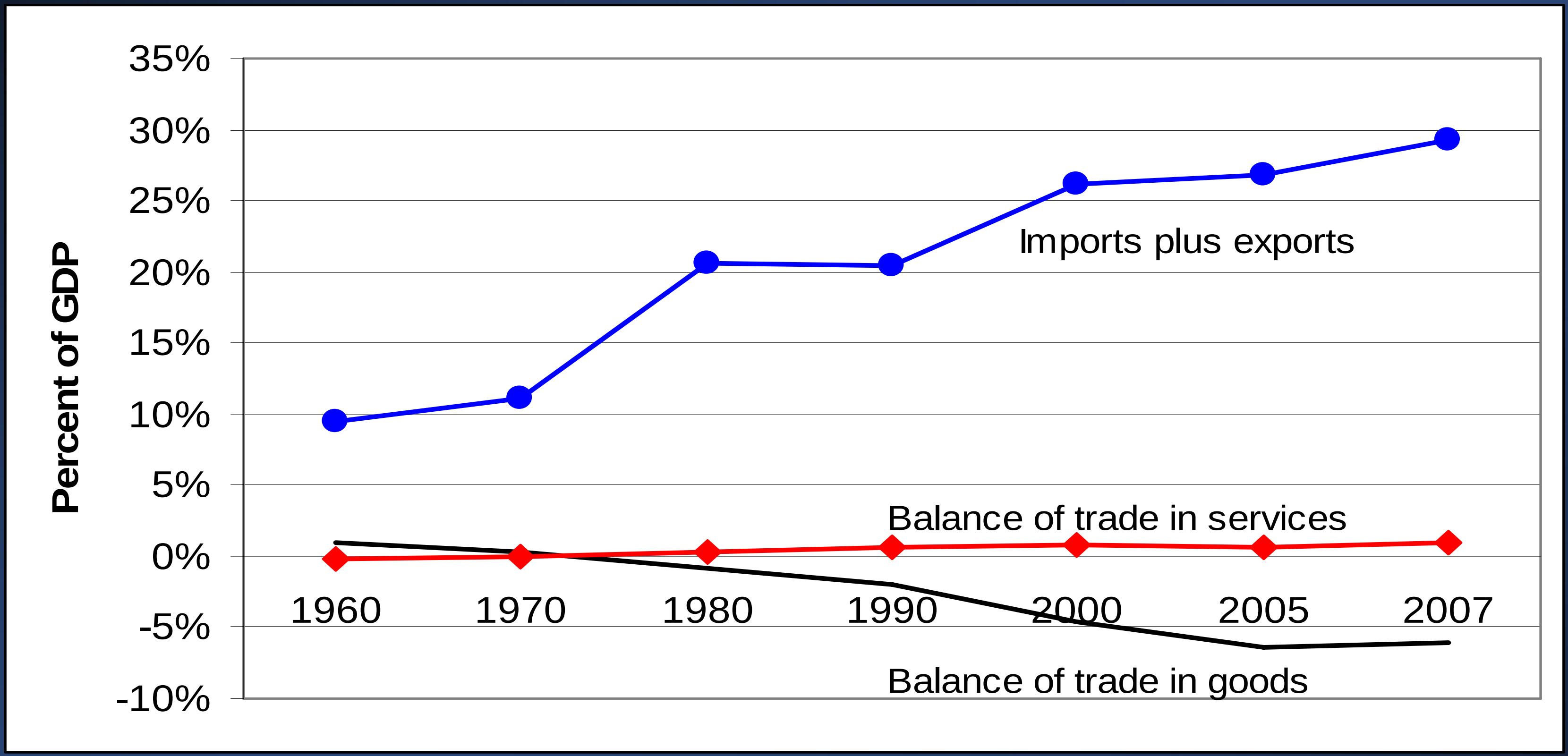


Source: UNCTAD, World Investment Report

- Cross-border FDI has expanded rapidly, both inbound and outbound
- US MNC's share of world FDI has fallen from 50% in 1965 to less than 18%
- In 1960, 18 of the world's 20 largest companies (ranked by sales) were US headquartered. Today just 8 are US based.

Global Economic Trends

US international trade



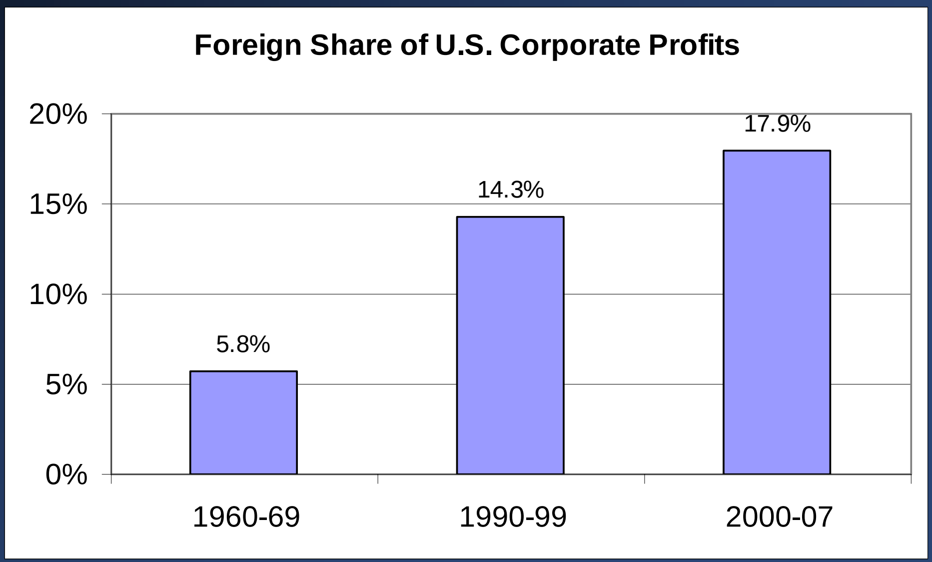
Source: Bureau of Economic Analysis, NIPA Table 1.1.5

- US economy has become more open: imports + exports = 29.2% of GDP
- This is a very low openness number, by world standards
- US now runs a large trade deficit in goods (6.1% of GDP) and a small surplus in services (0.9% of GDP)

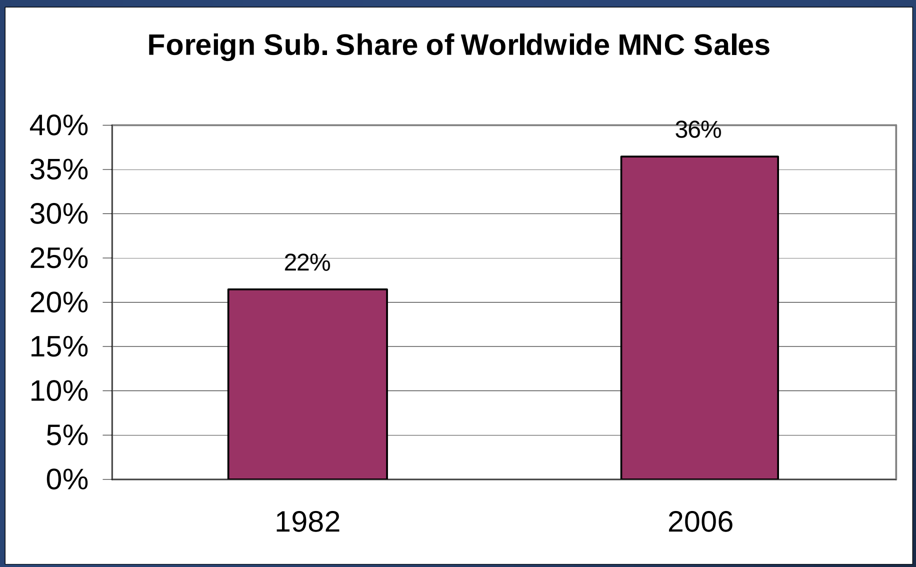
Global Economic Trends

- **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
- Technological change has made it easier to manage global enterprises (e.g., communications, computer processing)
- Creation 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 1/7/09)



Source: Bureau of Economic Analysis, U.S. Multinational Companies," *Survey of Current Business*, Nov 2008 and June 1994.

- Share of US corporate profits earned abroad has increased to nearly 18%
- Share of US MNC worldwide sales through foreign affiliates has increased to 36% in 2006 from 22% in 1982

US Foreign Direct Investment

Location

- **U.S. FDI primarily is located in developed countries[1]**
  - In 2006, 70% of foreign affiliate assets, 61% of sales, and 54% of employment were in developed countries (Canada, the EU and Japan)
- **U.S. FDI overwhelmingly supplies foreign, not US markets[2]**
  - In 2006, just 10.5% of sales of U.S.-controlled foreign corporations were made back to US (8.9% if Canada is excluded)
- **FDI mostly represents acquisitions of existing companies[3]**
  - For example, in 2007 92% of new foreign investment in the United States was acquisitions of existing companies; the numbers are similar for other years

[1] Source: Bureau of Economic Analysis, "U.S. Multinational Companies, Operations in 2006" *Survey of Current Business*, Nov. 2008, Table 17.2
[2] Source: Bureau of Economic Analysis, "U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and Their Foreign Affiliates, Preliminary 2006 Estimates" Table III.F.1.
[3] Source: Bureau of Economic Analysis, "Foreign Direct Investment in the United States: New Investment in 2007" *Survey of Current Business*, June 2008, 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.

US Plant Wages: Domestic Companies Compared to MNCs

Worker type	Plant size	
	Small	Large
Production workers	-15.2%	-9.5%
Non-production workers	-6.9%	-5.0%

Source: Mark Doms and Brad Jensen, 1996

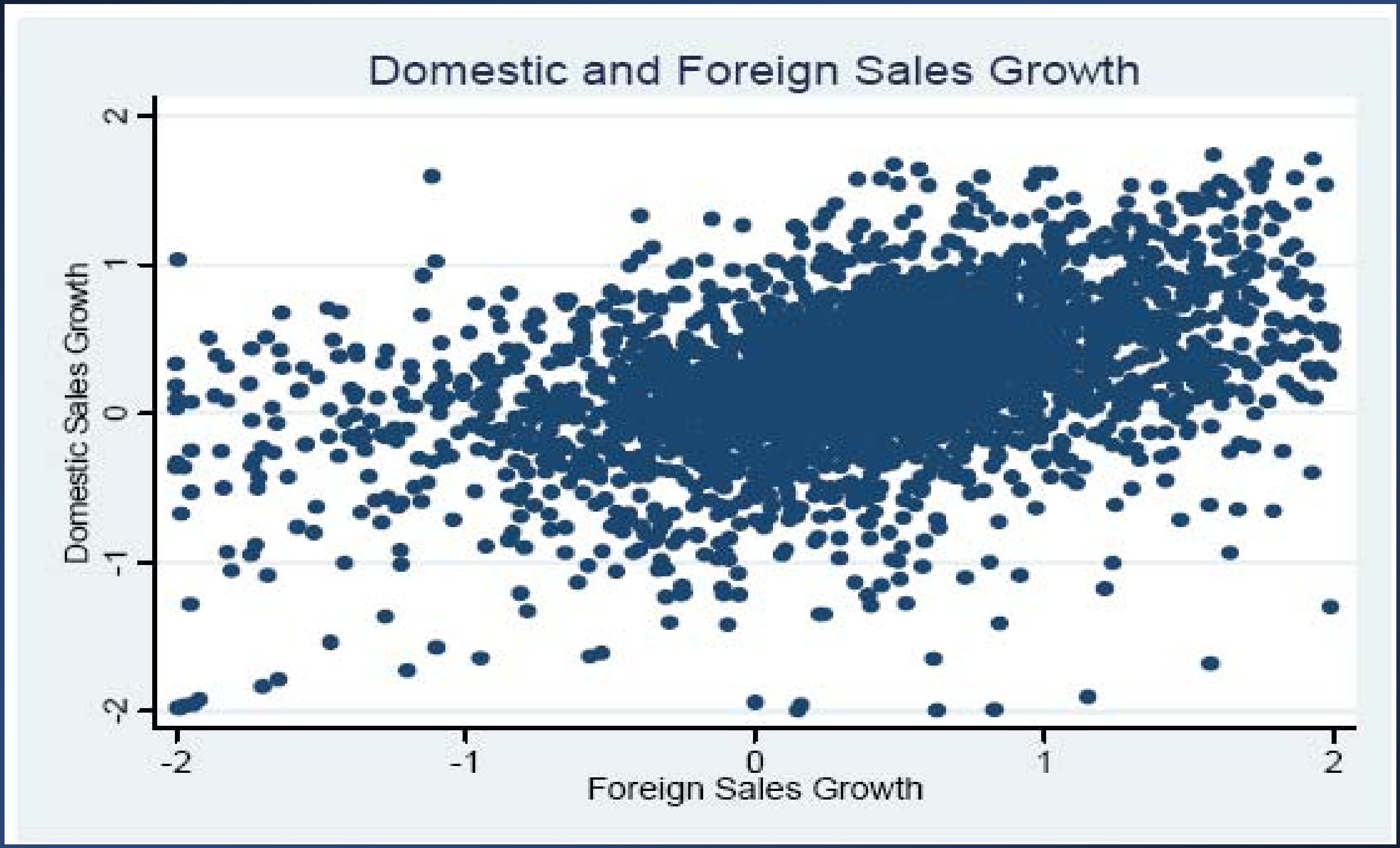
US Foreign Direct Investment

US employment and investment

- 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 for US MNCs:
    - →10% greater foreign investment is associated with 2.6% greater domestic investment, and
    - →10% additional foreign employee compensation is associated with 3.7% greater domestic employee compensation.
    - →"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."

US Foreign Direct Investment

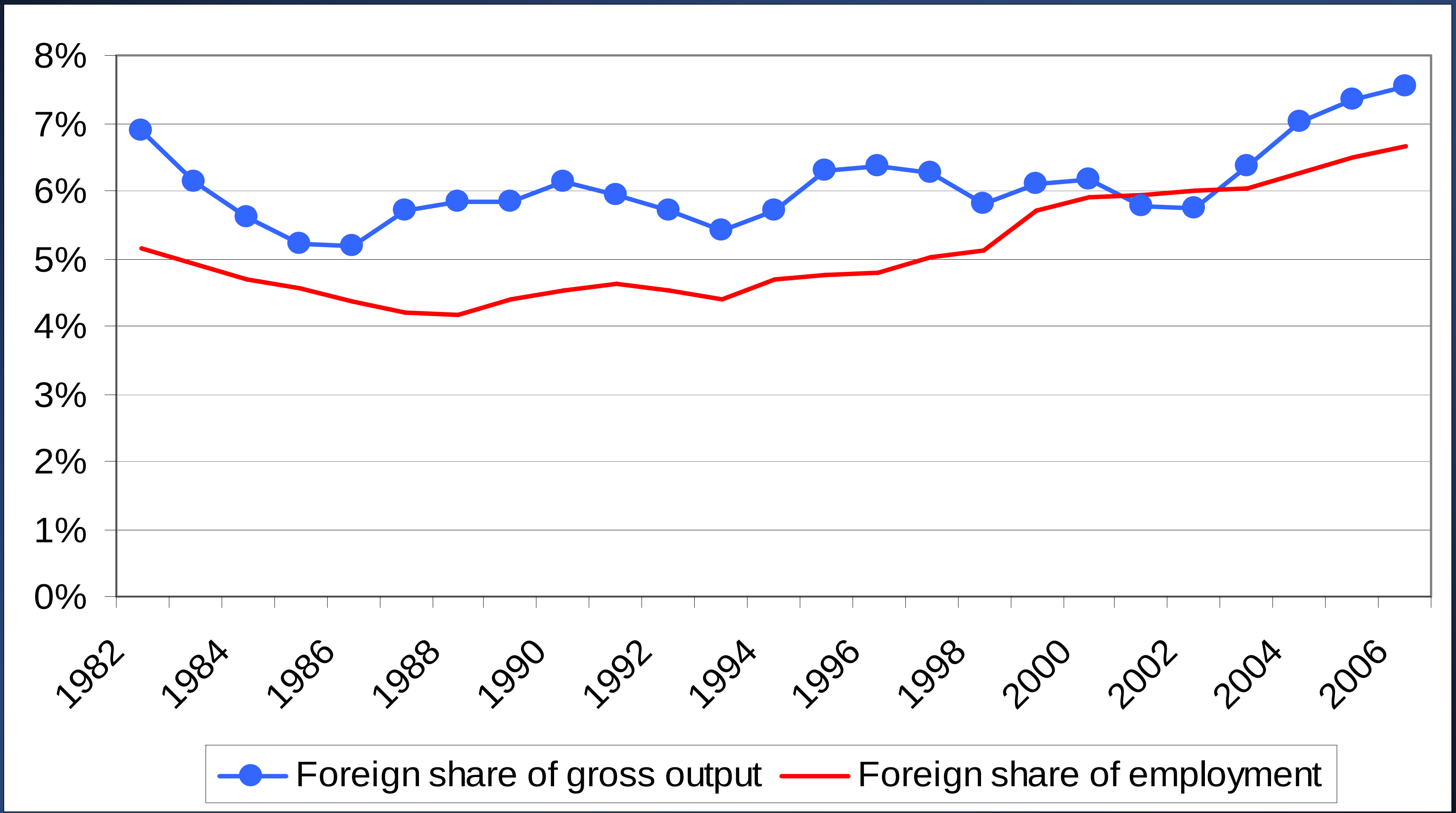
Changes in Foreign Sales and Changes in Domestic Sales by U.S. MNCs



Source: Desai, Foley and Hines, "Domestic effects of the foreign activities of U.S. Multinationals," *American Economic Journal: Economic Policy*, February 2009.

US Foreign Direct Investment

Foreign share of US MNC operations as a percent of U.S. Totals



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

US Foreign Direct Investment

Financing

- 2002 IRS data shows that foreign subs of US parents distributed $135 billion or 46% of net foreign earnings and profits[1]
- 73% of U.S.-controlled foreign corporation financing (including retained earnings) is from foreign sources[2]

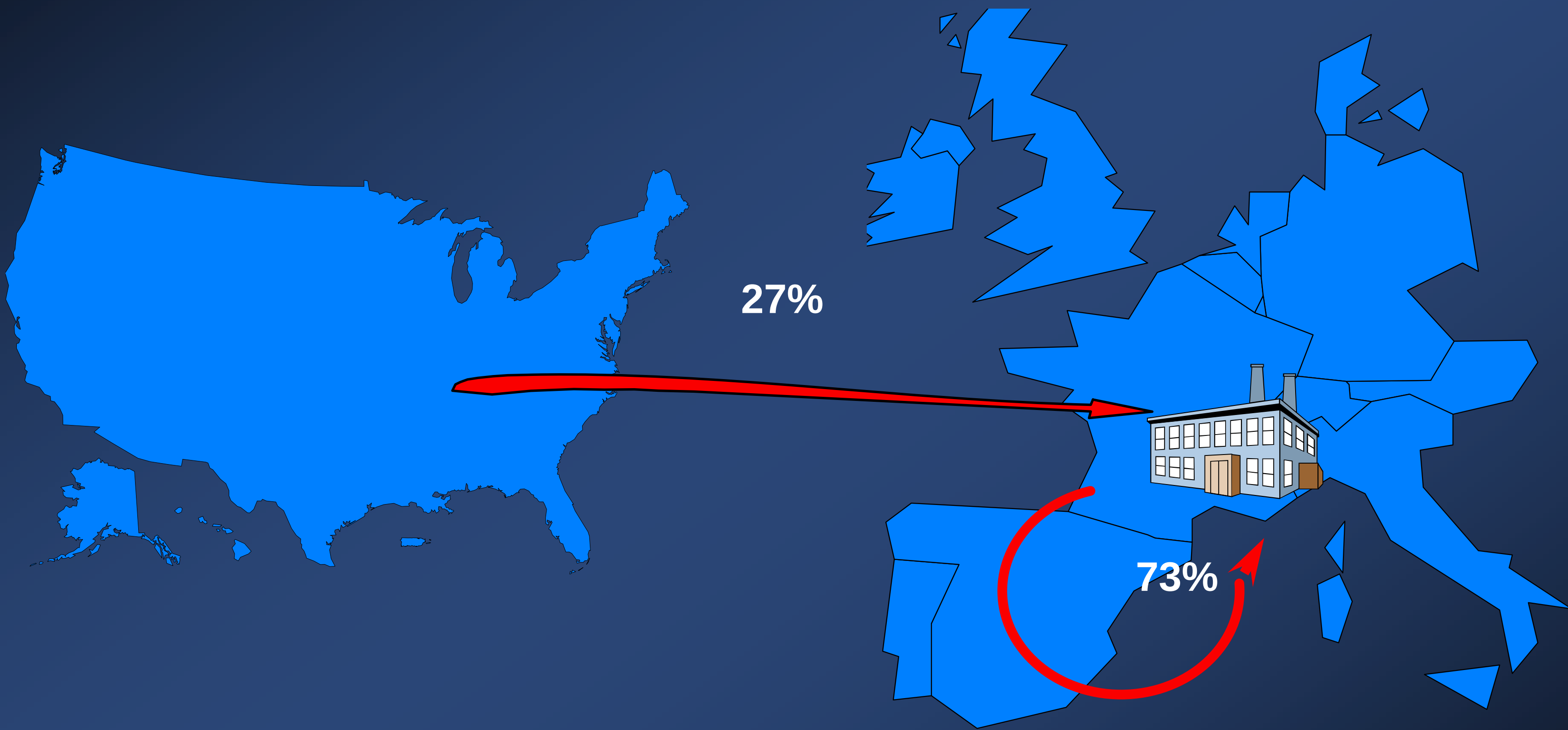
Sources:

[1] Internal Revenue Service, "Controlled Foreign Corporations, 2004" *SOI Bulletin*, Summer 2008.

[2] Bureau of Economic Analysis, "U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and Their Foreign Affiliates, Preliminary 2006 Estimates." Tables III.C.1 and III.B.1-2.

US Foreign Direct Investment

Financing of CFCs



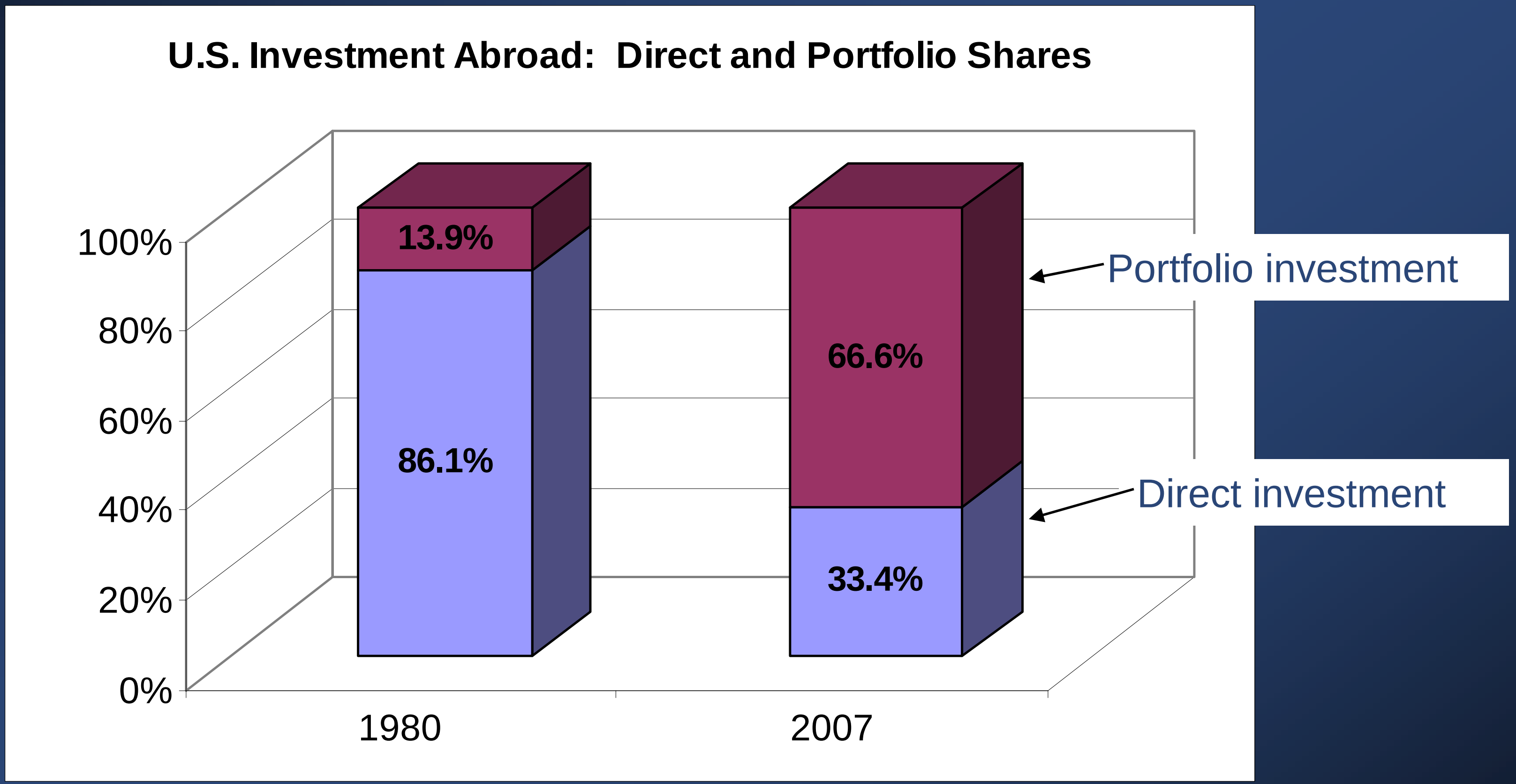
In 2006, 73% of the financing of US-controlled foreign corporations comes from foreign sources -- not US parents

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 89% 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

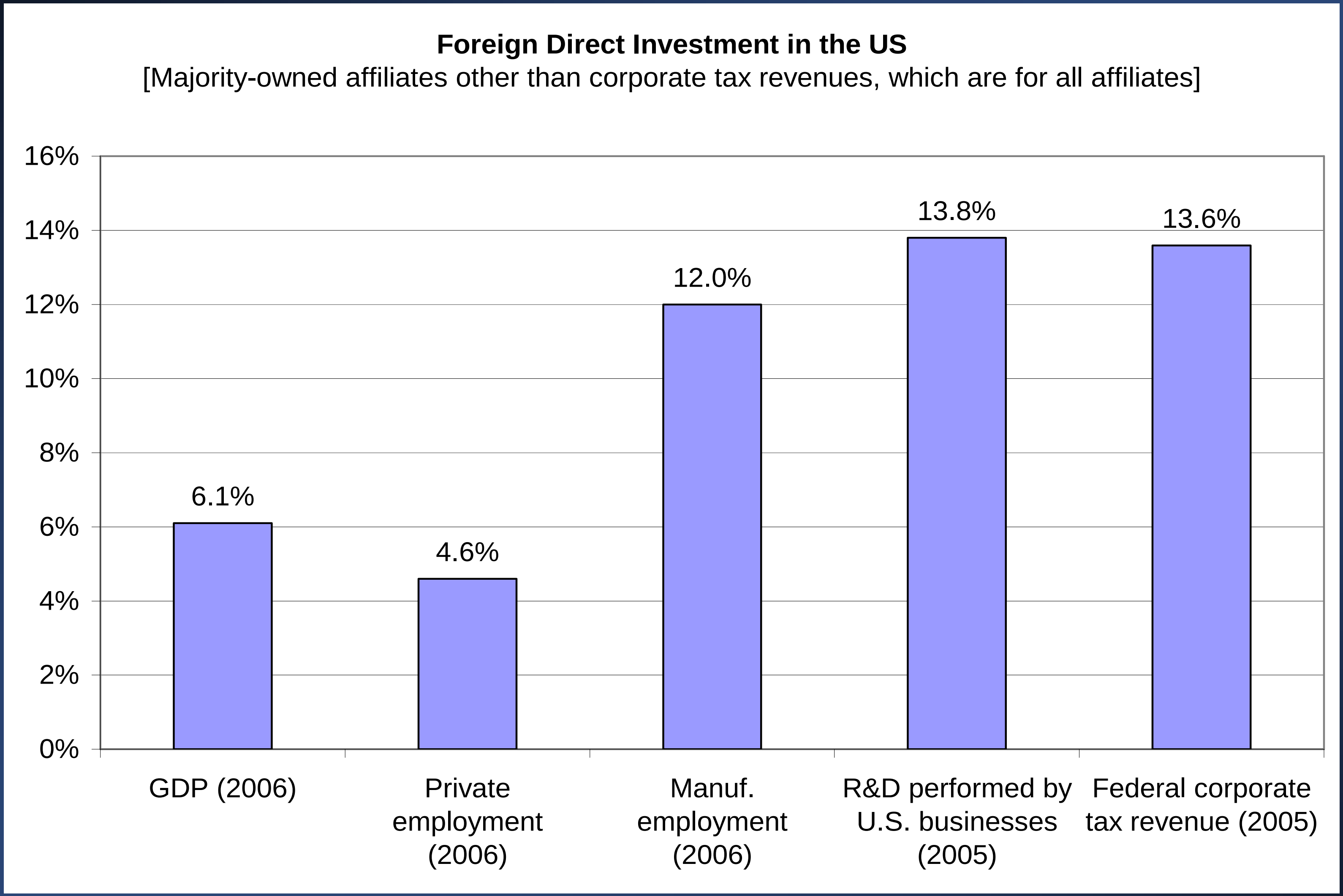
Foreign Portfolio Investment



In 2007, 67 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.)

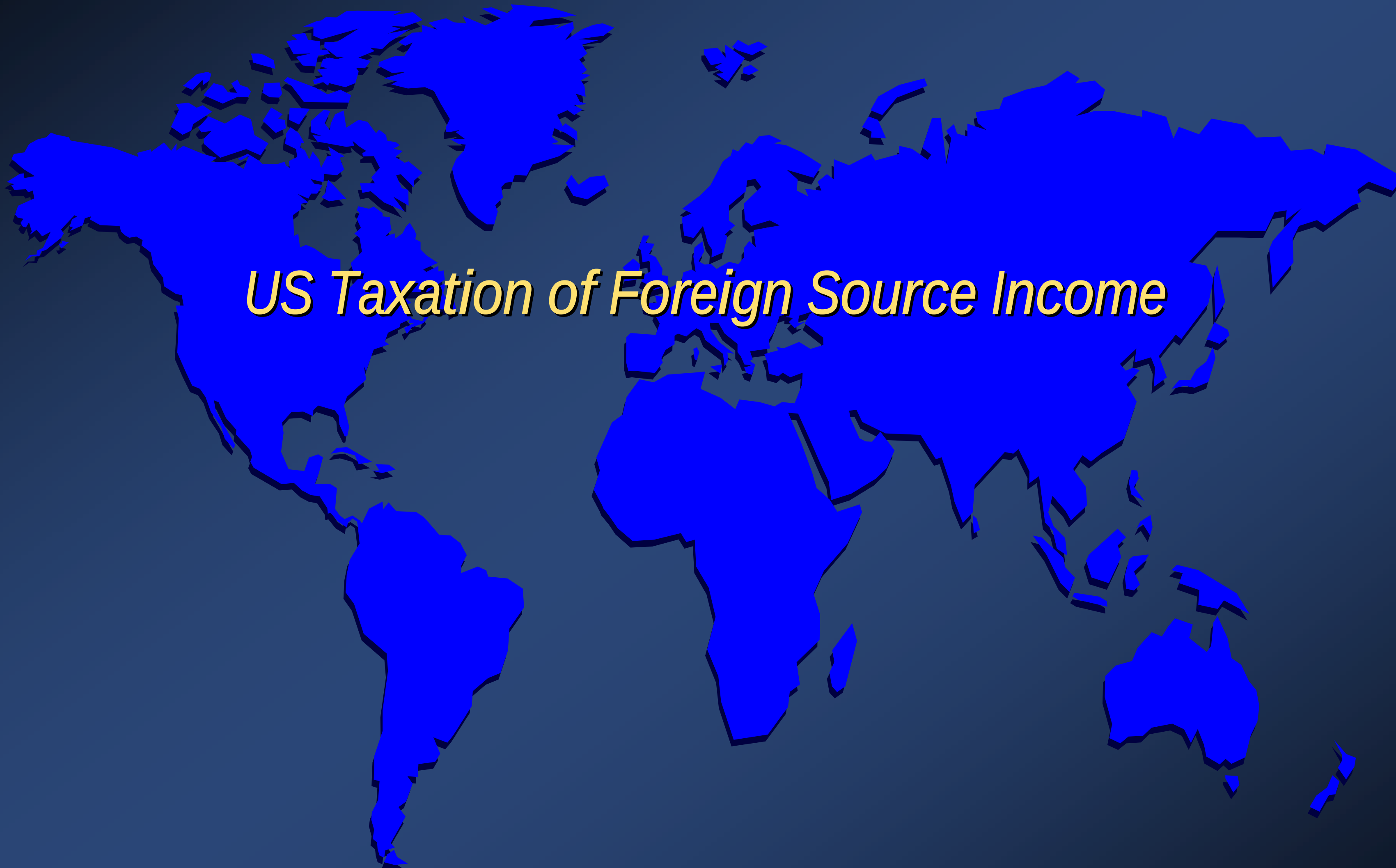
Source: Bureau of Economic Analysis, "International Investment Position" Table 2

Foreign Direct Investment in the US



Sources: Bureau of Economic Analysis, "U.S. Affiliates of Foreign Companies: Operations in 2006." *Survey of Current Business*, August 2008 and SOI Bulletin, "Foreign-Controlled Domestic Corporations, 2005" Summer 2008.

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

Type of income	Source
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 FTC Limit and 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 or lesser of overall and per-country limit; and separate limitations by type of income (e.g., passive).
- 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 12/31/2010, 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

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

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%	$350
Net income	$650
USCo	
US source income	$1,000
Dividend from ForCo	$650
Foreign tax gross up on dividend	$350
Taxable income	$2,000
US tax before FTC @ 35%	$700
FTC limit*	$280
FTC	$280
US income tax after FTC	$420
Worldwide operations of USCo	
Income	$2,000
Income tax	$770

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

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

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 in foreign corporations. Hence US taxes 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 2009)
    - →CFC look-through rule (expires after 2009)

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, 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[1]

- 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

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

Comparison of Foreign Tax Credit Rules

Canada, France, Germany, Japan, the Netherlands and UK[1]

- Canada, France, Germany and Netherlands have dividend exemption ("territorial") systems
- Japan, UK, and US have worldwide tax systems
  - 2009 budget proposals in both UK and Japan would adopt dividend exemption system
- Per country, per item, and overall foreign tax credit limitation systems are all in use for non-exempt dividends
- Detailed expense allocation rules generally do not exist outside the US
- Credit carryforward and carryback periods vary

[1] Based on National Foreign Trade Council, Inc., *International Tax Policy for the 21st Century,* Volume 1 274-75 (2001).

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.

More Policy

- 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.